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The Ohio State University, Ph.D., 1970
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TAXATION OF PENSION PLANS FOR SELF-EMPLOYED
INDIVIDUALS WITH RECOMMENDED REFORMS

DISSERTATION

Presented in Partial Fulfillment of the Requirements for
the Degree Doctor of Philosophy in the Graduate
School of The Ohio State University

By
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The Ohio State University
1970

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111
TABLE OF CONTENTS

ACKNOWLEDGMENTS ........................................ ii
VITA ..................................................... iii
LIST OF TABLES ........................................ vi

Chapter

I. INTRODUCTION; PREVIEW OF THE STUDY ........ 1

  Background of Problem
    Comparison of Tax Treatment of Retirement
    Funds of the Employed and the Self-employed
    Significance of the Alleged Inequity
    Example Indicating Impact of Differing Tax
    Treatment of Retirement Funds

  Statement of the Problem and Methodology
  Importance of Research
  Objectives and Scope of the Study
  Organization of the Study

II. EQUITY IN TAXATION AND OTHER CONSIDERATIONS .. 35

  Inequity in the Tax Law
  Equity in the Tax Law
  Reasonable Classification
  Pension Contributions as Income
  Equity in Taxation of Pension Fund Contributions

  Considerations Important in Proposal to Change Tax Law
  Neutrality
  Administrative Factors
  Social, Economic and Political Considerations
  Conflicts in Considerations

Summary

iv
Chapter

III. HISTORY OF TAX LEGISLATION REGARDING RETIREMENT FUNDS

Efforts to Change Taxation of Retirement Funds and Results Obtained
- Taxation of Retirement Funds
- Efforts by Self-Employed to Gain Tax Benefits by Incorporation
- Other Changes in the Tax Law
- Efforts by Self-Employed to Gain Tax Benefits by Changing Tax Law
- Arguments Supporting the Legislation
- Arguments Opposing the Legislation
- Relative Weights and Conflicts Among Considerations
- Provisions of the Act
- Developments Since Passage

Practices in Other Countries
- Great Britain
- Canada
- New Zealand
- Australia
- Summary

Conclusions

IV. CONCLUSIONS AND RECOMMENDATIONS

Proposal for Change in Tax Law
- Brief Description of Proposed Changes
- Coverage and Agreement
- Contributions
- Tax Benefit Limits
- Recognition for Past Services
- Immediate Vesting
- Earnings of the Fund
- Distributions
- Withdrawals
- Retirement Age
- Treatment of Tax Benefit on Tax Return
- Changes in Present Tax Law

Effect of Proposal
- Equity
- Neutrality
- Administrative Factors
- Social Effects
- Flexibility
- Revenue Loss

Summary

BIBLIOGRAPHY
# LIST OF TABLES

<table>
<thead>
<tr>
<th>Table</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Comparison of Retirement Fund Tax Benefits</td>
<td>24</td>
</tr>
<tr>
<td>for Selected Individuals</td>
<td></td>
</tr>
<tr>
<td>2. Comparison of Retirement Fund Tax Benefits</td>
<td>143</td>
</tr>
<tr>
<td>for Corporate Employees and Others</td>
<td></td>
</tr>
</tbody>
</table>
CHAPTER I

INTRODUCTION: PREVIEW OF THE STUDY

The federal income tax law is a highly complex piece of legislation. This results from the fact that income is used as the basis for the tax. The law starts with the premise that all income shall be taxed and then sets out exceptions from this rule. As exceptions are made, inequities are created—necessitating more exceptions. This study will deal with one small facet of the federal tax law—the taxation of retirement funds of self-employed individuals.

Background of Problem

Self-employed individuals have been the alleged victims of inequities under the federal income tax laws. The inequity charges arose because of the provision that certain tax benefits could be obtained under a qualified pension plan—i.e., a pension plan which met the requirements set out in the Internal Revenue Code.\(^1\) The tax advantages of a qualified pension plan are as follows:

\(^1\)Internal Revenue Code of 1954, Section 401(a).
1. Employer contributions on behalf of employees can be deducted immediately from taxable income. These amounts do not become income to the employee and he therefore pays no income tax on the amounts at the time the contribution is made.

2. Contributions to the pension fund are allowed to accumulate tax free, i.e., when amounts are paid into the pension fund, they are invested and earnings on the investments are not taxable to the plan.

3. Employee contributions are permitted in some plans. Even though the employee contributes after-tax funds, these funds are permitted to accumulate tax free in the fund. These funds can build up at a faster rate than they could if the employee invested them himself.²

4. Payments on retirement or death if contributed to the plan prior to 1970 (to the extent they exceed the employees own after-tax contributions) may be arranged so that they are taxed at the favorable capital gains rates.³

As mentioned above, a qualified pension plan must meet certain requirements set out in the Internal Revenue Code.⁴ One such requirement is that the plan be set up


³The Tax Reform Act of 1969 (Public Law 91-172, Section 515) has limited capital gains treatment to employer contributions prior to 1970 and all appreciation of and earnings on investments of the fund. Employer contributions to the plan after December 31, 1969 will be taxed as ordinary income under a special averaging rule.

⁴Internal Revenue Code of 1954, Section 401(a).
for the "exclusive benefit of employees." In other words, an employer-employee relationship must exist. This meant that a self-employed individual or partner was able to set up a qualified plan for his employees; however, he was not able to participate in the plan.

This fact that a self-employed individual was not able to participate in a qualified pension plan became the basis for the charges of inequity in the tax law. The inequity charges arose since the self-employed individual could not obtain the tax benefits of the qualified pension plan.

Legislation was passed in 1962 which gave the self-employed individuals tax benefits on retirement funds. Benefits were extended more recently with the enactment of additional legislation which became effective for tax years

5Tbid.


beginning after December 31, 1967. Much criticism was directed at the tax law prior to enactment of this legislation and criticism still exists as many believe the self-employed individual is receiving unfair treatment in the matter of taxation of retirement funds.

As stated previously, differences exist in the tax treatment of retirement funds of employed individuals and self-employed individuals. A comparison of the tax treatment of these groups and an example indicating the impact of the tax effect will show the significance of the problem.


Comparison of Tax Treatment of Retirement Funds of the Employed and the Self-Employed

Before an attempt is made to determine whether or not the charges of inequity are justified, a description of the differences in tax treatment of retirement funds and their tax impact is presented in order to determine the extent of these differences. The major differences lie in four areas: contribution limits, deduction limits, coverage, and vesting.¹¹

Contribution limits.—Under an employee pension plan, no maximum dollar limitation is placed on amounts contributed to the plan by an employer if they are reasonable additional compensation. The same holds true for an employee of a tax-exempt institution. Under a self-employed individual's plan, he can contribute on

¹⁰For the purposes of this study, the following apply: (1) A self-employed individual is an owner-employee. Under the law, self-employed individuals who own 10 per cent or less of their business are not considered owner-employees; therefore, some provisions of the law are not as restrictive for them. (2) Since Section 403(b) refers to the "Taxability of Beneficiary under Annuity Purchased by Section 501(c)(3) Organization—", only those tax-exempt institutions which qualify under Section 501(c)(3) of the Internal Revenue Code are referred to in this discussion.

his own behalf up to 10 per cent of earned income\(^\text{12}\) or
$2,500, whichever is smaller.\(^\text{13}\) The contribution on
behalf of an owner-employee has to bear the same
relationship to his earned income as the contribution on
behalf of the employee bears to the employee's compensa-
tion. This is similar to the antidiscriminatory provision
in employee plans. There is no antidiscrimination clause
in the tax law for tax-exempt organizations.\(^\text{14}\)

Any excess contributions must be returned to the
owner-employee within six months and are taxable. Failure
to return the amounts results in temporary disqualification
of the plan for the owner-employee. If an excess contri-
bution is wilfully made, more severe penalties apply. The
owner-employee loses his deduction and his retirement fund
will lose its tax exemption for five years.\(^\text{15}\) There are

\(^{12}\) Earned income is defined as professional fees and
other compensation received for personal services. See
Tax Savings Plans for Self-Employed (Chicago: Commerce

\(^{13}\) Prior to the 1966 amendments which became effective
after December 31, 1967, a self-employed person operating
a business in which both capital and personal services were
material income-producing factors could use only 30 per-
cent of his net profits from that business as his earned
income in computing his retirement contribution. See

\(^{14}\) Internal Revenue Code of 1954, Section 403(b).

\(^{15}\) Tax Savings Plans for Self-Employed, op. cit.,
p. 13.
no comparable provisions for corporate plans\textsuperscript{16} or for
tax-sheltered annuities.\vspace{1em}

The contribution limit also restricts the type of
pension plan that may be used by a self-employed individual.
Because of the limit imposed, the only practical type of
plan is what is known as the money purchase plan that
requires a defined or fixed contribution. Since a
corporation has no maximum limit on contributions, a
corporate plan may be a defined benefit plan or a defined
contribution plan.\textsuperscript{17}\vspace{1em}

\textbf{Deduction limits.}--One area in which criticism was
the greatest dealt with deduction limits. Corporate
employee plans have no maximum dollar limitation. If a
corporate employer's contributions are reasonable
additional compensation, he can deduct either:\vspace{1em}

1. 5 per cent of the pay of covered employees
   plus any sum necessary to pay past and
current service actuarially determined, or\vspace{1em}

2. a normal cost of the plan plus 10 per cent
   of past service costs. Past service costs
   are spread over a 10 year period.\textsuperscript{18}\vspace{1em}

Prior to the changes in the tax law which became effective
in 1968, a self-employed individual could deduct only \textit{half}\vspace{1em}

\begin{itemize}
\item\textsuperscript{16}\textit{Tax Help for the Self-Employed}, \textit{op. cit.}, p. 19.
\item\textsuperscript{17}For further discussion, see \textit{Infra}, p. 112.
\item\textsuperscript{18}\textit{Internal Revenue Code of 1954}, Section 404(a)(1).\vspace{1em}
\end{itemize}
of the contributions made on his own behalf. The maximum
deduction was $1,250. The recent change in the tax law
permits a full deduction for contributions up to $2,500
instead of the $1,250 formerly available. The provision
restricting the contribution for self-employed individuals
to the lesser of 10 per cent of earned income or $2,500
was retained, however. The self-employed individual can
deduct from taxable income all contributions for his
employees if they are within the same limits as apply to
corporate plans. The self-employed individual can not
carry over a deduction to the next year, and no recogni-
tion is given to past services. The deduction limit for
an employee of a tax-exempt organization is 20 per cent
of his compensation.\(^{19}\)

Coverage.--Another area where differences exist is
coverage. To qualify for a tax deferment on the total
employer's contribution for the benefit of the employees,
a corporate pension plan must cover:

1. 70 per cent or more of all employees; or

2. 80 per cent or more of all eligible
employees provided 70 per cent of all
employees are eligible; or

3. a special classification which does not
discriminate in favor of officers and
other highly paid personnel.\(^{20}\)

\(^{19}\) Internal Revenue Code of 1954, Section 403(b)(2).

\(^{20}\) Ibid., Section 403(a)(3).
The last provision allows a corporation a certain degree of flexibility in limiting participation in a plan. Employee eligibility requirements for limiting participation may be classified into two groups. First, there are those which defer an employee's participation until stipulated conditions are met. Examples of this type are:

1. Years of service. Only persons who have been employed by the company for a certain period of time (usually one to three years) are eligible to participate in the plan.

2. Minimum age. An employee must have attained a certain age before he is eligible to participate in the plan.

3. Earnings requirement. In order to be eligible to participate in the plan, the employee must be earning in excess of some amount.

The other group of eligibility requirements are those which exclude an employee from participation on a permanent basis. Examples of this type are:

1. Maximum age. Exclude from participation employees over some age such as 55, 60 or 65.

2. Employment classification. Establish a plan only for employees in a specific plant or at a specific location.21

"In lieu of meeting the percentage requirements of Section 401(a)(3)(A) of the Code, an employer may set up a classification of employees which, if found by the Commissioner of Internal Revenue not to discriminate in
On the other hand, a pension plan of a self-employed individual must cover all his employees with three or more years of service in order to qualify for a tax deferment. A self-employed individual with all his employees having been employed by him for three or more years must cover everyone in a pension plan—100 per cent coverage, compared to 70 per cent or even less for qualified plans.\(^\text{22}\) A greater disparity occurs when one considers the tax-exempt organizations where no coverage requirement exists. These organizations may cover one employee, several employees, or as many employees as they desire.\(^\text{23}\)

**Vesting.**—The vesting of rights to the pension funds is another area in which differences occur. Under a corporate plan, a provision may be made for complete vesting, partial vesting, or no vesting until retirement favor of officers, shareholders, supervisors, or highly compensated employees, will satisfy the requirements of section 401(a)(3)(B). Under such section, plans may qualify which are limited to employees who are within a prescribed age group, have been employed in certain designated departments, or are in other classifications, provided that the effect of covering only such employees does not discriminate in favor of employees within the enumerations with respect to which discrimination is prohibited." See Schreiber, *op. cit.*, pp. 22-23, and Joseph J. Melone and Everett T. Allen, Jr., *Pension Planning*. (Homewood, Illinois: Richard D. Irwin, Inc., 1966), pp. 23-27.

\(^\text{22}\) Internal Revenue Code of 1954, Sections 401(d)(3) and 401(a)(3).

\(^\text{23}\) *Ibid.*, Section 403(b).
provided lack of vesting does not produce the prohibited discrimination. Vesting is required on termination of the plan. There has been a noticeable trend in recent years for the Internal Revenue Service to require some degree of vesting if a pension plan is to qualify for the favorable tax treatment.

No such options are available under a self-employed individual's retirement plan. His plan must provide for full and immediate vesting of benefits for all covered employees. Contributions for employees are nonforfeitable at the time they are made. In other words, the employee can not be deprived of his benefits for any reason; however,

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24 Ibid., Section 401. Also, see Schreiber, op. cit., p. 31. Under the Internal Revenue Code, the only reference to vesting occurs in connection with a termination of or a permanent discontinuance of the plan. Full vesting is then required, and a statement to that effect must be included in the plan.

No reference is made in the Code or Regulations to accelerated vesting prior to retirement. The Internal Revenue Service generally does require some degree of vesting prior to retirement in order to prevent discrimination in favor of the prohibited group. The degree of vesting in a plan varies. A judgment determination is made by the Internal Revenue Service's pension reviewer regarding what he believes is necessary to prevent discrimination. Recently, greater and faster vesting has been required by the Internal Revenue Service.

25 Melone and Allen, op. cit., p. 53.


27 Ibid.
payment of benefits may be postponed until his normal retirement date, or his death if earlier.\textsuperscript{28} For a tax-exempt organization, immediate vesting with the employee must also occur.\textsuperscript{29}

Other differences.--Another area in which differences occur is the taxation of distributions. Lump-sum distributions under a qualified pension plan were, prior to the Tax Reform Act of 1969,\textsuperscript{30} taxed at the favorable capital gains rates.\textsuperscript{31} For contributions made after December 31, 1969, the capital gains treatment is withdrawn from that part of the distribution which represents employer contributions. These will be taxed as ordinary income subject to a special averaging rule; however, all appreciation of

\textsuperscript{28}Melone and Allen, op. cit., p. 318.

\textsuperscript{29}Internal Revenue Code of 1954, Section 403(b)(1)(C) states: "Amounts contributed under such annuity contracts are excluded from gross income of the employee... If...

\textsuperscript{30}U. S., Public Law, 91-172, Tax Reform Act of 1969, Section 515 amends IRC Sec. 402(a) and 72(n).

\textsuperscript{31}Internal Revenue Code of 1954, Section 402(a)(2) prior to amendment.
and earnings on investments will still be subject to the
more favorable capital gains rates. 32 Any such distribu-
tions to a self-employed individual receive a special
five-year income averaging treatment. 33

Under a qualified pension plan, the corporate
employee is entitled to a death benefit exclusion up to
a maximum of $5,000. This means that any lump sum distribu-
tion to the employee's beneficiary because of the
employee's death will have a maximum of $5,000 excluded
from taxable income. 34 No such death benefits are available
to the beneficiary of the self-employed individual. 35 This
$5,000 death benefit exclusion applies to tax-sheltered
annuity participants; however, it is not available to
employees of public school systems. It is available only
to a certain subclass of Section 501(c)(3) organizations. 36

32 "Concise Explanation of the Tax Reform Act of 1969,"
p. 32.

33 Internal Revenue Code of 1954, Section 72(a)(2).

34 Ibid., Sections 101(b)(1) and 101(b)(3).

35 Ibid., Section 101(b)(3).

36 Melone and Allen, op. cit., p. 375 stating: "The
subclass consists of those Section 501(c)(3) organizations
exempt from tax under Section 501(a) which are referred to
in Section 503(b)(1), (2) or (3); namely schools (not
publicly operated) having a student body in attendance;
churches, or convention or associations of churches; or
organizations receiving a substantial part of their support
from the general public or some governmental body."
Many qualified pension plans provide disability benefits. The benefits may qualify for a "sick pay" exclusion in which the employee may exclude from taxable income up to $100 per week.\textsuperscript{37} This "sick pay" exclusion is not available to self-employed individuals.\textsuperscript{38}

Under a qualified pension plan, any amounts distributed to a named personal beneficiary of the employee will be excluded from the employee's gross estate for federal estate tax purposes to the extent of the employer contributions.\textsuperscript{39} On the other hand, the full amount of the death benefit is considered part of the self-employed individual's gross estate for federal estate tax purposes and is fully taxable, even though paid to a named personal beneficiary.\textsuperscript{40} The favorable estate tax treatment does not apply to employees of public schools, but benefits are available to members in a specified subclass of the Section 501(c)(3) organizations.\textsuperscript{41}

Further tax benefits are available to an employee covered under a qualified pension plan. If he makes an

\textsuperscript{37}\textit{Internal Revenue Code of 1954}, Section 105(d).
\textsuperscript{38}Ibid., Section 105(g).
\textsuperscript{39}Melone and Allen, \textit{op. cit.}, p. 144.
\textsuperscript{40}\textit{Internal Revenue Code of 1954}, Section 2039(c).
\textsuperscript{41}Melone and Allen, \textit{op. cit.}, pp. 376-377.
irrevocable designation of a beneficiary to receive benefits payable at his death, the employee does not have to pay any federal gift tax.\textsuperscript{42} This gift tax exemption is not available to self-employed individuals.\textsuperscript{43} Favorable gift tax provisions do apply to the subclass mentioned above in the case of tax-sheltered annuity participants.\textsuperscript{44}

Another difference occurs in the retirement ages. The normal retirement age in most corporate plans is 65. The choice of this age is influenced by the fact that full social security benefits begin at 65 and also prohibitive costs would occur if employees were retired prior to age 65 with full benefits.\textsuperscript{45} Most plans allow an employee to retire early on a reduced pension. Typical requirements are that the employee must be at least 55 and must have completed 10 years service. Benefits payable are reduced in cases of early retirement. Many plans also allow an employee to defer his retirement after age 65, usually before age 68, however.\textsuperscript{46} The self-employed individual does not have to retire to obtain his benefits. Distributions

\textsuperscript{42}\textit{Ibid.}, p. 146. Also, \textit{Internal Revenue Code of 1954}, Section 2517.

\textsuperscript{43}\textit{Ibid.}, p. 325. Also, \textit{Internal Revenue Code of 1954}, Section 2517(b).

\textsuperscript{44}\textit{Ibid.}, p. 377.

\textsuperscript{45}\textit{Ibid.}, pp. 29-31.

\textsuperscript{46}\textit{Ibid.}
to the self-employed individual can not be made before death, disability, or age 59 ½. They must begin before age 70 ½. There are penalties imposed if distributions under the plan are made earlier than allowed. 47 No penalties exist in the case of corporate pension plans.

Other differences occur with regard to withdrawals. Corporate plans permit withdrawals of voluntary contributions if they do not affect: the member's participation, the employer's past or future contributions, or basic benefits. No interest is allowed on funds withdrawn. 48 Upon discontinuance of participation in the plan, an individual can withdraw his own contributions plus interest. 49 If a self-employed individual makes a withdrawal before age 59 ½ or disability, a 10 per cent penalty is added to the tax payable. 50 He is also disqualified from participating in a plan for a period of five years. 51


49 Ibid.

50 Ibid., p. 132. See also, Internal Revenue Code of 1954, Section 72(m)(5)(A), (B), (C), and (D).

51 Ibid., p. 132. See also, Internal Revenue Code of 1954, Section 401(d)(5)(C).
A further difference occurs in that a pension plan for a self-employed individual gives no recognition to past service. A corporate pension plan may include recognition of past services.\textsuperscript{52}

These are some of the areas where differences occur in the taxation of retirement funds of the self-employed and the employed individuals, some of which bring the inequity charges. The impact of these differences is shown by the number of people affected and the magnitude of the dollar amounts involved.

\textbf{Significance of the Alleged Inequity}

Before indicating the extent of the tax dollars involved as a result of these differences in tax treatment, significance is given to the problem by the number of persons who would be able to take advantage of the tax benefits for retirement plans. According to the \textit{Statistical Abstract of the United States: 1969}, the number of self-employed workers at the end of 1968 was as follows:

\begin{verbatim}
Employed in Agriculture
  Male 1,894,000
  Female 91,000

Employed in Nonagricultural
  Male 3,870,000
  Female 1,232,000

Total
  7,087,000
\end{verbatim}

\textsuperscript{52}Internal Revenue Code of 1954, Section 404(a)(1)(B).

The alleged inequity against the self-employed individual is no small matter, as evidenced by their numbers. If an inequity does exist, it affects over seven million individuals. According to the figures available, only a very small number of the total self-employed individuals do have pension plans. The number of plans in 1966 was estimated to be 25,000, even though there were almost seven million self-employed individuals in 1966. Figures also indicate that only eight per cent of all physicians, two per cent of all dentists and lawyers, and one per cent of all accountants do participate in self-employed pension plans. Critics of the tax law state that one major reason for the small number of self-employed individual pension plans is the inequity created by the tax law.

Further significance of the problem is indicated by the growth of the tax-favored qualified pension plans. Partly due to the tax benefits of a qualified plan, the

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rapid growth of private pension plans is indicated by the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Workers Covered Under Private Pension Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>1940</td>
<td>4,100,000</td>
</tr>
<tr>
<td>1950</td>
<td>9,800,000</td>
</tr>
<tr>
<td>1960</td>
<td>21,600,000</td>
</tr>
<tr>
<td>1970 (estimate)</td>
<td>34,000,000</td>
</tr>
<tr>
<td>1980 (estimate)</td>
<td>41,700,000</td>
</tr>
</tbody>
</table>

Of the approximately 76.5 million employed individuals in the United States at the end of 1968, some 32 million were covered by private pension plans. This represents a 42 per cent coverage of employed individuals. In 1964, only .5 per cent of all self-employed individuals had taken advantage of the tax benefits on retirement plans. There has been an increase more recently, however.

Not only is the number of individuals affected by the tax treatment of retirement funds for the self-employed important; but also, the dollar impact which the differences


create adds further significance to this problem. The impact in dollar amount of the differing tax treatment given retirement funds can be shown by an example.

**Example Indicating Impact of Differing Tax Treatment of Retirement Funds**

The example which follows illustrates the dollar effect which differences in the tax treatment of retirement funds create and further emphasizes the importance of these differences. This example compares the tax savings of several individuals—each in a situation which results in a different tax treatment of his retirement funds.

In order to make the comparison, certain assumptions were necessary. In the computation to determine the amount of federal income tax that would be paid at each salary level, the individual was assumed to be: married, filing a joint return, and using the 10 per cent standard deduction. He was assumed to be 45 years old with twenty years until retirement. The federal tax rates used were those in effect during the 1969 taxable year. The individual's federal tax liability was computed by assuming he was taxed on his full gross income, and also on his gross income less any allowable deduction for contributions to a retirement plan made in his behalf. The difference between the two figures appears in the example as the amount of the annual tax savings.
In order to obtain an idea of the full impact of this tax savings over a 20-year period, another assumption was made. The tax savings each year was assumed to be invested at a yield of 4 per cent compounded semiannually. The resulting figure represents the amount, in addition to any accumulated retirement funds, which the individual would have available at his retirement strictly due to the savings in taxes over the 20-year period assuming no change in the current federal income tax rates.

Further assumptions regarding each individual were also made. Individual A, the self-employed owner-employee, contributes in his own behalf the maximum amount allowed for tax benefits under the Self-Employed Individuals' Tax Retirement Act of 1962 and as amended for taxable years beginning after December 31, 1967.61 The maximum amount allowed for tax benefits is the lesser of 10 per cent of earned income or $2,500. One difference exists in this case that the example does not indicate. When the self-employed individual is viewed as an employer rather than an employee, and he sets up a retirement plan making contributions in his own behalf, he must also cover 100 per cent of his employees with three or more years of service. This compares to the corporate employer who only

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needs a 70 per cent coverage; or, if he classifies his employees, coverage may even be less as long as no discrimination exists. The tax-exempt organization employer has no limitations or restrictions placed on him in the matter of coverage. He may include anywhere from one to all of his employees in the retirement plan.62

Individual B, the employee of a corporation which has a qualified pension plan for its employees, is entitled to tax benefits on 5 per cent of his compensation plus an amount for past service. An assumption was made that the employee had past service credits of $2,500. A further assumption makes the plan noncontributory. In other words, the employee does not contribute to the plan.

Individual C, the employee of a tax-exempt organization, entered into an agreement whereby he would take a reduction in his future salary at the maximum amount allowed in order to derive the full tax benefits under Section 403(b) of the Internal Revenue Code. The amount allowed each year in the case of a salary reduction agreement is computed by taking one-sixth of the salary he would otherwise receive.63

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62 Internal Revenue Code of 1954, Section 403(b).

63 Internal Revenue Code of 1954, Section 403(b)(2) states: "(2) Exclusion allowance. For purposes of this subsection, the exclusion allowance for any employee for the taxable year is an amount equal to the excess, if any, of-- (A) The amount determined by multiplying
Individual D is an employee who is in the unfortunate position of either being employed by an organization which has no pension plan set up for its employees, or is employed by a corporation which does have a pension plan but he is not covered. He obtains no deduction from gross income and therefore has no tax benefits or tax savings on any retirement funds. He may use a portion of his after-tax dollars to set aside funds for retirement years; however, income earned on the savings will be currently taxable.

The reader should note that this table indicates only the benefits on the amount of tax savings due to the tax deduction allowed on the retirement contribution. One must also note that additional tax benefits accrue to A, B, and C since any earnings on the pension fund investments are not taxable currently. They are taxed when distributed, however.

The table which compares the impact of the tax law on these individuals in the various salary brackets follows:

(1) 20 per cent of his includible compensation, by
(ii) the number of years of service, over
(B) The aggregate of the amounts contributed by the employer for annuity contracts and excludable from the gross income of the employee for any prior taxable year."
Since one sixth of salary before reduction is equal to 20 per cent of the five-sixths of salary which remains after the reduction—See Melone and Allen, op. cit., pp. 379-382.
TABLE 1

COMPARISON OF RETIREMENT FUND TAX BENEFITS FOR SELECTED INDIVIDUALS

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Self-employed Individual</td>
<td>Corporate Employee</td>
<td>Tax-Sheltered Annuity Participant</td>
<td>Pensionless Employee</td>
</tr>
<tr>
<td>Annual Salary</td>
<td>$ 10,000</td>
<td>$ 10,000</td>
<td>$ 10,000</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>Amount of Retirement Contribution</td>
<td>$ 1,000</td>
<td>$ 3,000</td>
<td>$ 1,667</td>
<td>-0-</td>
</tr>
<tr>
<td>Taxable Amount</td>
<td>6,900</td>
<td>3,100</td>
<td>6,300</td>
<td>7,800</td>
</tr>
<tr>
<td>Federal Income Tax</td>
<td>1,171</td>
<td>829</td>
<td>1,057</td>
<td>1,342</td>
</tr>
<tr>
<td>Annual Tax Savings</td>
<td>171</td>
<td>539</td>
<td>285</td>
<td>-0-</td>
</tr>
<tr>
<td>Amount in 20 Years if Savings were Invested at 4%</td>
<td>$ 10,329</td>
<td>$ 30,986</td>
<td>$ 17,215</td>
<td>-0-</td>
</tr>
<tr>
<td></td>
<td>$ 20,000</td>
<td>$ 20,000</td>
<td>$ 20,000</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Amount of Retirement Contribution</td>
<td>$ 2,000</td>
<td>$ 3,500</td>
<td>$ 3,333</td>
<td>-0-</td>
</tr>
<tr>
<td>Taxable Amount</td>
<td>15,800</td>
<td>14,300</td>
<td>14,467</td>
<td>17,800</td>
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<tr>
<td>Federal Income Tax</td>
<td>3,210</td>
<td>2,835</td>
<td>2,877</td>
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<tr>
<td>Annual Tax Savings</td>
<td>554</td>
<td>929</td>
<td>887</td>
<td>-0-</td>
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<tr>
<td>Amount in 20 Years if Savings were Invested at 4%</td>
<td>$ 33,463</td>
<td>$ 56,113</td>
<td>$ 53,576</td>
<td>-0-</td>
</tr>
<tr>
<td></td>
<td>$ 40,000</td>
<td>$ 40,000</td>
<td>$ 40,000</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Amount of Retirement Contribution</td>
<td>$ 2,500</td>
<td>$ 4,500</td>
<td>$ 6,667</td>
<td>-0-</td>
</tr>
<tr>
<td>Taxable Amount</td>
<td>35,300</td>
<td>33,300</td>
<td>31,133</td>
<td>37,800</td>
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<tr>
<td>Federal Income Tax</td>
<td>10,046</td>
<td>9,206</td>
<td>8,322</td>
<td>11,150</td>
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<tr>
<td>Annual Tax Savings</td>
<td>11,104</td>
<td>1,944</td>
<td>2,828</td>
<td>-0-</td>
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<tr>
<td>Amount in 20 Years if Savings were Invested at 4%</td>
<td>$ 66,684</td>
<td>$ 117,421</td>
<td>$ 170,817</td>
<td>-0-</td>
</tr>
<tr>
<td>A</td>
<td>B</td>
<td>C</td>
<td>D</td>
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<td>---</td>
<td></td>
</tr>
<tr>
<td>Self-employed Individual</td>
<td>Corporate Employee</td>
<td>Tax-SHELTERED Annuity Participant</td>
<td>Pensionless Employee</td>
<td></td>
</tr>
<tr>
<td><strong>Annual Salary</strong></td>
<td>$60,000</td>
<td>$60,000</td>
<td>$60,000</td>
<td>$60,000</td>
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<tr>
<td><strong>Amount of Retirement Contribution</strong></td>
<td>2,500</td>
<td>5,500</td>
<td>10,000</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>Taxable Amount</strong></td>
<td>55,300</td>
<td>52,300</td>
<td>47,800</td>
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<tr>
<td><strong>Federal Income Tax</strong></td>
<td>19,809</td>
<td>18,219</td>
<td>15,960</td>
<td>21,134</td>
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<tr>
<td><strong>Annual Tax Savings</strong></td>
<td>1,325</td>
<td>2,915</td>
<td>5,174</td>
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<tr>
<td><strong>Amount in 20 Years if Savings were Invested at 4%</strong></td>
<td>80,033</td>
<td>176,072</td>
<td>312,520</td>
<td>-0-</td>
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</table>

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<th>D</th>
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<tbody>
<tr>
<td><strong>Annual Salary</strong></td>
<td>$80,000</td>
<td>$80,000</td>
<td>$80,000</td>
</tr>
<tr>
<td><strong>Amount of Retirement Contribution</strong></td>
<td>2,500</td>
<td>6,500</td>
<td>13,333</td>
</tr>
<tr>
<td><strong>Taxable Amount</strong></td>
<td>75,300</td>
<td>71,300</td>
<td>64,467</td>
</tr>
<tr>
<td><strong>Federal Income Tax</strong></td>
<td>30,635</td>
<td>28,435</td>
<td>24,677</td>
</tr>
<tr>
<td><strong>Annual Tax Savings</strong></td>
<td>1,429</td>
<td>3,629</td>
<td>7,387</td>
</tr>
<tr>
<td><strong>Amount in 20 Years if Savings were Invested at 4%</strong></td>
<td>86,314</td>
<td>219,199</td>
<td>446,190</td>
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</table>

<table>
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<th>A</th>
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<tbody>
<tr>
<td><strong>Annual Salary</strong></td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Amount of Retirement Contribution</strong></td>
<td>2,500</td>
<td>7,500</td>
<td>16,667</td>
</tr>
<tr>
<td><strong>Taxable Amount</strong></td>
<td>95,300</td>
<td>90,300</td>
<td>81,133</td>
</tr>
<tr>
<td><strong>Federal Income Tax</strong></td>
<td>42,360</td>
<td>39,360</td>
<td>33,997</td>
</tr>
<tr>
<td><strong>Annual Tax Savings</strong></td>
<td>1,500</td>
<td>4,500</td>
<td>9,863</td>
</tr>
<tr>
<td><strong>Amount in 20 Years if Savings were Invested at 4%</strong></td>
<td>90,603</td>
<td>271,809</td>
<td>595,745</td>
</tr>
</tbody>
</table>
Several observations can be made from an analysis of these dollar amounts. Individuals are not treated alike under the tax law with regard to retirement funds. Amounts allowed as a deduction from taxable income range from zero for the pensionless employee to 20 per cent of compensation for the employee of a tax-exempt institution.

For employees whose salary is $10,000 or $20,000, the greatest benefits accrue to the corporate employee; however, for salaries above these levels, by far the greatest beneficiary of the tax law is the employee of the tax-exempt organization. The pensionless employee has no tax benefits. The self-employed owner-employee has less benefits than the covered corporate employee or the tax-exempt institution employee.

Because an individual has the opportunity to invest his tax savings, the example indicates the sizeable amount that is accumulated during the 20-year period assuming the savings are invested. For a younger taxpayer who has more than 20 years until retirement, the benefits would be much greater. The greatest difference occurs in the higher salary brackets. A corporate employee with a $100,000 salary would accumulate three times more over the 20-year period than would the self-employed individual. The employee of a tax-exempt organization would have accumulated
two times more than the corporate employee—six and one-half
times more than the self-employed individual.

The employee who is not covered under any pension
plan is in the worst position of all taxwise. He has no
tax savings on any amounts he may set aside for his own
retirement. Any retirement investment would have to be
made with dollars remaining after income tax had been
paid. He would also be taxed currently on any income
received from the investment; whereas, the other individuals
gain an additional tax advantage (not shown in this example)
since earnings on their pension fund assets are not taxed
currently.

One factor should be made clear, however. This
example assumes that the amount of the contribution to
the retirement plan in behalf of each individual is the
maximum amount allowable under the Internal Revenue Code
for the tax deferral. Actually, individual contributions
may not be at these maximum allowable amounts. These
amounts were used in the example merely to emphasize the
extent of the differences allowed by the tax law in the
treatment of funds set aside for retirement.
Statement of the Problem and Methodology

The central thesis of this study focuses on the alleged inequity in the tax treatment of retirement funds of self-employed individuals. That such an inequity in the tax treatment of retirement funds of self-employed individuals does exist when compared to employed individuals will be proved. A proposal will also be developed which will help to correct the existing inequities.

Importance of Research

The importance of research of this nature lies not only in the future use to which any results are put, but also in the study of the legislative process through which the tax law has evolved. This process has resulted in a highly complicated tax code. Insight into this process may prove beneficial in the future in avoiding such complexities. A study of a particular section of the tax code to determine whether or not an inequity exists will prove helpful in any effort to correct the existing inequity as well as in avoiding the creation of new inequities when new tax proposals are being considered.

The fact that pressures for changes in the tax law are always being made gives rise to the need for some guide to follow in order that old inequities are corrected and new ones are not created. Collection and publication of
the legislative history of the tax law is not only desirable but also necessary for accountants, lawyers, and others interested in improving the scheme of taxation.

In 1913 when tax rates were one per cent, a tax deferment on retirement funds would not have been as important as it is today when it can mean up to a 70 per cent deferment of taxes. 64 Also, as indicated previously, pensions for employees have had a tremendous growth. Evidence indicates that some individuals who would otherwise be self-employed are attracted to the large-scale enterprises which offer the many fringe benefits only one of which is the pension plan. For example, as the president of the American Bar Association stated in 1966:

The number of lawyers employed in private concerns, primarily industry, has increased 127 per cent since 1951. Studies indicate that a major factor has been the attractive retirement benefits offered to corporate employees. 65

This is contrary to the pattern of legislation throughout the history of our nation in which the laws have favored the small businesses and have discouraged the large-scale enterprises. 66

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**Objectives and Scope of the Study**

Since this study is concerned with the charges of inequity in the tax law with regard to the taxation of retirement funds of self-employed individuals, one of the first items that will be considered is the definition of inequity as it applies in tax legislation. A determination will then be made with regard to its existence in the present law regarding taxation of self-employed retirement funds.

Another objective of this study is to determine the considerations that become important in a proposal for a change in the tax law. The use of the considerations will be examined in order to determine the relative weight given to equity, since equity is the primary concern of this study. The other considerations will be reviewed to determine their importance when proposed legislation is under study.

To make this determination, the legislative history of the tax law pertaining to retirement funds will be examined. Special attention will be given to the origin of the changes in the tax law that created the differences. After a determination of the considerations important in changing tax legislation has been made, a proposal will be developed for a tax policy for retirement funds of self-employed individuals that will attempt to correct existing inequities as determined by this study.
The point should be emphasized that any proposal which would strive for equity in the tax treatment of self-employed individuals should not create any new inequities for any other individuals. Because of this, any proposal developed in this study may necessarily have to be broad enough to include other individuals. This factor should be recognized at the outset.

This study will not attempt to deal with other areas of the tax law in which inequities are found to exist. This study is primarily concerned with the inequity in taxation of retirement funds of self-employed and employed individuals. It does not consider any other inequities in the tax law with regard to these two groups such as; hospitalization, life insurance, and other fringe benefits which a corporate employer may use as a substitute for wages with no tax to the employee but which a self-employed individual may only obtain with after-tax dollars.

This study is not primarily concerned with employees of tax-exempt institutions or corporate employees who are not covered under a qualified pension plan. These individuals are mentioned only to give emphasis to the different tax treatment of retirement funds.

When a corporation sets up a pension plan, it has a wide variation in features from which it may choose; therefore, individual corporate pension plans vary greatly.
Some of these features have been discussed briefly; however, to discuss these features in detail is beyond the scope of this study. For purposes of the discussion and examples presented, an assumption will be made that corporate pension plans will be noncontributory, i.e., all contributions to the plan are made by the employer. Other features of corporate pension plans, such as retirement benefits and funding media, will not be discussed in this study. The problem in this study deals with equity in the taxation of retirement funds for the self-employed individual as compared to an individual employed by a corporation and covered under a qualified pension plan. To discuss the many and varied features of the corporate pension plan would complicate the study and would detract from the primary emphasis in the study.

One other point should be made clear. The law makes a distinction between "self-employed individuals" and "owner-employees." The law is much more restrictive for self-employed individuals who are classified as "owner-employees." An "owner-employee" is a self-employed individual who owns the entire interest in an unincorporated business (i.e., a sole proprietor) or, if a partner, owns more than 10 percent of the capital or profit interest of the partnership.

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67 Internal Revenue Code of 1954, Section 401(c)(3).
68 Ibid., Section 401(c)(3)(A) and (B).
In this study, the self-employed individual will be assumed to be a sole proprietor or a partner with more than a 10 per cent ownership of the capital or profit interest of the business.

Organization of the Study

In the chapter that follows, a development of the concepts that will be used throughout the study will be presented. The definition of an inequity in the tax law will be presented and the existence of inequity with regard to retirement funds of self-employed individuals will be determined. The other considerations which ought to be examined when any change in the tax law is under study will also be presented. In order to determine the relative weights given these considerations when a change in the tax law is under examination, a study of the legislative history will be made.

Chapter III will present this legislative history regarding retirement funds. The changes in the tax law pertaining to the taxation of employee retirement funds will be presented first. Next, the changes in the taxation of retirement funds of self-employed individuals will be discussed. Movements by groups of self-employed individuals to change the tax law will be examined. Other changes in the tax law dealing with retirement funds will also be presented. Study will be made of any developments since
the passage of the Self-Employed Individuals' Tax Retirement Act of 1962. Practices in other countries with tax systems similar to that in the United States will be examined to reveal any comparisons or special tax treatments of retirement funds.

The fourth and concluding chapter will present the conclusions and recommendations that are drawn from the study. A proposal will be presented that will attempt to correct the inequities existing in the taxation of retirement funds. It will also reflect the other considerations that the study has indicated are important in any proposed change in the tax law. The conflicts in these considerations and the tradeoffs that occur among them as reflected in the proposal will also be discussed. This will provide a guide for any future legislative changes in this area.
CHAPTER II

EQUITY IN TAXATION AND OTHER CONSIDERATIONS

This chapter is divided into two major parts. The first part considers the definition of inequity in the tax law; the second part deals with the other considerations that should be examined when any change in the tax law is proposed. A study of these topics becomes necessary in order to determine whether or not inequity does exist in the taxation of retirement funds of self-employed individuals as charged. Also, recognizing that equity in taxation is only one consideration which should be examined for a desirable tax system, a determination of the other considerations must be made. When any proposal for a change in the tax law is under study, it must be examined in the light of all these considerations, not only that of equity. These are the matters which are examined in this chapter.

Inequity in the Tax Law

Many authors have suggested that there are inequities against the self-employed individual as compared to the employed individual in the matter of taxation of retirement benefits. Their charges take several forms. Some charges
refer to individuals, themselves, stating that they are not treated alike in this regard.¹ Others aim their charges at the retirement funds, stating that unfair differences exist in the taxation of different types of retirement funds.² Still others refer to the differences existing in the taxation of the broad classification—savings.³

With regard to pension funds, inequities in the tax law occur in various ways. One such way is a postponement of tax. The interest factor would determine the extent of the inequity since tax not paid currently could be invested. If a postponement occurs over a very long period, it may produce an additional advantage to the particular individual who has reached age 65 and obtains a double exemption. He may not pay any tax on the amount received from his pension fund. Another possibility is that he may be in a lower tax bracket at the time he receives the pension income. Another type of inequity is to have what would be taxed as ordinary


²Corbett, op. cit., p. 20.

income taxed at the more favorable capital gains rates. \(^4\) Each type may occur in the taxation of retirement funds and will be considered in this study.

Many authors of articles charging inequity in this regard seldom specifically define the term. They discuss what they feel is unfair taxation, but they do not clearly define their terminology as it applies in the tax law. Before being able to determine whether the charges are justified, a determination must be made as to what constitutes inequity in the tax law.

**Equity in the Tax Law**

According to Webster, "equity" is defined as "fairness; impartiality; justice." \(^5\) The determination of equity rests on value judgments; however, it should conform to what is regarded as optimum by a consensus of opinion in contemporary society. \(^6\) Equity involves social attitudes toward a fair distribution of taxes. \(^7\) In democratic societies, its source

\(^4\) The Tax Reform Act of 1969 has lessened the extent of this inequity by applying capital gains treatment only to the appreciation of and earnings on the investments of the qualified pension plan funds.


\(^7\) Ibid., p. 118.
is the principle of the equality of individuals before the law.  

Adam Smith, in his Wealth of Nations, set forth a list of canons which are still applicable today. His first canon was that of equality. Smith stated:

"Equity," as used by Smith, refers to "reasonable classification." The equity principle of taxation states that persons or things similarly situated should be treated similarly. In other words, persons who are in similar situations should be treated alike; and persons who are in dissimilar situations should not be treated alike. For tax purposes, individuals may be classified providing that the classification does not violate the equity principle. The equity principle is not violated if the classifications are reasonable, if equals within the categories are treated

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10 Ibid., pp. 777-778.

11 Buchanan, op. cit., pp. 182-183.
equally,\textsuperscript{12} and if unequals are treated differently based on their differences. Or, as Shultz and Harriss state:

\textit{Equity...relates differences in treatment to reasonable or relevant bases or sources. Equal treatment is not always equitable—and neither is unequal treatment. The crucial factor in deciding whether inequality is equitable is the adequacy or relevance of the element which accounts for the difference.}\textsuperscript{13}

A "reasonable classification" becomes the basis for equitable differences in taxation.

\textbf{Reasonable Classification}

A reasonable classification is based on relevant differences. Relevant differences exist when the circumstances of the individuals are not alike. There are two approaches to the problem of defining "like circumstances."\textsuperscript{14}

First, the benefit theory states that there should be equal treatment of persons receiving equal benefits from government activities. An adjustment should be made for those who receive different benefits in proportion to the amount of benefits they receive. Under this theory, the governmental sector would operate like the private sector in that each individual would pay for what he obtains.

\textsuperscript{12}Ibid., p. 183.


\textsuperscript{14}Due, op. cit., p. 118.
The major objection to taxation on the benefit basis is the difficulty in the measurement of the benefits each individual receives from the governmental activities. This theory is also contrary to all government welfare programs.\textsuperscript{15}

The other approach to the definition of "like circumstances" is the ability-to-pay theory.\textsuperscript{16} Individuals are in like circumstances if they have the same ability to pay taxes. Taxpaying ability is defined as the economic well-being, or the overall level of living, enjoyed by the taxpayer. Economic well-being may be measured by income, wealth accumulated, or consumption expenditures.\textsuperscript{17} Income is generally regarded as the best measure of economic well-being since it is the primary determinant of the level of living which an individual enjoys.\textsuperscript{18} The income tax levied by the federal government is the tax with which this study is concerned; and, in this study, economic well-being will be measured by income. When income is used, it is often adjusted for factors which affect expenditures necessary for a given standard of living, e.g., number of children.\textsuperscript{19}

When income is used as a measure of economic well-being, i.e., representing the taxpaying ability of the individual, then for equity in taxation to exist:

\begin{itemize}
\item \textsuperscript{15}Ibid., pp. 119-121.
\item \textsuperscript{16}Ibid., pp. 121-122.
\item \textsuperscript{17}Ibid., pp. 122-123.
\item \textsuperscript{18}Ibid., p. 134.
\item \textsuperscript{19}Ibid., p. 123.
\end{itemize}
1. All individuals with the same income pay the same amount of tax providing other factors affecting expenditures necessary for a given standard of living (e.g., number of children)\textsuperscript{20} are the same, and

2. All individuals with different incomes pay different amounts of tax based solely on the differences in individual incomes, providing other factors affecting expenditures necessary for a given standard of living (e.g., number of children)\textsuperscript{21} are the same. The difference in the taxes that must be paid at the different income levels is based on a systematic pattern. This systematic pattern in the federal tax law is based on a progressive rate structure.

When a tax does not result in the above situations, an inequity does exist in the tax law.

Progression is regarded by the consensus of opinion in society today as necessary for equity. This is the strongest argument for progression. This rate structure has general acceptance because the pattern of income distribution before taxes is believed to involve excessive inequality in terms of the best interests of society.\textsuperscript{22}

The degree of progression also rests upon the consensus of opinion in society; thus there are no objective criteria to determine a scale of progression. The degree of progression must rest upon personal opinions of the legislators.

\textsuperscript{20}The assumption is made that an income tax, based on income adjusted to reflect standard of living differences, is equitable.

\textsuperscript{21}\textit{Ibid}.

\textsuperscript{22}\textit{Due, op. cit.}, p. 128.
regarding the consensus of opinion about desired patterns of income distribution and possible incentive effects of the degrees of progression.23

Before further investigation into the problem of inequity in the taxation of retirement funds, a definition of income for tax purposes must be developed in order to determine the inclusion or exclusion of items such as pension contributions.

Pension Contributions as Income

The definition of income for tax purposes that has gained increasing acceptance is that of total accretion. Income is defined as consumption plus the increase in net worth during the period.24 This definition includes all income, realized or unrealized, during a given period of time. This broad concept of income would include items such as imputed income of owner-occupied houses, and home-produced goods and services. This definition of income is the one most logical in terms of the intent of income taxation—adjusting the burden of the tax on the basis of net economic gain.25 Use of this definition for tax purposes would cause administrative problems, e.g.,

23 Ibid., pp. 129-130.


25 Due, op. cit., p. 135.
determination of income values when no market transactions are involved. Most experts believe the income tax should be limited to realized income as reflected in transactions or conventional accounting statements.26

A more easily measurable definition of income for tax purposes is the current-income (net-flow) concept. Income is defined as the net addition to income available for spending during a given time period.27 Although this definition is more administratively feasible, it does give rise to inequity and to illogical features in the tax structure.28 As administered in the United States, the income tax law is not fully consistent with either of these definitions of income.29 It does not attempt a general definition of income; instead, it enumerates items to be included, excluded, or deducted.30


28Discrimination occurs against the individual who rents a house or hires a housekeeper.

29Buchanan, op. cit., p. 290. Also, for example, long term capital gains are taxed only on one-half the amount realized. Capital loss treatment is inconsistent with the definition. Flows of wealth occur with interest on state and local government securities, and social security benefits, but no tax is imposed. Personal exemptions and deductions further remove the present tax law from adherence to either definition.

The Internal Revenue Code states that all income is taxable unless exempted from tax by law.\textsuperscript{31} Examples of income items are listed and the highly complex law explains the exemptions in detail.\textsuperscript{32}

Among the items of income included in the tax law are wages and salaries earned.\textsuperscript{33} Pension fund contributions are included in income since they are considered wages—-even though payment is deferred.\textsuperscript{34} Supporting evidence is found in the fact that employers and unions negotiate pension plans as deferred wages.\textsuperscript{35} Pensions are considered a disbursement which adds to labor costs in the same manner as other wage payments. Basic wages are deferred a short period of time, vacation payments are deferred a year or more, and pensions are deferred for a working life.\textsuperscript{36}

Consideration for the employer's promise to pay a pension is found in the daily work of the employee——he may forfeit his claim if he fails to work until retirement age.

\begin{itemize}
\item \textsuperscript{31}Internal Revenue Code of 1954, Sections 61 and 62.
\item \textsuperscript{32}Ibid., Sections 61, 62, and 63.
\item \textsuperscript{33}Ibid., Section 61(a)(1).
\item \textsuperscript{34}Ibid., Sections 61, 62, 63, and 401. Exemptions for contributions to a qualified plan are explained in Section 401.
\item \textsuperscript{36}Ibid.
\end{itemize}
One court stated: "Where the employer has a pension plan and the employee knows of it, continued employment constitutes consideration for the promise to pay the pension. The pension is considered to be deferred compensation." Legal support for pensions as deferred wages may be obtained from the line of cases holding that pensions are "wages" or other conditions of employment within the meaning of Section 9(a) of the National Labor Relations Act and are subject to mandatory collective bargaining.

Among the items exempted from current income tax are contributions to qualified pension plans. The highly complex Section 401 of the Internal Revenue Code explains the rules under which tax is deferred. This tax deferral is believed to be one of the major factors that has contributed to the growth of corporate retirement plans. All pension contributions would have to be made with dollars remaining after tax has been paid by the employee if it were not for the provision of the Internal Revenue Code that exempts from tax certain contributions made to plans that qualify for the special tax deferral.

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Some question the tax deferral on pension fund contributions since the amounts are considered supplementary compensation for employees. The postponement of tax gives the employee the interest advantage plus the advantage of being in a lower tax bracket after retirement. The alternative usually suggested is to tax pension contributions at the time they are made and to tax the earnings on the fund investments. The benefits received would be exempted from taxation. This could be done under plans where employees acquire vested rights to the funds, but it is considered unreasonable where rights are not vested since the employee would be taxed on amounts he may never receive. The expectation of benefits has some value but can not be measured easily enough to be included for tax purposes. This leads to the subject of equity in the taxation of pension fund contributions.

Equity in Taxation of Pension Fund Contributions

For equity in the taxation of pension fund contributions to exist, all individuals having the same income (income being defined as including pension fund contributions), the same number of exemptions, the same amount of deductions from gross income, and alike in all other ways which affect the income tax, and also contributing or having

contributed in their behalf the same amount toward a retirement fund, should pay the same amount of tax.

And, all individuals having the same income (income being defined as including pension fund contributions), the same number of exemptions, the same amount of deductions from gross income, and alike in all other ways which affect the income tax, and also contributing or having contributed in their behalf different amounts toward a retirement fund, should pay a different amount of tax—the difference being determined solely on the basis of the amount of difference in the pension fund contributions. A systematic pattern should exist which determines the degree of difference.

Equity, as defined above, does not exist in the taxation of pension fund contributions as the following brief example will indicate. In this example, both individuals are situated identical to each other with regard to the factors that are important for tax purposes. Both have one source of income which amounted to $10,000 for the taxable year. Both file joint returns, take the standard deduction, and have two dependents.

1. Individual A is an employee of a corporation which contributes $3,000 to a qualified pension plan in his behalf. Rights to the contribution vest with the employee and tax is deferred on the amount. In other words, the employee pays no tax at the time the contribution to the plan is made. With the assumptions as stated above, this individual pays $829 in income tax currently.
2. Individual B is self-employed. He contributes $3,000 toward a pension plan in his own behalf. Prior to 1962, no tax would have been deferred on this contribution, and he would have had to pay $1,342 in taxes. From 1962 through 1967, tax would have been deferred on $1,250; however, beginning in 1968, tax is deferred on $2,500 and his tax liability would be $1,171.41

Both individuals have the same amount being contributed to a pension plan. They should be paying the same amount of tax in order for equity to exist in the taxation of the pension funds. As indicated, this is not the case. One should note, however, that Individual A will have to pay tax in later years when pension benefits are received; but at that time, he may be in a lower tax bracket or he may receive additional tax exemptions.

Further examination of the tax law indicates that taxation of pension funds has been based on a classification—not of the type of funds or the individual himself, but a classification based on the form of organization of the employer or in the case of a self-employed individual the manner in which he chooses to operate. The following examples indicate situations where individuals are identical in all respects except in the form of the organization or the manner of doing business. Each individual is taxed differently on any contributions he makes to a pension fund or any contributions made in his behalf.

411969 tax rates were used.
A self-employed doctor would be able to set up a pension plan under which he could gain a tax deferment subject to the limitations of the Self-Employed Individuals' Tax Retirement Act of 1962. On the other hand, if he chose to work as a plant physician for a corporation, he would probably be eligible to participate in the qualified pension plan of his employer. The doctor would gain greater tax benefits if he chose to become employed as the plant physician.

Further benefits may accrue to him as a corporate employee that are not available to him as a self-employed individual. An employee may receive fringe benefits such as hospitalization, life insurance, and other benefits that the employer gives an employee as a substitute for wages. No income tax is paid on these amounts by a corporate employee; however, a self-employed individual would have to purchase coverage with dollars remaining after tax has been paid.

Although these particular items are not under study, they do indicate additional benefits sometimes received by employees but that are not available to a self-employed individual. On the other hand, critics charge that self-employed individuals enjoy greater opportunities for charging expenses, such as vacation trips,

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as business expenses. Any such actions are illegal under the tax law. They deal with the problem of enforcement and will not be considered in this study.

Any individual who operates his own business would gain more tax benefits with regard to retirement funds if he were an employee rather than self-employed. For example, a hardware store proprietor would be limited in the tax benefits he would receive under a pension plan as a self-employed individual. If he chose to form a small family corporation, he would be able to set up a qualified pension plan to take advantage of all the tax benefits while still retaining control of his business. Until recently, however, one difference arose when one would compare this situation to that of the doctor. This individual may incorporate his business if he so desires; however, a doctor was not able to incorporate because of the nature of his profession. The Internal Revenue Service has recently accepted court decisions that invalidated the professional corporation regulations, thereby allowing doctors and other professionals to incorporate in order to take advantage of the tax benefits.

Although this study is not primarily concerned with employees of tax-exempt organizations or the pensionless

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^3Ohio, Revised Code, Annotated (Baldwin, 1964), Sec. 1701.03 and Sec. 1785.02.

employed, an example involving these individuals will further illustrate differences in tax benefits based on form of organization. Compare the situation of a dietitian at a cafeteria in a tax-exempt institution versus a dietitian at a corporation cafeteria. They do identical work; however, tax benefits (if covered under a pension plan at the tax-exempt institution) are far greater than they would be if the dietitian were a corporate employee under a qualified pension plan.\footnote{Internal Revenue Code of 1954, Section 403(b).}

Still further differences exist when two individuals are employed by the same corporation and only one of them is covered under the company's pension plan. As stated previously, a corporation is allowed a certain degree of flexibility in limiting participation in a plan while still meeting the nondiscrimination requirement.\footnote{Supra, p. 9.} If one employee is covered under the company qualified pension plan, he has substantial tax benefits when compared to the employee who is not covered under the plan and who has to provide for his retirement with dollars after tax has been paid.

The existence of an inequity in the tax law regarding taxation of self-employed retirement funds has been shown. Before an attempt is made to propose a method for correcting
the inequity, one must determine what considerations are necessary when examining a proposal to change the tax law.

Equity is one consideration; however, it is not the only consideration. Even though this study is concerned primarily with equity, a determination of the other considerations must be made. A proposal must be examined in light of all the considerations, not just that of equity. The considerations presented in the next section are those which should be examined when a tax proposal is under study.

Considerations Important in Proposal to Change Tax Law

Before beginning a discussion of the considerations important in any proposal to change the tax law, one should recognize the impossibility of each consideration existing in its most desirable form for each proposal. Many times the considerations are in direct conflict with each other. The duty of the legislators is to weigh the relative merits of the considerations when a tax proposal is under study. The decision regarding the proposal should be made after a proper examination of all considerations and the conflicts arising among them. Since equity has already been discussed, attention will now be turned to the other considerations which affect the tax law.
Neutrality

If complete tax neutrality existed, the tax structure would not interfere with the attainment of an optimum allocation and use of resources. The belief in democratic societies is that the free play of prices, consumer choices, and investment decisions will produce better results than can be secured from a directed economy. Also, taxes would not interfere with the attainment of optimum standards of living, i.e., taxes would not alter the choices of courses of action unless a closer attainment of society's goals could be achieved. In general, tax neutrality means that taxation would not be used to alter consumption, personal activity, or investment. One should note that almost every tax has certain effects. The task of the policy maker is to judge these effects.

Administrative Factors

Among the administrative factors that should be considered when reviewing a tax proposal is the cost of

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48 Due, op. cit., pp. 115-118.


50 Due, op. cit., pp. 115-118.

51 Dan Throop Smith, op. cit., p. 12.
collection and compliance. In order for society to receive the maximum benefits possible, taxation should involve minimum costs of collection and compliance which are consistent with an effective enforcement of the tax. Adam Smith included "economy in collection" as one of his canons. He stated:

"Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state."  

An effective and inexpensive administration of a tax is essential if the use of resources in effecting the transfer is to be minimized.  

Effective administration of the tax law is also essential in order to maintain equity in the tax law. If individuals are able to evade the tax, it will not conform to accepted standards of equity. For effective enforcement, individuals should not be able to escape the tax by readjusting the manner in which they conduct their activities.  

Another administrative consideration is that of simplicity. Simplicity, as pertaining to taxation, means  

52Adam Smith, op. cit., p. 778.  
53Doe, op. cit., p. 130.  
54Ibid.  
55Ibid., p. 131.  
56Dan Throop Smith, op. cit., p. 9.
that the tax should be as simple as possible in order to facilitate compliance. It does not mean that the tax is so simple that it conflicts with equity. In other words, a tax with one rate levied on all persons would be extremely simple; but it would not be considered fair. When a tax proposal is under study, the effects on other factors must also be considered and the decision must be made in light of all the factors. Simplicity also means that the tax base can be clearly defined and the tax liability is determinable with relative ease.

Social, Economic and Political Considerations

In addition to the considerations discussed above, certain others must be examined when any proposal to change the tax law is under study. For example, a social effect of a change may be the encouragement of individual savings with less dependence on government aid. Also, an economic effect may result if a law were passed whereby income received from amounts invested for retirement were exempted from current tax. Individuals would be encouraged to provide for their own retirement and a lesser amount of social security benefits would be required. Political effects also occur since any changes made are likely to bring a response in the form of pressure for changes in other areas of the tax law. For example, when the oil industry was granted
the favorable 27 per cent depletion allowance, pressure was brought to extend similar tax benefits to other extractive industries. 57

Conflicts in Considerations

The considerations discussed above are often in conflict with one another. There exists a conflict between equity and neutrality. From the neutrality standpoint, the most desirable form of tax would be one that is completely independent of the economic activities of an individual. A single tax for all would be ideal in this case, but it would be considered inequitable under the usually accepted standards. 58 Also, the simplest tax would be the single tax for all; however, this again would not be regarded as equitable by the consensus of opinion in our society. 59

The many deductions and exemptions found in the tax law are intended to ease the burden of the tax and to make it equitable according to the individual's ability to pay. They do, however, complicate the tax law.

Accelerated depreciation methods have been allowed for the purpose of encouraging investment in capital assets.

57 Internal Revenue Code of 1954, Section 611, Allowance of Deduction for Depletion (27½% for oil and gas; 23% for sulfur, uranium, etc.; 15% metal mines; 10% asbestos, 7½% clay and shale for sewer construction, etc.)

58 Due, op. cit., p. 130.

59 Dan Throop Smith, op. cit., p. 10.
These methods complicate the law and are in opposition to the neutrality consideration. Benefits are restricted to those who acquire new depreciable assets. The same was true for the more recent 7 per cent investment credit. This addition to the tax law was against the neutrality consideration since it was designed to influence investment. It also complicated the tax law considerably. Benefits were restricted to those who acquired particular assets.

A further example of conflicts arising among the considerations is the 10 per cent surcharge. This surcharge was passed in order to reduce an inflationary trend. The tax increase had an unneutral effect. Some business decisions were altered because of the surcharge. Even before passage, business decisions were affected in anticipation of the additional tax. The surcharge violated tax neutrality.

60 Bernard P. Herber, Modern Public Finance (Homewood, Illinois: Richard D. Irwin, Inc., 1967), p. 226. See also Internal Revenue Code of 1954, Sections 167(b) and 167(c)(2).

61 Internal Revenue Code of 1954, Section 38 added by Public Law 87-834, October 16, 1962. Sections 46-48 explain the amount of credit and definitions.


The preceding examples illustrate the conflicts which arise when a change is made in the tax law. The fact that the changes were made indicates that a tax proposal does not necessarily have to meet each consideration. Tradeoffs occur among the considerations, and in each particular case, one or two considerations may have outweighed all the others. For this reason, one finds it necessary to examine the legislative process with regard to the tax law in order to determine the relative weight given to the equity consideration when compared to the other considerations.

Summary

The inequity in the taxation of retirement funds of the self-employed individual has been discussed. In order to correct this inequity, an examination is necessary of the considerations that are important when attempting to change the tax law. These considerations have also been discussed.

Next, attention will be turned to the manner in which proposals for a change in the tax law become implemented. Emphasis is given to the considerations used by the legislative bodies when evaluating the merits of various proposals. In order to determine the relative weights given the considerations by the legislators, a study of the legislative history of the taxation of retirement funds
is necessary. A study of this nature may also reveal other factors which influence tax legislation.

The approaches taken by those groups who worked for many years to effect a change in the taxation of retirement funds of self-employed individuals will also be discussed. The arguments, both pro and con, presented when legislation was under consideration indicate the reasons for acceptance or rejection of the changes. This review of the legislative history is the subject of the chapter which follows.
CHAPTER III

HISTORY OF TAX LEGISLATION REGARDING RETIREMENT FUNDS

In this chapter, the changes in the tax law which created differences in the tax treatment of retirement funds will be examined. First, a brief historical description of the tax law pertaining to retirement funds of employed individuals is presented. Next, legislation which allows tax benefits on retirement funds of certain other individuals and groups will be discussed.

The efforts by self-employed individuals to gain similar tax advantages proceeded in two directions. One effort attempted to bring associations of self-employed individuals under the Internal Revenue Code's definition of a "corporation" thereby making them "employees" eligible to be covered under a qualified pension plan. The other approach was an attempt to change the tax law itself. Both approaches will be described along with the issues raised during the long legislative process. A brief description will also be presented of the tax law regarding self-employed individuals' retirement funds in countries with tax systems similar to that in the United States.
Efforts to Change Taxation of Retirement Funds and Results Obtained

In this discussion, emphasis is directed toward the considerations that were important when the proposals for a change in the tax law were under study. This examination will reveal the relative weights given the considerations, especially that of equity, and serve as a guide to the characteristics necessary to make a proposed revision acceptable.

Taxation of Retirement Funds

Under the federal tax law prior to 1921, employers could deduct from taxable income only actual payments made to employees or their dependents.¹ No deductions were allowed to make a retirement plan actuarially sound or to fund past service liabilities. The employee had to include in taxable income amounts deducted from his salary for contribution to a pension fund.² If his employer made contributions in his behalf, the employee had to pay tax on such amounts if there was a reasonable expectation that the employee would benefit from them.³

The first tax deferment for employees came in the Revenue Act of 1921. Congress recognized the social good

²Ibid., p. 288.
³Ibid.
to be obtained from "security" plans for the benefit of workers by exempting from taxation a trust created by an employer for the exclusive benefit of some or all of his employees. The employee would not be taxed on any amounts until he actually received them, and then only to the extent they exceeded his contributions.

Whenever a tax deferment is given to a particular class of individuals, and not to others, an inequity arises. This initial tax deferment created an inequity. A difference in tax treatment arose between those individuals who were eligible for the tax deferral and those individuals who were not eligible for it. This initial tax deferment became the basis for arguments in later years charging inequitable tax treatment of individuals.

In extending this tax deferment to particular employees, the legislators held a social consideration above the equity consideration. The policy of encouraging the establishment of retirement plans was thought to provide beneficial effects which would outweigh the negative effect on the equity consideration.

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As will be shown throughout the remainder of this review of the legislative history of taxation of retirement funds, once this initial step was taken to defer tax for particular individuals, there was no turning back. Pressure grew for similar tax benefits for other individuals, especially in later years as the tax rates increased making tax deferrals more attractive.

The question of the timing of deductions arose when many employers made large contributions to their plans within a one-year period in order to establish sound pension plans. The matter was clarified in the Revenue Act of 1928 when an employer was allowed to deduct the contribution covering the current year's liability. Any amount in excess of this was to be deducted over a ten-year period.

Various other changes were made in the tax law with regard to qualified pension plans, but these changes were primarily concerned with eliminating abuses of the tax benefits and preventing corporate management from gaining the major tax benefits. The result was that in order to

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7 Ibid.
gain the tax benefits, the retirement plan had to qualify with respect to a number of provisions set out in the Internal Revenue Code.\(^9\) If a plan met the specified requirements, tax was deferred on amounts contributed to the plan by the employer on behalf of the employee regardless of when the rights to the amounts vested. Also, income of the fund was allowed to accumulate tax free. Although tax had to be paid at the time distributions were made, the taxpayer still benefited since he was usually in a lower tax bracket with a double exemption. Also, the distribution could have been arranged so that the favorable capital gains rates applied.\(^10\)

If a plan did not qualify, the special tax treatment did not apply, i.e., contributions to a retirement plan by an employer in behalf of an employee were taxable to the employee at the time the contribution was made if rights to the funds vested with the employee. If rights did not vest with the employee, no tax was paid until the amounts were actually received by him; since, prior to receipt, there was no assurance that the employee would receive the funds.


The social good consideration was not extended to everyone, however. One requirement of a qualified pension plan was that the plan be for the "exclusive benefit of employees." Prior to 1962, self-employed persons and partners could establish qualified pension plans for their employees, but could not participate in them. On the other hand, owners operating their businesses in the corporate form could participate, since they were considered employees of the corporation. Sole proprietors and partners felt they were not being treated fairly under the tax law.

In 1942, the Internal Revenue Code extended favorable tax treatment to another group.\(^{11}\) Tax-exempt institutions had no incentive to set up pension plans for their employees since they could derive no tax benefits. To correct this situation, the tax law was changed to allow employees of certain tax-exempt institutions to reduce future salary payments and have the amount placed in a form of pension plan.\(^{12}\) Employers were allowed to purchase annuities for their employees and tax on such amounts would be deferred until benefits were actually received by the employee.

This provision became used to a far greater extent than the Internal Revenue intended; and, in 1961, a

\(^{11}\)Internal Revenue Code of 1954, Section 403(b).

considerably more detailed provision was enacted. No prohibitions against discrimination were included allowing employers much latitude in establishing plans. Employers of the specified tax-exempt organizations were allowed to select participants in a discriminatory manner and to allocate contributions and benefits discriminatorily.

This provision of the tax law favors a particular group of individuals—employees of certain tax-exempt institutions. It was passed in order to compensate for the lack of the tax incentive to set up retirement plans for employees. The provision presents a good example of a change made in the tax law to benefit certain individuals with regard to the taxation of retirement funds. It leads to the question of why there was so much opposition to and such a long delay in the passage of legislation that would benefit another group of individuals—self-employed individuals and partners.

Efforts by Self-Employed to Gain Tax Benefits by Incorporation

As tax rates increased, the benefit derived from tax deferrals increased. The number of pension plans grew and


more employees were receiving the tax benefits resulting from this provision of the tax law. Recognizing the increasing tax benefits given employees who were covered under qualified retirement plans, individuals who were self-employed became interested in gaining similar benefits. Their efforts proceeded in two directions.

One effort took the form of an attempt to be brought under the Internal Revenue Code's definition of a corporation. This effort involved mainly members of the medical profession and their attempts to form associations having the major characteristics of a corporation. By having themselves taxed as employees of the corporation, they would meet the employer-employee requirement of a tax deferral on retirement funds.

The key issue involved was the question of form versus substance. The form of the organization was an association with some corporate characteristics. It was not an actual corporation since, under state law, certain professionals were not able to operate in the corporate form. In other words, these associations could not be taxed as corporations since they did not possess all of the

15Supra, p. 19.

16Morrissey v. Commissioner, 36-1, U. S. Tax Court, Paragraph 9020, 296 U. S. 344, 1935; Bert v. Helvering, 92 F. 2d, 491. (Most state laws have since been changed, however.)
ordinary corporate characteristics. Some courts placed more emphasis on the substance, or economic reality, that the associations had sufficient corporate characteristics to be considered corporations and should be considered as such for tax purposes. States began to change their laws until nearly three-fourths of the states allowed professionals to form associations or corporations.

The early regulations issued by the Treasury Department were not very clear and were characterized by continual change and reversal of position. Later, regulations were issued which took a firm position and rejected this attempt as a means to gain favorable tax treatment of retirement funds by members of the professions. Proposals also came

17 Regulation Sections 301.7701-1 and 301.3301-2.

18 52-2 U. S. T. C., Paragraph 9626, 216 F. 2d 418 (CA9), and 59-2 U. S. T. C., Paragraph 9602, 175 F. Supp. 360.


before the Congress to have professional associations come under the tax definition of a corporation. No action has been taken on the bills.

A recent announcement by the Internal Revenue Service has accepted court decisions which invalidated the professional corporation regulations. In other words, organizations of professionals will now be treated as corporations for tax purposes. Even though this concession was made for professionals, many self-employed individuals and those professionals who preferred not to incorporate would still not be eligible to obtain the tax benefits on retirement funds that are available under qualified corporate plans.

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23 Search made of the following: Congressional Index, Commerce Clearing House, 89th and 90th Congress; Congressional Record Index, 89th and 90th Congress, and the Congressional Quarterly.


Other Changes in the Tax Law

The belief that tax effects should not be the determining factor in the selection of the form of business organization led to the passage of legislation that would allow a partnership to be taxed as a corporation (Subchapter R) and a corporation to be taxed as a partnership (Subchapter S).\(^\text{26}\)

**Subchapter R.**—Section 1361 of the Internal Revenue Code allowed a partnership to be taxed as a corporation; however, the law stated that it could not set up a qualified pension plan.\(^\text{27}\) This eliminated one of the methods by which a partner could have taken advantage of the tax benefits on retirement funds.

This legislation was recently repealed. However, it still has significance to the problem under study.\(^\text{28}\)

When the legislation was under consideration, statements made by the Treasury, the Joint Committee on Internal Revenue Taxation, and the Supreme Court agreed that a citizen should not be penalized taxwise by reason of his

\(^{26}\) *Internal Revenue Code of 1954*, Section 1361, Subchapter R, Unincorporated business enterprises electing to be taxed as domestic corporations. Subchapter R was repealed by Public Law 89-389, effective January 1, 1969. Subchapter S, Section 1371.

\(^{27}\) *Internal Revenue Code of 1954*, Section 1361(d).

\(^{28}\) Subchapter R was repealed by Public Law 89-389, effective January 1, 1969.
choice of the form of his business enterprise. The purpose of the legislation was to permit small businesses "...to select the form of business organization desired without the necessity of taking into account major differences in tax consequences." This point was one of the issues raised by critics of the tax law regarding self-employed individuals' retirement funds. If a self-employed individual incorporated his business, he could set up a qualified pension plan to take advantage of the tax benefits. If he operated as a partner or sole proprietor, these benefits were not available to him.

Subchapter S.—Section 1371 of the Internal Revenue Code allows a small corporation to be taxed as a partnership. Until recently, it could set up a qualified pension plan since there existed the employer-employee relationship; and, it could take advantage of the tax benefits given the plans. This advantage has now been eliminated. The Tax Reform Act of 1969 provides limitations similar to those applicable to partnerships in the matter of


31 Internal Revenue Code of 1954, Section 1373(a) stated: "The undistributed taxable income of an electing small business corporation...shall be included in the gross income of the shareholders of such corporation...."
contributions to retirement plans for individuals who are significant shareholders of Subchapter S small business corporations. Even with the changes, however, a pension plan under Subchapter S corporation rules is more favorable than one under the rules for self-employed individuals. Under the new rules for Subchapter S corporations, any excess contribution does not disqualify the plan as it would for a self-employed individual. The excess will be taxable to the shareholder-owner but can remain in the plan earning tax-free income. Nevertheless, this change did eliminate the alternative for a self-employed individual of incorporating his business, being taxed as a partnership, and still having all the tax benefits of a qualified retirement plan.

While these changes were being made in the tax law, another group of self-employed individuals was attempting to gain the desired tax benefits by effecting other changes.

Efforts by Self-Employed to Gain Tax Benefits by Changing Tax Law

While certain members of the medical profession were attempting to have professional associations recognized as


corporations for tax purposes, members of the legal profession were attempting to effect a change in the tax law itself which would produce the desired results.

The first organized effort came in 1945 when a small group of lawyers met to consider the problem. Discussions continued, various proposals were studied, and finally a bill was drafted and introduced into Congress in 1951. The bill permitted a deferment of income tax by excluding from gross income the portion of earned income which was paid to a restricted retirement fund. An individual could exclude the lesser of 10 per cent of his earned net income or $7,500. Coverage included pensionless employees and also employees who were inadequately covered under an employee pension plan. The employee's limit would be reduced by any contributions made by his employer.

At the outset, proponents of this change in the tax law used as their major consideration equity in the tax law.


36 A restricted retirement fund was defined as a trust forming part of a retirement plan set up by a bona fide agricultural, labor, business, industrial, or professional association, or similar organization, for the exclusive benefit of its participating members.
The equity consideration resulted in very broad coverage under the proposed legislation. The group responsible for the bill felt it should not ask for relief from the tax inequity for its own members without trying to obtain similar benefits for the pensionless employed and the inadequately covered. 37

Opponents denounced the proposal as an "upper bracket" proposal, but their major objection centered around the predicted revenue loss that would result from such legislation. 38 Even though other issues arose, these two considerations—revenue loss expected and equity—continued as the major issues throughout the ten-year history of this legislation.

The bill was modified to exclude individuals already covered under employee pension plans because of alleged administrative difficulties. 39 Because of the revenue loss objection, pensionless employees were also excluded. 40

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38 Ibid., pp. 47-48.
39 Rapp, op. cit., p. 62.
40 Ibid., p. 67.
Bills introduced in 1954 again covered all taxpayers, only to be changed again the following year.\footnote{Digest of Public General Bills, 83d Congress, 2d Sess., H. R. 9618 (Hay), June 2, 1954. Also, Rapp, op. cit., p. 63.}

A favorable vote was obtained for the first time in the Ways and Means Committee in 1955.\footnote{Rapp, op. cit., p. 67.} The bill had been amended to be confined only to self-employed individuals. The dollar limit was reduced to $5,000.\footnote{Ibid.} A significant factor at this time was the admission by the Treasury Department, the bill's major opponent, that an inequity did exist; however, it still opposed the bill because of the expected revenue loss.\footnote{U. S., Congress, House, Committee on Ways and Means, Hearings, Individual Retirement Act of 1955, 84th Cong., 1st Sess., 1955, pp. 34-36.}

A significant development during 1957 was the organization of the American Thrift Assembly which originated primarily to support the bill.\footnote{Among the members were the following: American Bar Association, American Medical Association, American Institute of Certified Public Accountants, American Institute of Architects, National Association of Real Estate Boards, and National Small Business Association.} This group, with a membership in excess of 500,000, was the primary moving force behind the bill.\footnote{Rapp, op. cit., p. 70.}
The bill to give tax benefits on retirement funds of self-employed individuals was passed into law on October 10, 1962. The issues raised during the long period of legislative consideration of the bill influenced the final form of the bill as passed. A summary of the arguments, both pro and con, which were presented during the legislative consideration of the bill to give tax benefits to self-employed individuals on their retirement funds follows.

Arguments Supporting the Legislation

The arguments presented to urge passage of legislation giving tax benefits to retirement funds of self-employed individuals were as follows:

1. Equity
   In order to achieve equity in the tax law, deferment of tax on retirement funds should be allowed for the following individuals:
   a. self-employed individuals
   b. pensionless employed individuals
   c. employees who are inadequately covered under a pension plan


48 This summary of arguments has been prepared from a study of the legislative history and current literature available when the proposals were under consideration. See bibliography for source data.
d. employees under a contributory plan on funds they themselves contribute

e. employees of self-employed individuals with less than three years' service

2. Neutrality
Savings are anti-inflationary and therefore should be encouraged. This legislation encourages savings for retirement.

3. Revenue Loss
The tax is merely postponed by the legislation, not eliminated. The tax revenue is only deferred. It will be received in later years when distributions are made of the pension benefits.

4. Social Effects
Public policy encourages professions and self-employment. This legislation would do the same.

Arguments Opposing the Legislation

The arguments opposing any legislation which would give tax benefits to retirement funds of self-employed individuals were as follows:

1. Equity

   a. Equality is difficult to achieve in any case since the cost of a corporate pension plan is borne by the stockholders, while the cost of a plan for a self-employed individual is borne by the self-employed individual himself.
b. If only self-employed individuals were covered under the legislation, new inequities in the tax law would be created against the following:

(1) pensionless employed individuals

(2) employees who are inadequately covered under a pension plan

(3) employees under a contributory plan on funds they themselves contribute

(4) employees of self-employed individuals with less than three years' service

c. An inequity is created against the employee where rights do not vest, since a self-employed individual's rights vest immediately.

d. To achieve equity, two alternatives exist:

(1) Take away the existing advantages for employees

(2) Eliminate the employer-employee requirement

2. Administration

a. Tax administration would be more complex.

b. Tax reductions would have to be extended to other forms of savings.

c. Any changes should be part of a general tax reform.

d. Another "tax gadget" would be created.
3. Revenue Loss
   a. The revenue loss would be too great.
   b. Some of the lost revenue may never be recovered.
   c. The revenue loss would come at a time when heavy defense expenditures were expected.

4. Social Effects
   a. Tax relief would be given to a particular group of taxpayers.
   b. Those who would benefit most are self-employed professionals in the upper income groups.
   c. Many self-employed individuals do not report large sums of income.

5. Political Effects
   a. When the tax base is reduced, more pressure for special relief occurs since the result would be higher tax rates, which are a positive and harmful control of the utilization of human resources.
   b. Pressure would be applied to have the favorable treatment extended to other forms of savings.

6. Other Considerations
   a. Self-employed individuals have no definite retirement age, and therefore have an advantage over employees. Some were reluctant to be brought under social security.
b. Employer contributions are deferred supplements to income, contingent on some factors. There is no assurance employees would benefit by them. Such is not the case for self-employed individuals.

c. Most wage and salary workers are not covered by pension plans. If they are, unions have bargained for them. Unions have one-third of the workers as members. Average employer contributions are 5 per cent or $220 per year.

The above arguments were the major ones which were presented before the committees of legislators when the proposals to give tax benefits to retirement funds of the self-employed were under study. Next, a brief analysis will be presented of the part which the major considerations played in the early failures of the legislation and its eventual passage. A review of the conflicts arising among the considerations will also be presented.

Relative Weights and Conflicts Among Considerations

During the period from 1951, when the bill to obtain tax benefits on retirement funds was first introduced into Congress, until 1962, when the bill was finally passed, the consideration which outweighed all the others was the practical consideration of the loss in revenue that would result. This consideration had the greatest relative
weight among all the considerations as evidenced by the failure of passage for so many years. It was the major argument presented by the major opponent of the bill, the Treasury Department.

The influence of the Treasury Department's opposition was considerable throughout the period. Not until 1955, when the attitude of the Treasury Department changed and it admitted the existence of an inequity against the self-employed individual with regard to his retirement funds, was a favorable vote obtained in the House Committee on Ways and Means. The Treasury Department had, nevertheless, still opposed the bill on the grounds of the loss in revenue that would occur. The strength of the Treasury Department's opposition and the revenue loss consideration was shown in the following statement:

Many in Congress, while favoring the principle embodied in the legislation have a reluctance, in view of the Treasury Department's opposition, plus the high cost of Government today, to support the measure in their desire to bring about a balanced budget. There is an attitude of postponement until such time as the budget becomes balanced.

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50 Ibid.

Another important consideration was that of equity. This was the major consideration used by proponents of the tax benefits for self-employed individuals with regard to their retirement funds. Throughout the period during which the legislation was proposed, the proponents stressed the inequitable treatment of the self-employed individuals' retirement funds. The majority of those who worked toward passage of the legislation were self-employed professionals who sought to include the pensionless employed and the inadequately covered in order to provide an equitable solution. Their position shifted as evidence indicated the passage of the all-inclusive legislation seemed unlikely. The bill was modified—extending coverage to fewer individuals. In effect, this concession illustrates a trade-off of considerations—a less equitable law for a smaller revenue loss.

The review of the legislative history of this tax proposal indicates how it was modified and remodeled as it was presented for legislative consideration. Proponents, in their attempt to gain passage of the bill, tried to anticipate the objections that would be raised and made

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52 Rapp, op. cit., p. 57.

53 Ibid., pp. 62 and 67.
modifications in the proposal accordingly. They shifted from what they considered the most equitable solution to a somewhat less equitable solution in order to help gain passage. The broad coverage under the original bill was changed to include only the self-employed in order to promote passage of at least some tax benefits. The early objection of the Treasury Department to the large revenue loss would seem to have been at least partially overcome; however, the Treasury Department then criticized the bill on an equity basis.

The major opponent of the legislation, the Treasury Department, again used the equity consideration during the period just before passage. Its arguments included one which stated that the proposal would create inequities and unjustifiable differences in tax treatment. It also stated that the proposed legislation was not an adequate solution to the problem.

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The considerations which would rank next in importance are the social and political effects. Critics were very strong in their objections based on the social effects. They stated that tax relief would be given to a particular group of taxpayers, and especially those in the upper income groups. Political effects were also important. The Treasury Department felt more pressure for special relief and extending tax benefits to other forms of savings would result.

The administration of the tax, especially with regard to simplicity, was considered at various times during the legislative history of the proposal under study. Some of the early proposals were later modified in order to make them more simple to administer. For example, the inclusion of individuals already covered under employee pension plans was thought to make administration of the law too complex in connection with computing the contribution attributable to each employee. The legislative proposal was rewritten and these individuals were excluded. The Treasury Department also objected to the entire proposal on the grounds that tax administration


59 Rapp, op. cit., p. 62.
would be made more complex by passage of the legislation. The simplicity consideration did influence the form of the bill and was an important consideration. This demonstrates how equity was sacrificed to make the law more simple and to ease the administrative difficulties.

In reviewing the other considerations, one finds difficulty in determining the weight each was given when the proposal was being evaluated by the legislators. One can say, however, that relative to the considerations that have already been discussed the remaining ones played minor roles in the legislative consideration of the bill. For example, the argument that savings are anti-inflationary and should be encouraged was raised at a time when methods to curb the inflation were being considered. The bill did not pass at that time. Had this consideration been more important, the proposal should have passed. There was no evidence that the tax neutrality consideration entered into the arguments in any other way.

A review of the considerations which arose during the lengthy history of the proposals indicates that conflicts

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arose among some of them. The major conflict arose between the two main considerations--revenue loss and equity. As already discussed, the conflict was partially resolved as the bill was modified to cover fewer individuals. This lessened the anticipated revenue loss. In order to gain final passage, the deduction limit of 50 per cent of contributions further reduced the expected revenue loss and again equity was sacrificed for a reduction in the revenue loss. This conflict between the anticipated revenue loss and equity had the greatest effect on the form of the bill passed as the Self-Employed Individuals' Tax Retirement Act of 1962.

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62 The maximum in the House bill had been $2,500 and the maximum in the Senate Finance Committee had been $1,750. The amendment was made by Russell B. Long who stated it would make pension plans of the self-employed consistent with other plans where the employer's contribution is not taxed until withdrawn on retirement and the employee's contribution comes from his after-tax salary. Also, the amendment might forestall a Presidential veto of H. R. 10. For further discussion, see Congressional Quarterly Almanac, op. cit., p. 535. Administration opposition would be reduced also since the tax loss to the Treasury would be less. See Congress and the Nation 1945-1964 (Washington, D. C.: Congressional Quarterly Service, 1965), p. 1325.

Provisions of the Act

The efforts in behalf of the self-employed individuals to gain tax benefits on retirement funds culminated in the passage of the Self-Employed Individuals' Tax Retirement Act of 1962. The bill, as passed on October 10, contained the following provisions, briefly stated:

1. An owner-employee may contribute on his own behalf up to 10 per cent of earned income or $2,500, whichever is smaller.

2. The owner-employee may deduct for tax purposes 50 per cent of such contributions made in his own behalf. The maximum deduction is $1,250.

3. In order to qualify for the tax deferment, the owner-employee must cover all his employees with three or more years of service.

4. The pension plan must provide for full and immediate vesting of benefits for all covered employees.

5. Where both capital and personal services are material income-producing factors in a trade or business, "earned income" is defined

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65 An "owner-employee" is a self-employed individual who owns the entire interest in an unincorporated business (i.e., a sole proprietor) or, if a partner, owns more than 10 per cent of the capital or profit interest of the partnership.
as not more than 30 per cent of net profits from that business for computing the amount of retirement contribution.66

Further provisions of the law indicate the penalties applied in the case of excessive contributions. Also prescribed are the methods permitted for investment of the retirement savings.67 The law also describes the timing of distributions, penalties for early withdrawals, and the taxation of lump-sum distributions.68

Developments Since Passage

After the bill was passed into law, the issues were not entirely resolved. Because of the changes made to the early proposals, some felt the inequity against the self-employed individual in the matter of taxation of retirement funds still existed. Critics of the law, as passed, pointed to the actual experience of usage of the Act's provisions by the self-employed to support their charges. The findings and recommendations of a special Senate Committee tended to reaffirm the position that

66 Tax Savings Plans for Self-Employed, op. cit., p. 18. If the share of net profits from the business did not exceed $2,500, the entire amount of the share could be considered earned income. The 30 per cent rule could not reduce earned income below $2,500.

67 Ibid., pp. 12-17.

68 Ibid., pp. 23-26.
the Act, as passed, did not provide sufficient incentive to promote usage of the provisions under the Act to the extent desirable.69

A report by the Treasury Department indicated that only about .5 per cent of the self-employed took advantage of the Act during 1964. When the Act was passed, the Treasury estimated the cost at $115 million for the first full year. As late as 1964, the actual cost amounted to only $9 million.70 One witness testified that only 15,000 persons had been covered by plans under the Act, out of 7 million who were eligible.71

Mainly because of the very small response of the self-employed individuals to the tax deferral offered by the Self-Employed Individuals Tax Retirement Act of 1962, amendments were passed in 1966 which liberalized the provisions of the Act.72 One amendment permits a 100


70U. S., Congress, House, Contributions by Self-Employed Individuals to Pension Plans, etc., 89th Cong., 2d Sess., 1966, Rept. 1557, p. 3.


per cent deduction on the contribution to the retirement plan instead of the 50 per cent deduction. "Earned income" was redefined as 100 per cent of net earnings from self-employment, instead of the 30 per cent, for businesses in which capital and personal services were material income-producing factors.73

The arguments supporting the amendments were:

1. There was an exceedingly small response to the Self-Employed Individuals' Tax Retirement Act of 1962.

2. Congress intended the tax deferral to be available for self-employed individuals in a manner comparable to that of employees.

3. Treasury estimates far exceeded actual revenue loss. This indicated the act did not carry out its objectives.

4. Since, in effect, self-employed individuals' plans had to be contributory and since nearly 75 per cent of the corporate plans were noncontributory, an inequity was created.

5. The 30 per cent limit was "too restrictive." It discouraged small proprietors, and especially farmers, from setting up pension plans.74

The Treasury Department was again the major opponent with the following objections:

1. The revenue loss was completely inconsistent with the economic situation and the war in Vietnam.

2. Benefits would go mainly to highly paid doctors, dentists, and lawyers.

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73Ibid. 74Ibid., pp. 3-4.
3. The liberalizations would attract more high-income individuals into pension plans.

4. An overall reevaluation of the pension system should be made.

5. The deferment of tax on investment income is inconsistent with the basic concept of pension provisions. The minimum amount treated as personal service earnings should be raised.75

The main objection to the liberalizations of the Self-Employed Individuals' Tax Retirement Act of 1962 was again the revenue loss. The strongest force must have been the arguments that the response to the Act was exceedingly small. The findings of the Senate's Special Committee on Aging and the recommendations made by the Committee provided additional support for the amendments. The amendments became effective for tax years beginning after December 31, 1967.76

Evidence indicates there has been an increase in the number of self-employed individuals taking advantage of the changes in the law. More than five times as many plans were approved by the Internal Revenue Service in 1968 (when the new rules became effective) than in the previous year.77 Even with these amendments, the tax

75 Ibid., pp. 16-18.


benefits available to employees covered under a qualified corporate pension plan exceed the benefits available to the self-employed individual. An inequity still exists.

Before attempting to propose a solution to the problems existing in this area of taxation, some further insight might be obtained by looking at the tax regulations in other countries which have a tax system similar to that of the United States.

Practices in Other Countries

While the long struggle by the self-employed individuals to gain tax benefits on retirement funds was taking place in the United States, progress was being made in changing the tax laws of other countries to provide for similar benefits. A brief discussion of the taxation of retirement funds in Great Britain and Canada follows, with a look at the provisions in the tax laws of Australia and New Zealand.

Great Britain

One of the first countries to pass legislation giving tax relief to the self-employed was Great Britain. Effective April 6, 1956, Part III of the British Finance Act included a provision which enabled the self-employed and pensionless employed to deduct from amounts taxed any premiums paid on retirement annuity policies and also
contributions made to approved retirement trust plans. The annuity payments would be included in taxable income when paid.

The first formal consideration of the problem started in 1950 when the Tucker Committee was appointed to study the situation. Recommendations were presented in 1954 which were later approved with certain modifications and passed into law as a provision in the Finance Act of 1956. The provision was described as giving self-employed individuals and the pensionless-employed individuals "a measure of fiscal justice."

More specifically, Part III of the Finance Act contains provisions by which taxpayers are put on almost a par with employees participating in tax-exempt pension plans. Persons eligible are individuals engaged in any taxable trade, profession, vocation, office or employment. The Act applies to individuals who derive earnings from

80 Rapp, op. cit., p. 68.
two sources (one with pensionable rights and the other without), employees who are not entitled to participate in their employers' pension plans, and employees who choose not to join their employers' pension plans. In other words, the British law applies to all persons except those engaged in a "pensionable office or employment" in connection with which there is a "sponsored super-annuation scheme." The annuity contract must be approved by the Commissioners of Inland Revenue. The approval is granted if the contract meets certain specified conditions.

82 Kent, op. cit., p. 222.

83 Approval is granted if the contract is made with a life insurance company in the United Kingdom and if the contract contains the following provisions: annuities must be the only benefits, benefits must not begin before age 60 or after age 70, benefits must be confined to annuities to the insured or surviving spouse, the annuity must be for the life of the annuitant, and the annuity must not be capable of surrender, commutation, or assignment. Only in the case of death is there a lump sum repayment of premiums with interest.

A later section permits the approval in certain cases of contracts not meeting fully the above-described conditions. For example, an annuity may begin before age 60 on retirement through illness or when some earlier age is customary in the occupation; however, it may not begin before age 50.

The funds may be accumulated through purchase from an approved insurer of noncommutable, nonassignable annuities or by contributions to an approved trust. In the case of a trust, the trust must be established for the benefit of individuals connected with a particular occupation or group of occupations. The trust is not subject to income tax. If no trust is established, the individual must use the annuity-funding method. (For further discussion, see Rapp, op. cit., p. 68, and Kent op. cit., pp. 222-223.)
Eligible persons are allowed a deduction for income tax purposes up to the lesser of 10 per cent of relevant earnings or $2,100 on amounts voluntarily set aside for retirement. Relevant earnings are described as earnings from an office or employment (other than a pensionable office or employment) or from a trade, vocation, or profession. If an individual has income from both pensionable and nonpensionable sources, the $2,100 limit on the deduction is reduced by one-tenth of his pensionable compensation. A provision is included which allows a carry forward privilege if relevant earnings are not sufficient to allow the full amount during the current year. The stated limits were increased for individuals over 40 years of age at the time of passage of the act to enable the individuals to create an adequate annuity.

With regard to the passage of this legislation, reaction in the United States is indicated by the following statements:

Britain has become the first major nation in the world to accept the principle that under today's tax laws, a corporate employee covered by a pension plan gets a great tax break not available to the self-employed wanting to build his own retirement program. Britain formally has admitted a glaring injustice exists.

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84 Rapp, op. cit., p. 68.
85 Kent, op. cit., p. 223.
86 Ibid.
Bill after bill has been introduced into Congress with the sponsorship of both Republicans and Democrats—only to be killed because of protests that the move would cost the Treasury too much in revenue.87

After Britain took the initial step in passing legislation expanding tax benefits on retirement funds, Canada and New Zealand followed with similar legislation the next year.

Canada88

The Canadian treatment of retirement funds is similar to the British plan in a number of areas. In 1957, Canada adopted legislation allowing a tax deduction to individuals for amounts voluntarily set aside for retirement purposes. The Canadian Plan was called the Registered Retirement Savings Plan. It was the result of ten years of effort by professional groups to obtain equality of tax treatment with respect to private pensions.

All persons having earned income are entitled to the benefits under the plan. The self-employed and the pension-less employed are permitted an income tax deduction up to


the lesser of 10 per cent of earned income and $2,500 for amounts paid as premiums under a Registered Retirement Savings Plan.

Unlike the British plan, under Canadian law no provision is made for a carryover of unused deductions where the amounts are contributed in excess of the allowable deductions. Those covered by a qualified employee pension plan may deduct only the difference between their own contributions under the employer-sponsored plans and an amount equal to the lesser of 10 per cent of their earned income and $1,500.\(^8\)

Withdrawals must be in the form of equal annual installments for life. Lump sum payments are not permitted except in the case of the death of the participant before

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\(^8\) Under the Canadian plan, three permissible forms of investment exist: (1) a life annuity policy purchased from licensed insurers, or life insurance to the extent of the savings element, (2) the savings or investment contract purchased from an authorized corporation which provides for the payment of a fixed or determinable amount at maturity, and (3) a corporate trust. When contracts or corporate trusts are used, the funds must, at maturity, be used to provide the individual with an annuity for life. Once contributions are made, borrowing or assignments are not permitted. Withdrawals may begin at any time, but they must begin no later than age 71.
retirement. Distributions are taxed at regular income tax rates as they are received.\textsuperscript{90}

While the Canadian plan was initiated by professional groups, the law as later passed included all persons having earned income who were not already adequately covered by an employer pension plan.

**New Zealand\textsuperscript{91}**

In 1957, New Zealand also adopted certain changes in its income tax laws which gave limited tax relief to self-employed persons in regard to savings for retirement. Under prior law, a tax deduction of the lesser of 15 per cent of assessable income and $490 was allowed to taxpayers for premiums on life insurance policies and employee contributions to approved pension plans. The legislation, enacted in 1957, allowed the self-employed a total deduction of $700 for life insurance premiums and contributions to approved retirement plans for the self-

\textsuperscript{90}Death benefits are subject to a flat tax rate of 15 per cent. Provision is made for participants who desire to withdraw savings before maturity. The qualifying provisions of the policy may be cancelled so that it is no longer eligible for registration. Distributions after the de-registration will be taxed as regular income subject to withholding at the source at the rate of 25 per cent, the minimum tax payable. An automatic penalty would be incurred if a lump-sum distribution was made since the amount would be taxed at the individual's highest bracket rate.

\textsuperscript{91}Rapp, op. cit., p. 78; and Taxation in New Zealand (New York: Haskins & Sells, 1967), p. 50.
employed. The Commissioner of Inland Revenue does not require each occupational group to operate its own plan, but will approve standard plans to be submitted by life insurance companies and the National Providend Fund. Benefits are payable only in the form of annuities, with or without survivorship privileges, beginning not earlier than age 60.

Australia

The Australian tax law contains similar provisions. Contributions by employees and employers to a fund for employees, and contributions by members of a fund for the self-employed, are deductible from income. The amount of the deduction is limited to the greater of $400 or 5 per cent of the employee's remuneration. If the employee contributes to the plan, the maximum annual amount allowed as a deduction is slightly higher. Upon retirement or termination of employment, 5 per cent of the lump sum payment is taxable. Annuity payments are fully taxable. If tax was already paid on part of the contribution (i.e., if it exceeded the allowable amounts), this may be excluded. The income of pension funds is exempt from

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taxation if operated for the benefit of employees. In the case of self-employed individuals, conditions for exemption of the fund are entirely discretionary with the tax commissioner.

Summary

Other countries with tax systems similar to that of the United States have made provisions in their tax laws to permit some tax benefits to self-employed individuals and also pensionless employed individuals who wish to set aside funds for their retirement. In Great Britain, the legislation was passed as early as 1956, while in Canada and New Zealand legislation was passed in 1957.

The basic provisions of the tax law pertaining to the treatment of retirement funds in these countries are similar to those of the United States. The major difference appears to be in the coverage. In the United States, no tax benefits are allowed employed individuals who are not covered or who are inadequately covered under an employer-sponsored retirement plan. In the countries discussed, favorable tax treatment for retirement plans include the pensionless employed and—in all but one country—those inadequately covered by an employer plan.

Restrictions to the plans—which are similar to those in the United States' tax law—stated the type of plan
necessary, the age limits on withdrawal of benefits, the method of distribution, and limitations on amounts contributed annually. When individuals contribute to any plan meeting the requirements, the contributions within the limitations are allowed as a deduction from taxable income. In other words, tax is deferred on these amounts until paid back to the individual during his retirement years. Regular tax rates are applied to the amounts distributed during retirement unless lump-sum distributions are made which are allowed special tax treatment.

One finds difficulty in determining the extent to which the United States' tax law was influenced by the events in other countries. Evidence indicates that proponents of the legislation in the United States could have used the tax laws of other countries to add further support to their arguments for passage of the bill allowing tax benefits to self-employed individuals in the matter of retirement funds.

**Conclusions**

This study of the legislative history of the law pertaining to retirement funds reveals the characteristics necessary in any proposed revisions in the tax law. Ideally, a proposed revision would possess the following characteristics:
1. Equity in the highest degree, i.e., coverage extended to all individuals.

2. Minimum loss in governmental revenue.

3. Simple administration, i.e., a clearly defined tax base and a tax liability determinable with relative ease.

4. Flexibility, i.e., retirement objectives achieved by greatest number of individuals with a maximum degree of individual choice.

5. Social effect of encouraging individual savings resulting in less dependence on government aid; and also, encouraging, at least not discouraging, professions and self-employment.

6. Political effects of minimizing pressure for other changes, e.g., providing similar benefits for other forms of savings.

While this list of ideal characteristics may serve as a guide in drafting a proposed revision in the tax law, an assumption that this ideal could be achieved is unrealistic. As indicated by the review of the legislative history, conflicts are resolved by tradeoffs among the considerations.

The legislative history revealed that the greatest conflict arose between equity and the revenue loss. In terms of difficulty, the revenue loss factor is the one that causes the problem since Congress is unlikely to pass legislation that reduces governmental revenue at a time when heavy expenditures are expected. To overcome this conflict is difficult, especially when government
social programs have continued to expand. Perhaps with a change in budgetary policy, the conflict could be resolved. A change in attitude regarding emphasis in tax policy would also be effective. As was indicated by the review of practices in other countries, their tax laws are ahead of the United States' tax law with regard to equity in the taxation of retirement funds.

This area of the tax law does need revision. In the concluding chapter, a proposal for revision of the tax law will be presented which will attempt to correct the inequities existing in the taxation of retirement funds.
CHAPTER IV

CONCLUSIONS AND RECOMMENDATIONS

This study originated in order to determine whether or not an inequity exists in the taxation of retirement funds of self-employed individuals as compared to employed individuals participating in a qualified pension plan. If an inequity was found, a further goal became the development of a proposal to change the tax law in order to correct the inequity.

In order to determine the existence of an inequity, the first step was to define "inequity" as it applies in the tax law. Next, the existence of the inequity with regard to retirement funds of self-employed individuals was discussed and its existence was proved.

Before an attempt could be made to set forth a proposal to correct the inequity in the taxation of self-employed individuals' retirement funds, a determination of the considerations important in a proposal to change the tax law became necessary. In order to help make this determination, a study of the legislative history of the law that gave tax benefits to individuals with regard
to retirement funds was conducted. Special attention was
given to the changes in the tax law which created the
differences in the tax treatment of retirement funds and
also to a detailed study of attempts to gain benefits for
self-employed individuals' retirement funds.

This study of the legislative history revealed the
relative weights given the considerations when legislative
proposals were under study. It revealed those which were
most important in initially extending tax benefits to
retirement funds, as well as the effect of pressures to
extend benefits to other groups. The considerations which
were important in rejecting and finally yielding to the
pressures were also revealed. The conflicts that arose
among the considerations and the compromises that were
made in order to effect a solution were examined. The
study also indicated the reasons that the enactment of
the legislation came after such a long period since the
bill was first introduced.

Knowledge of the considerations and their relative
weights are helpful when an attempt is made to draft a
proposal. For example, the revenue loss objection weighed
very heavily in opposition to the proposed legislation.
It caused modifications in the law as finally passed.
When the present proposal is considered, major emphasis
should be on equity and one should stress that revenue
loss should not bar equity. Revenue loss could be dealt with by means other than denying equity to particular groups. For example, rates could be increased.

In order to gain further insight into the problem and its possible solutions, the tax regulations of several other countries with tax systems similar to that of the United States were described as they pertained to the taxation of self-employed individuals' retirement funds. These tax regulations indicated that emphasis was placed on equity. The tax law extended benefits on retirement funds to individuals on a much wider scale than in the United States. The changes in their laws came several years ahead of the initial changes in the United States tax law which gave partial benefits to self-employed individuals. The experiences in these countries provides further support for any proposal which would place emphasis on equity in the tax treatment of retirement funds.

The problem now becomes one of developing a proposal which will be acceptable and which will provide a more equitable law with regard to the taxation of retirement funds of self-employed individuals. To these ends the remainder of the chapter will be directed.
Proposal for Change in Tax Law

This study initially set out to develop a proposal to correct the inequity existing in the taxation of retirement funds of the self-employed individual. As the study progressed, the necessity of drafting an equitable proposal involving a much broader scope than originally intended became evident. The proposal which follows has been designed as a substitute for certain sections of the present tax law pertaining to retirement funds. The purpose of the proposed change is to alleviate the inequities which currently exist with regard to the taxation of retirement funds.

To repeal Section 401 of the Internal Revenue Code and its related provisions pertaining to qualified pension plans would cause unnecessary complexities, especially for existing corporate plans. The approach suggested as a result of this study is to repeal the sections of the Internal Revenue Code pertaining to taxation of self-employed individuals' retirement funds and the tax-sheltered annuities, and to substitute a proposal which would give these individuals and those other than adequately covered employees the incentive to participate in a program for retirement. One should note that adequately covered employees would still follow the rules under Section 401.
Brief Description of Proposed Changes

The proposal which shall be presented contains several changes in the tax law. Each of the changes will be discussed briefly.

Coverage.—First, under the current tax law, many individuals are either not extended tax deferral benefits or are inadequately covered under an employer-sponsored plan or a self-employed individual plan. Under the proposal presented, all individuals with earned income—except those adequately covered under a qualified plan—will be eligible to participate.

Contribution limits.—Contribution limits vary under the existing tax law. For example, under a qualified corporate plan there is no limit to the amount of contribution that may be made as long as it is considered reasonable additional compensation. Self-employed individuals are limited to the lesser of 10 per cent of earned income and $2,500. The proposal states no limit to the amount of contribution except in the case of an employer who contributes to a plan in behalf of an employee, in which case the contribution is limited to reasonable additional compensation. This provision is the same as that existing at present under qualified plans. Also, under present law, penalties are imposed on self-employed
individuals who contribute amounts in excess of the contribution limit. No penalties exist for corporate contributions to plans. Under the proposal, no penalties shall be imposed.

**Tax benefit limits.**--The current tax law allows tax deferments on several different percentages of earnings. Corporate employees covered under qualified plans are allowed 5 per cent or the normal cost plus certain amounts. Tax-sheltered annuity participants are allowed a 20 per cent deferral. Self-employed individuals are allowed the lesser of 10 per cent of earned income or $2,500. The proposal that shall be presented allows all individuals with earned income a tax credit applied to a maximum of 15 per cent of earned income. In other words, the amount that an individual may contribute is not limited; however, the amount of contribution on which the individual gains tax benefits is limited.

**Past service.**--The current tax law gives recognition to past services of employees covered under a qualified corporate plan; however, no recognition is given self-employed individuals. The proposal will extend recognition for past services to all individuals.

**Vesting.**--The current tax law also calls for different degrees of vesting of pension rights. Qualified corporate plans are allowed a choice of complete, partial or no
vesting until retirement. Immediate vesting is the rule for tax-sheltered annuity participants as well as self-employed individuals and their employees. The proposal requires immediate vesting of rights to pension fund contributions.

_**Distributions.**—Under the current law, distributions under a qualified corporate plan are taxed as ordinary income unless received in a lump sum. Under a lump sum distribution, the portion attributable to employer contributions are taxed as ordinary income with a special averaging method and any capital appreciation or earnings of the fund are taxed as capital gains. Distributions under a self-employed individual's plan are taxed by a special averaging method. The proposal would treat all distributions alike and use the method as described above for qualified corporate plans.

_**Withdrawals.**—Under corporate plans at present, withdrawals of voluntary contributions are permitted if they do not affect the member's participation in the plan, the employers past or future contributions or basic benefits. If an individual desires to discontinue participation, he may withdraw his own contributions plus interest. In the case of a self-employed individual, a penalty is provided for early withdrawals—10 per cent is added to the tax payable. Also, he is disqualified
from participating in the plan for five years. Under the proposal, withdrawals are permitted only in cases where the individual desires to discontinue participation in the plan.

_Treatment on tax return._—At present contributions to retirement plans, within the deduction limits, are treated as exclusions in the cases of covered employees and tax-sheltered annuity participants. Contributions to retirement plans within the deduction limits for self-employed individuals are treated as deductions for adjusted gross income. Under the proposal presented, a tax credit would be given in the amount of 15 per cent of the retirement contribution which does not exceed 15 per cent of earned income.

Each of these changes will be discussed in detail along with the reasons for the proposed changes in the tax law. The proposal contains the provisions as explained below.

_Coverage and Agreement_

Any employer or individual with earned income can establish a retirement plan for the benefit of his employees or for his own benefit which qualifies for a tax credit. In order to do so, the employer or individual enters into an agreement whereby contributions are placed
in an approved depository for investment. This agreement specifies the provisions under the pension arrangement which govern management and distribution of the fund.

The agreement may contain a definite benefit plan which states the benefits to be received after retirement. Contributions to the plans are determined in advance by a formula and the contribution is the variable factor. Or, the agreement may contain a money purchase plan in which the contribution is fixed and the benefit is the variable factor. Benefits are the amounts which can be provided by the sums contributed.

Under present law, if an employer makes contributions in behalf of an employee, deductibility for tax purposes is limited by the reasonableness as additional compensation. If a definite benefit plan is used, the amount deductible is that which would provide actuarial soundness. On the other hand, a self-employed individual has limits imposed on his contributions, thereby limiting his choice of plan to the money purchase (definite contribution) plan.

1Approved depositories would be: a corporate fiduciary institution as trustee, an insurance company, authorized bonds, or approved mutual funds. Approval would be given by the Internal Revenue Service.

Under the proposal, no limits are placed on contributions even though there is a limit on the amount of contribution on which a tax benefit will be derived. Also, either the definite benefit or definite contribution type of plan is made available for all individuals with earned income. Where an employee is adequately covered under a corporate plan, contributions in his behalf will be subject to the limitations mentioned; whereas, a self-employed individual has no limits imposed. One finds difficulty in achieving equity in the case of the adequately covered corporate employee as compared to the self-employed individual because of the necessary restraints on employer contributions and the difficulty of placing comparable restraints on a self-employed individual.

The agreement used in establishing a retirement plan should be as simple as possible in order to prevent discouraging its use. It should be clearly written and easily understood. Simplicity enforces the social good factor by encouraging more individuals to provide for their own retirement with less dependence on government aid. If more individuals take advantage of retirement programs, fewer would have to depend solely on social security which is often criticized as being insufficient to meet the essentials for a satisfactory retirement.
Equity is hereby increased since all individuals with earned income may come under the same provision in the tax law with the exception of an employee covered under a qualified corporate plan who feels he is adequately covered. Some equity is traded for simplicity. The most equitable solution would have been to eliminate the entire sections of the Internal Revenue Code which deal with taxation of retirement funds and to substitute a new proposal. Then, everyone would come under the same provision. In the interest of simplicity, this was not done.

The tax laws of the other countries studied were ahead of the tax law in this country with regard to correcting inequities in taxation of retirement fund contributions. Tax benefits on retirement funds were extended to a very broad group. Perhaps legislators could have benefited by looking at the experience in other countries when similar proposals were presented in the United States.

Contributions

Contributions can be made by an individual or by an employer in behalf of an employee. No dollar limitation is placed on contributions if made by an individual for his own benefit. If made by an employer for the benefit of an employee, the contribution can not exceed what is considered reasonable additional compensation.
If the contribution exceeds the tax benefit limit, the excess is not allowed the tax benefit in computing the tax. The amount contributed is not limited, but the amount on which tax benefits will be given is limited to 15 percent of earned income. Excess contributions have the advantage of tax-free earnings accumulation.

This provision should tend to prevent abuse by employers since they would be limited to contributions on behalf of employees which are reasonable additional compensation. It should also eliminate the need for the complicated nondiscrimination section as it appears for qualified corporate plans at present since employees would be able to obtain the tax benefits on funds they invest on their own in a retirement fund. This should not discourage employers from covering employees since the contributions cost the employer less than a wage increase which would have to be substituted.

Simplicity is gained, as is ease of administration; however, compliance and ease of enforcement may be sacrificed, as guidelines for reasonable additional compensation must be agreed upon. 3

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The flexibility factor is aided by the provision of no dollar limitation. This provision would not hinder an individual in contributing what he believes would be sufficient to provide for his retirement even though the tax incentive would be less since any amount contributed over the tax benefit limit would be done with after-tax dollars. Some tax incentive would remain since earnings on contributions accumulate tax-free in the retirement fund. 4

Under present law, there is a contribution limit for self-employed individuals. Severe penalties are imposed if this limit is wilfully exceeded, i.e., the plan will be disqualified. 5 No penalties exist for corporate employees. The proposal treats all individuals alike in this regard.

Tax Benefit Limits

The maximum amount allowed the tax benefit is 15 percent of earned income. 6 Amounts contributed to a retirement plan will be deductible by the employer when made in an employee's behalf. All contributions are included in the gross income of the individual for whose benefit they were made. The individual will receive a tax credit on


6Earned income is defined as that which is subject to social security and self-employment taxes, but with the following exceptions. The limits imposed will be disregarded and ministers and others exempted from social security will be included.
contributions made by his employer in his behalf or made by himself to a retirement plan for amounts within the 15 per cent limit. The maximum amount allowed the tax credit would be reduced by contributions made either by the individual himself or by an employer in his behalf to an existing plan on which a deferment is obtained.

The 15 per cent of earned income allowed tax benefits was selected after viewing the present tax law. Some individuals who participate in corporate pension, profit-sharing and stock bonus plans may gain a tax deferral as high as 25 per cent of income. Others participating in tax-sheltered annuity plans obtain a deferral on 20 per cent of their income while the self-employed are allowed 10 per cent up to a stated limit. Corporate employees participating in pension plans only may have taxes deferred on 5 per cent or more of their income.

This proposal would result in a more equitable treatment since all individuals with earned income have the opportunity to obtain tax benefits on amounts contributed to a retirement fund up to the 15 per cent limit. The 15 per cent of earned income represents a systematic pattern which determines the degree of difference among individuals receiving the tax benefits.

The 20 per cent allowed at present for certain public employee participants in the tax-sheltered annuities would
not be allowed; however, until the entire Section 401 of
the Internal Revenue Code is revised, there will be some
differences existing since an employee who feels he is
adequately covered may continue under the Section 401
requirements. As was stated earlier, some equity is
sacrificed for simplicity at this time.

In cases where an individual participated in more
than one pension plan, the overall limit would be the 15 per
cent tax credit. If a covered corporate employee were also
covered under a plan as a self-employed individual, his tax
credit would be 15 per cent of earned income less any amount
on which tax was deferred under the corporate plan. The
Section 401(a)(7) overall limitation of 25 per cent would
also remain in cases where employees also participate in
stock bonus and profit-sharing plans. The limits under
each different type of plan would have to be observed, and
the total of all benefits could not exceed the 25 per cent. 7

7 Under the present law, the limit under a stock bonus
plan is 15 per cent of earnings, and the limit under a
profit-sharing plan is also 15 per cent of earnings. The
corporate employee who is also self-employed has no overall
limits to contributions to more than one pension plan. He
may participate in the corporate pension plan and also
under a self-employed pension plan as long as he follows
the limits for each. He may not, however, be covered under
more than one self-employed pension plan to an extent greater
than the 10 per cent, $2,500 limitation. See Tax Savings
Plans for Self-Employed (Chicago: Commerce Clearing House,
In proposing the benefits apply to 15 per cent of earned income, one must justify the exclusion of unearned income. The major argument generally advanced supporting more favorable tax treatment for earned income is equity, i.e., a person with a given amount of earned income has less ability to pay than another with the same amount of unearned income. Three reasons support this statement:

1. The owner of a capital asset is allowed to deduct in full an allowance for depreciation and maintenance of the asset. Earned income recipients do not have this benefit, yet their productive capacities decline as they grow older and are exhausted.

2. The expenses of earning an income are not fully accounted for by income tax deductions, e.g., car fare, lunches, clothing, etc.

3. Psychic costs are involved in earning an income as well as sacrifice of leisure.8

The second reason above could be solved by liberalizing deductions allowed and the third reason is questionable since costs and sacrifices are also involved in acquiring unearned income. The first reason above merits investigation.

Since one would find difficulty in measuring an expenditure for depreciation and maintenance of a human

asset, one alternative would be to give more favorable tax treatment to earned income that is set aside in a retirement program for years when the individual is less productive and his earning capacity diminishes. The proposal, by allowing the tax benefits on earned income only, attains a greater degree of equity than exists at present.

Aside from this argument, the individual who does not have earned income but has income from investments in securities and property has, in effect, his own retirement savings program. The interest, dividends, and rentals received would serve as retirement funds and he would probably have less need to be included under a formal retirement program.9

Recognition for Past Services

When initiating a retirement program, the individual may also gain tax benefits on any amounts that are necessary to make the plan actuarially sound based on past services rendered. Past service costs must be spread over a period of ten years in order to obtain the tax benefits.

This provision is similar to the one included for qualified plans. In order to achieve equity in the

9He also has other tax benefits available, such as: capital gains treatment, retirement income credit, tax-free earnings on state and municipal investments.
taxation of retirement funds, past services are recognized as they are under qualified corporate plans. The spreading of past service costs over a ten-year period is also necessary to make the proposal comparable to the one for employees covered under a qualified corporate plan. The reason for the spreading of costs was to prevent taking them all in one period when, in fact, the past service extended over several or many past periods. It also prevents tax abuse. Without the spreading of past service costs, a plan could be initiated in a year when a large profit was expected. Past service costs would then be used to reduce the amount of taxes paid. Simplicity is gained also by having all past service costs treated alike.

Immediate Vesting

Under this proposal, rights to the funds contributed vest immediately with the individual. Corporate plans differ in the degree of vesting of rights to funds contributed. The Internal Revenue Code gives much flexibility on this point. Until 1962, the Code did not require vesting of credits upon plan termination. The trend recently, however, has been to encourage some degree of vesting.

This proposal includes immediate vesting of rights to funds contributed. The reasons for this are several.

First, flexibility and neutrality from an individual
standpoint are aided since the employee has more freedom in the selection of his employer, occupation, and location. Also, the tax remains a neutral factor in his decisions since rights to the funds would follow him. Labor mobility is not hindered.

The vesting of rights with the individual would encourage participation in retirement plans. The encouragement of retirement savings is generally accepted as being socially desirable. Another reason favoring immediate vesting is that pension contributions (as well as other fringe benefits) are generally considered substitutes for wages and rights to the funds should go to the individual. Also, an individual who makes contributions in his own behalf would have immediate vesting and equity would be aided with the similar treatment among individuals. Simplicity would also be aided in that administration would be less complex if all contributions were treated in the same manner.

Employers usually object to immediate vesting because of cost factors. Also, they fear increased mobility of labor with the resulting loss of desirable employees.\textsuperscript{10} If cost is a serious consideration, another alternative would be a contributory plan in which employees also make

contributions. As far as holding good employees, other company practices--such as the opportunity for advancement and availability of other fringe benefits--would serve to accomplish the purpose. The vesting of rights is desirable from the standpoints of simplicity, flexibility, neutrality, and equity.

Earnings of the Fund

Under this proposal, earnings of the retirement fund are not subject to income tax. The tax-free earnings of these funds raises a question of equity. Investments should all be taxed or should all be exempt from tax. In other words, all investments should be treated alike. However, this is another problem which is beyond the scope of this study. Since earnings on funds invested in qualified corporate pension plans are not subject to income tax, this provision was included in the proposal. In other words, the same exemption for earnings on pension fund investments is given to all. Partial justification for this provision is that it further encourages retirement savings which is a socially desirable objective. The provision represents a tradeoff. Equity is sacrificed in order to attain a socially desirable objective--the incentive to set up retirement programs. The President's Committee on Corporate Pension Funds and Other Retirement
and Welfare Programs supports this provision. In the Committee's findings, published in January, 1965, the following appeared:

The basic justification for the indirect public subsidy involved in favor of tax treatment lies in the social purposes served by private pension plans. In view of these social purposes, public policy should continue to provide appropriate incentives to private plan growth...¹¹

One should note that the tax-free accumulation of earnings on the fund is the principal advantage to the employer. If in fact fringe benefits such as a pension plan are a substitute for wages, then there is little tax advantage to the employer in the deductibility of contributions for employee plans since an increase in wages would be tax deductible also. There is an advantage to the employer in that an element of postponement exists with pension contributions as compared to wage payments. The advantage to the employer of the tax-free accumulation is that the amount that would have been paid out in taxes is invested and has its own earnings. The accumulation keeps building until paid out in benefits. One other advantage to the employer is that he can cover key

personnel as long as the contributions are reasonable
additional compensation. If tax-free accumulation of
pension fund earnings were eliminated, employers may not
have as much incentive to set up plans. This would hinder
the social objective of encouraging retirement savings.

Distributions

Distributions would be taxed as ordinary income when
received upon retirement, permanent disability or death.
If a lump distribution is made, the portion attributable
to employer or individual contributions would be taxed as
ordinary income with an averaging method available;\(^{12}\) the
portion attributable to capital appreciation would be
taxed at capital gains rates. Any portion attributable
to individual contributions which were made after taxes
had been paid would be nontaxable.

Since distributions from corporate plans are taxed
as ordinary income at the time they are received, the same
provision is included in this proposal. At this time, the
taxpayer is usually in a lower income tax bracket and may
have additional exemptions, thus further encouraging
retirement savings because of the possible tax benefits.

\(^{12}\)The tax would be 7 times the tax increase that
would occur if \(1/7\)th of the ordinary income were added to
other taxable income reduced by compensation from the same
employer in the distribution year and the capital gain
element of the distribution. This provision is the same
as that for qualified plans under the Tax Reform Act of 1969.
Prior to the Tax Reform Act of 1969, lump-sum distributions from qualified corporate retirement plans were given the favorable capital gains treatment. This was changed by the Act. Distributions are now taxed in two parts. The portion attributable to employer contributions is taxed as ordinary income with a special averaging method. The portion attributable to capital appreciation is taxed at the capital gains rates. The law is more equitable with this change. The capital gains treatment accorded capital appreciation when distributed is in line with the capital gains treatment accorded other forms of capital investment. In the future, if capital appreciation is not given capital gains treatment for other investments, then it should not be given in the case of pension plan funds.

An alternative to the taxation of distributions from pension funds would be to tax the individual when the contribution is made and to exempt the distributions from tax. The major argument against this at the present time is that in cases where rights do not vest with the employee

13 The tax on the ordinary income element is seven times the tax increase that would occur if 1/7th of the ordinary income were added to other taxable income reduced by compensation from the same employer in the distribution year and the capital gain element of the distribution.

U. S., Public Law 91-172, Tax Reform Act of 1969, Section 515 Amends Sections 402(a) and 72(n) of the Internal Revenue Code.
and he leaves his employment, he is taxed on amounts he will never receive. There could be some refund method employed, but this would complicate matters. With the trend toward vesting, or if in the future the law provided for immediate vesting for every individual covered under a retirement plan, the taxation of the contribution when made is an alternative that could be considered. This is the procedure followed at present with social security contributions.

Withdrawals

Under this proposal, withdrawals are permitted if an individual desires to discontinue participation in the plan. The amount withdrawn is taxable as ordinary income in the year withdrawn and the individual is prevented from participating in another plan for a period of five years.

This provision is included in order to prevent the retirement plan from becoming an income averaging device whereby an individual could contribute to the plan in his high income years and withdraw amounts in low income years. To prevent such abuse, withdrawals are not permitted unless participation is discontinued. This should discourage withdrawals and further the objectives of the proposal in encouraging individuals to continue participation in plans.
Retirement Age

Under this proposal, the normal retirement age would be 65. Individuals could begin to receive benefits at this age if they retired. They could also receive reduced benefits if they retired at an earlier age. If the individual did not retire, he could not receive any benefits until his actual retirement.

At present, corporate pension plans call for retirement in order to receive pension benefits. The normal retirement age is 65. Early retirement at a reduced pension is usually permitted as is an optional late retirement. On the other hand, under present tax law, self-employed individuals are not faced with a mandatory retirement in order to receive their retirement benefits. They may begin to receive benefits at age 59½. Benefits must be distributed upon reaching age 70½, however.

Under this proposal, all individuals would be treated alike. They would have to retire in order to receive their retirement benefits. Self-employed individuals would no longer be able to receive benefits prior to actual retirement. The present law is criticized in this regard since self-employed individuals do not have to retire in order to receive their benefits whereas employees do. Under this proposal, more equitable treatment would result.
Treatment of Tax Benefit on Tax Return

The tax benefit on the contribution to a retirement fund could take several forms. The contribution could be considered an exclusion, a deduction to arrive at adjusted gross income, a deduction from adjusted gross income, or a tax credit. This proposal recommends that the tax benefit be given in the form of a tax credit. Each of the alternatives shall be discussed to indicate its advantages and disadvantages.

Exclusion.—If the amount were treated as an exclusion from income broadly defined to arrive at gross income, it would not appear on the return itself and compliance could not be checked as easily. According to one author, an exclusion is justified when it serves an important social or economic purpose that could not be served by other means, and when it eases excessive costs of administration and compliance.\(^{14}\) In the case of retirement funds, they do serve an important social purpose; but, administrative and compliance costs could be lessened if amounts were required to be reported on the return. Also, the appearance of the item on the tax return is desirable since many times taxpayers are not aware of benefits available unless they are specifically included in the tax form. At present, the

amount contributed in behalf of an employee by an employer under a qualified retirement plan is treated as an exclusion; however, amounts contributed by employees are taxable and included in gross income.

Another important disadvantage of this treatment for retirement funds is essentially a result of the tax rate structure. By allowing the tax deferral of 15 per cent of earned income to be considered an exclusion, the individuals themselves benefit to different degrees depending on their tax brackets. In other words, an individual in the 70 per cent tax bracket would benefit by such a deferral to a far greater extent than the individual in the 14 per cent bracket. To eliminate the benefit's dependence on the tax bracket of the individual would be more equitable.

Deduction for adjusted gross income.—The case for treatment of retirement fund contributions as deductions to arrive at adjusted gross income is a little stronger. First of all, administrative and compliance considerations would be enhanced if the full amount were included in gross income and then subtracted out along with other adjustments, if any. Since an individual is allowed to make the contributions to a retirement fund within the specified limits, the figures necessary in making the computation would be included on the tax return. A separate schedule showing
the computation and other pertinent data could be filed along with the return as is done at present with payments to self-employment retirement plans.\textsuperscript{15}

This method would be better than the treatment as an exclusion since the item would appear on the tax return. Some individuals may not be aware of the opportunity provided by a provision unless it appears on the tax return itself. This is especially true for the taxpayer with a modest income who prepares his own tax return. This would be one way of increasing awareness among taxpayers that the opportunity is available. The major disadvantage under this treatment is again the dependence of the tax benefit on the tax bracket of the individual.

Deduction from adjusted gross income.--Another alternative would be to consider the contribution a deduction from adjusted gross income. This also has the advantage of appearing on the tax return itself. It differs from the other two alternatives discussed in that, while the fund contributions are included in gross income, they are deducted after adjusted gross income is computed.

\textsuperscript{15} On the 1969 Form 1040, the full amount of gross income would be shown on Line 11 along with wages, etc., and on Line 14 for Other Income from Schedule C etc. On Line 15b where it states "Less Adjustments," the amount deductible could be subtracted. Other items on Line 15b include: Sick Pay (attach Form 2440), Moving Expenses (attach Form 3903), Employee business expenses (attach Form 2106), Payments to self-employment retirement plans (attach Form 2950SE).
While the treatment as an exclusion or a deduction for adjusted gross income have the same effect on adjusted gross income, (i.e., reducing adjusted gross income and thereby reducing any amounts computed on the basis of adjusted gross income), treatment as a deduction from adjusted gross income would not affect the figure itself or any computations based on it. It would still have the disadvantage that the tax benefit would be influenced by the taxpayer's tax bracket. Since this study is concerned with equity in the treatment of retirement fund contributions, the best alternative is the tax credit.

**Tax credit.**—A tax credit is applied directly against the tax itself and is a dollar for dollar benefit. There are several methods by which the amount of credit could be determined. It could be a stated dollar amount, a fixed percentage of some amount, or a percentage based on the tax bracket of the individual applied to a specified amount. There could also be a stated upper limit when percentages are applied, as currently exists with regard to the retirement income credit.\(^\text{16}\)

If the stated dollar amount were used, all taxpayers would receive the same dollar amount of benefit. In the case of retirement plans, little tax incentive would exist.

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\(^{16}\) Internal Revenue Code of 1954, Section 37.
for individuals to contribute more than what was required to obtain the credit. While this would be the most simple method, it would not be regarded as equitable by the consensus of opinion in society. Arguments against this treatment would be similar to those against the single tax for all method of income taxation.

If a percentage based on the individual's tax bracket were used, the value of the benefit would depend on the tax bracket of the taxpayer, i.e., the individual in the 70 per cent tax bracket would gain tax benefits far greater than the individual in the 14 per cent tax bracket. This would be similar to the situation resulting from use of the exclusion or deduction. It also would have the effect of giving a double recognition to different retirement needs at different income levels.

In the matter of retirement funds, the most equitable treatment would be to give each taxpayer the same tax benefit per dollar contributed to a retirement fund. In other words, applying a fixed percentage to the retirement fund contribution each individual makes gives that individual the same tax benefit per dollar contributed as is given to any other individual making a similar contribution. It equalizes the benefit per dollar contributed while recognizing retirement needs differ among individuals at different income levels.
Under this proposal, a tax credit of 15 per cent of the tax benefit limit is recommended. Each individual making a contribution to a retirement plan would be able to apply 15 cents on each dollar allowed the tax benefit (i.e., 15 per cent of earned income) as a direct credit against his tax payable. This method, while retaining the benefits of the exclusion and deduction, also overcomes the disadvantages. It achieves equity to a greater degree in that individuals receive the same tax benefit per dollar contributed to retirement plans instead of the degree of benefit derived depending on the tax bracket of the individual. It does not favor "upper bracket" taxpayers, as the present law for self-employed individuals was criticized for doing. It does not favor any particular income group. The examples on the following page will demonstrate this:

More specifically, 15 per cent of earned income is allowed as the basis for the tax credit. The tax credit is 15 per cent of this amount, i.e., 15 per cent of the 15 per cent of earned income is a direct credit against tax payable.
Example 1
Retirement Contribution treated as Exclusion or Deduction from Gross Income

<table>
<thead>
<tr>
<th>Annual Earned Income</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>$ 1,500</td>
<td>$ 15,000</td>
</tr>
<tr>
<td>Tax Savings</td>
<td>257</td>
<td>8,896</td>
</tr>
</tbody>
</table>

Example 2
Retirement Contribution treated as Deduction from Adjusted Gross Income

<table>
<thead>
<tr>
<th>Annual Earned Income</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>$ 1,500</td>
<td>$ 15,000</td>
</tr>
<tr>
<td>Tax Savings</td>
<td>285</td>
<td>8,896</td>
</tr>
</tbody>
</table>

Example 3
Retirement Contribution treated as Tax Credit

<table>
<thead>
<tr>
<th>Annual Earned Income</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>$ 1,500</td>
<td>$ 15,000</td>
</tr>
<tr>
<td>Tax Savings</td>
<td>225</td>
<td>2,250</td>
</tr>
</tbody>
</table>

In Examples 1 and 2, the tax savings depend on the tax bracket of the taxpayer. The higher the tax bracket, the greater the benefit. The differences in tax savings at low income levels in Examples 1 and 2 are caused by the standard

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18The earned income figure includes the retirement fund contribution. The amount contributed is 15 per cent of earned income and the tax credit is 15 per cent of the amount contributed. In computing the tax payable, the assumptions were made that the individuals use the 10 per cent—$1,000 standard deduction and they also have two exemptions.
deduction percentage which is based on adjusted gross income. In Example 3, fifteen cents on each dollar contributed is a direct credit against the tax each individual pays. Individual B is allowed a contribution ten times greater than Individual A since his earned income is ten times greater. He therefore is entitled to a credit which is ten times greater. As the examples indicate, the tax credit is more equitable in that the effects of the individual's tax bracket are removed insofar as the tax benefit on retirement fund contributions is concerned.

**Tax credit carryover.**—In cases where an individual has no tax to pay, or has less tax to pay than the amount of the tax credit, he may carry forward the unused tax credit until it can be applied against tax payable. A time limit of five years is imposed in order to reduce administrative costs. That is, the taxpayer must apply the unused tax credit during the five succeeding tax periods or it will be lost.

The alternative of receiving a tax refund from the government on the unused credit was not selected, since there are other similar cases where a refund may be appropriate (e.g., unused retirement income credits, unused personal exemptions, etc.) and a major change in tax policy would be required.
This provision only applies in cases where an individual is unable to use the tax credit because his tax payable is less than the amount of the credit. The carryover provision does not apply in cases where an individual fails to use the maximum amount allowed the tax credit, i.e., the 15 per cent of earned income. This could lead to tax abuse and administrative complexity as well as increased compliance costs.

Changes in Present Tax Law

Several sections of the Internal Revenue Code would be affected by the proposal. These effects are described below.

Section 401.—In general, the employee pension plans set up under Section 401 could remain essentially the same; however, a few changes become necessary. Since any individual with earned income could obtain the tax credit on funds set aside for retirement under the proposal suggested, the nondiscrimination clause and its related provisions would no longer be necessary. If an employee is already covered under a pension plan set up by his

19Section 401(a) pertaining to employee retirement plans. Section 401(c), (d), (e), 404(a)(8), (9), and 404(e) dealing with self-employed individuals' retirement plans. Section 403(b) pertaining to tax-sheltered annuities. Sections 101(b), 2039(c), and 2517 dealing with death benefits and federal estate and gift taxes.
employer, he may make additional contributions himself up to the limits as indicated in the proposal. Tax benefits would be available on these amounts. This will give those who feel they are inadequately covered the opportunity to participate with full tax benefits to the extent they feel is most desirable for them.

Sections 401(c), (d), (e), 494(a) (8), (9), and 401(c).—These sections dealing with the taxation of retirement plans for the self-employed individual would no longer be necessary since any plans could be set up under the proposal. Plans already set up under these sections could continue under the new proposal, but with some modifications. For example, since individuals can obtain a tax credit on funds set aside for retirement, the law need not make it mandatory for a self-employed individual to cover his employees in any plan he sets up for himself. His employees could continue their retirement programs themselves. If the employer no longer covered his employees, some wage or salary adjustment would be necessary since fringe benefits are generally considered substitutes for wages.

Section 403(b).—This section pertaining to tax-sheltered annuities should also be repealed. It gives preferential treatment to a particular group of taxpayers. Repealing this section would eliminate this preferential treatment and the individuals could then continue their
retirement programs under the proposal as outlined on the same basis available to others.

In effecting this change, a minimum of difficulty would be encountered since any plans set up under Section 403(b) could continue under the new proposal with the only exception being that the maximum amount contributed each year would be reduced in cases where the maximum or near maximum amounts were contributed.

Sections 101(b), 2039(c), and 2517.--These sections dealing with death benefits and federal estate and gift taxes should be amended to extend benefits to individuals covered under the proposal, not just employees covered under qualified corporate retirement plans. Since these benefits are available to covered employees at present, the proposal suggests extending the benefits to all individuals rather than eliminating them for the covered employees. This alternative may be considered in any future proposals to change the tax law.

Future changes.--This tax proposal would provide a simple method of achieving the goals stated earlier in the taxation of retirement funds without further complicating the tax law to any great extent. In the future, if a tax reform proposal would call for a complete revision and simplification of the tax law, the entire Code provisions with respect to taxation of retirement funds could be
revised and simplified in order to put all taxpayers under one simplified section of the Internal Revenue Code with regard to retirement funds. One Code section could apply in all cases.

Some of the changes affecting retirement plans that require further study are: the treatment as a tax credit rather than as an exclusion for qualified corporate plans, requirement of immediate vesting of rights for qualified plans, and the possible elimination of death benefits and federal estate and gift tax benefits under pension plans.

**Effect of Proposal**

If the proposal as suggested were passed, the effect the changes would have on the tax law and individuals would be several. These effects are discussed below.

**Equity**

Under the proposal, as suggested above, equity as defined in Chapter II\(^{20}\) would exist to a far greater extent than it does at present in the taxation of retirement funds. No individual with earned income would be denied the opportunity to set aside funds for his retirement on which tax benefits would be derived. Individuals already covered under a plan, but covered inadequately, could supplement

\(^{20}\)Supra, pp. 46-47.
their coverage up to the limits provided. This plan provides a more equitable tax treatment of retirement funds than exists at present.

With regard to self-employed individuals, this study originated in order to provide more equitable treatment in the taxation of their retirement funds. After examination of the problem, a determination was made that inequities would still exist if a proposal only sought to correct inequities for the self-employed. The necessity of drafting a proposal which would have a broad coverage became evident. This proposal has sought to provide equity in the taxation of retirement funds for all individuals who render personal services, not just the self-employed.

In order to demonstrate the effect on individuals, the table presented in Chapter I \(^{21}\) will be shown as it would appear if the proposed changes were incorporated into the tax law and individuals took advantage of the maximum tax benefits available with regard to retirement savings.

As the reader will recall, Table 1 illustrated the differences in taxation at various salary levels for four individuals: a self-employed owner-employee, a corporate employee covered under a qualified pension plan, an employee of a tax-exempt organization, and a pensionless employee.

\(^{21}\) Supra, pp. 24-25.
Under the proposal presented, all individuals except the employee who feels he is adequately covered under a qualified corporate plan would come under the same tax provision. An individual who felt he was inadequately covered under a qualified corporate pension plan would also be able to participate under the proposal up to the limits provided. Since all except the adequately covered employee would come under the same provision, there is no need to show each individual separately. Only the corporate employee and a single grouping of all others will be shown.

The assumptions used to determine the federal income tax that would be paid at each salary level are essentially the same as in the previous comparison.\(^{22}\) Again, the maximum amount is assumed to be placed in the retirement fund each year. No past service credits are used, however.

The table that follows illustrates the effects of the proposed changes in the tax law for all individuals having earned income.

\(^{22}\) The individual is married, filing a joint return and uses the 10 per cent standard deduction. He is assumed to be 45 years old with twenty years until retirement. The federal tax rates used were those in effect during the 1969 tax year. The individual's federal tax liability was computed first by assuming he was taxed on his full gross income, and secondly, his tax was computed on his gross income less any allowable deduction for contributions to a retirement plan. The difference between the two figures appears in the example as the amount of the annual tax savings. The tax credit computation for the other individuals was computed as 15 per cent of their retirement fund contribution. Supra, pp. 20-21.
### TABLE 2

**Comparison of Retirement Fund Tax Benefits for Corporate Employees and Others**

<table>
<thead>
<tr>
<th>Annual Salary</th>
<th>Corporate Employee</th>
<th>Other</th>
<th>Corporate Employee</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ 10,000</td>
<td>$ 10,000</td>
<td>$ 60,000</td>
<td>$ 60,000</td>
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<tr>
<td>Amount of Retirement Contribution</td>
<td>$ 500</td>
<td>$ 1,500</td>
<td>$ 3,000</td>
<td>$ 9,000</td>
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<tr>
<td>Taxable Amount</td>
<td>7,350</td>
<td>7,800</td>
<td>54,800</td>
<td>57,800</td>
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<tr>
<td>Federal Income Tax</td>
<td>1,256</td>
<td>1,117</td>
<td>19,544</td>
<td>19,784</td>
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<td>Tax Credit or Savings</td>
<td>85</td>
<td>225</td>
<td>1,590</td>
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<td>Amount in 20 Years if Invested at 5%</td>
<td>5,164</td>
<td>13,590</td>
<td>96,039</td>
<td>81,543</td>
</tr>
</tbody>
</table>

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<tr>
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<th>Other</th>
<th>Corporate Employee</th>
<th>Other</th>
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<tbody>
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<td>$ 20,000</td>
<td>$ 20,000</td>
<td>$ 80,000</td>
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<tr>
<td>Amount of Retirement Contribution</td>
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<td>$ 4,000</td>
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<td>Taxable Amount</td>
<td>16,800</td>
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<td>Federal Income Tax</td>
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<td>3,314</td>
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<td>Tax Credit or Savings</td>
<td>280</td>
<td>450</td>
<td>2,254</td>
<td>1,800</td>
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<tr>
<td>Amount in 20 Years if Invested at 5%</td>
<td>16,913</td>
<td>27,181</td>
<td>136,146</td>
<td>108,724</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Annual Salary</th>
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<th>Other</th>
<th>Corporate Employee</th>
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</tr>
</thead>
<tbody>
<tr>
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<td>$ 40,000</td>
<td>$ 40,000</td>
<td>$ 100,000</td>
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<tr>
<td>Amount of Retirement Contribution</td>
<td>$ 2,000</td>
<td>$ 6,000</td>
<td>$ 5,000</td>
<td>$ 15,000</td>
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<td>Taxable Amount</td>
<td>35,800</td>
<td>37,800</td>
<td>92,800</td>
<td>97,800</td>
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<tr>
<td>Federal Income Tax</td>
<td>11,936</td>
<td>10,260</td>
<td>40,860</td>
<td>41,610</td>
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<tr>
<td>Tax Credit or Savings</td>
<td>894</td>
<td>900</td>
<td>3,000</td>
<td>2,250</td>
</tr>
<tr>
<td>Amount in 20 Years if Invested at 5%</td>
<td>53,999</td>
<td>54,362</td>
<td>181,206</td>
<td>135,904</td>
</tr>
</tbody>
</table>

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\( ^{a} \)5% Exclusion for Corporate Employee, 15% of Earned Income for Other
When comparing the tax results of this table with those resulting from Table 1, the reader notes that the wide variation in tax savings no longer exists. The only variation which may still exist involves the adequately covered corporate employee as compared to all others with earned income. In this table, the corporate employee in the lower income brackets would not gain the full tax benefit; however, he can make contributions on his own up to the limits stated in order to gain the full benefit if he so desires. The assumption is made that the individual under "Other" will take advantage of the tax benefits to the fullest extent. If an individual chooses not to participate to the extent allowed, variations would still exist. Equity does not require that all participate to the fullest extent. Equity would require merely that individuals have the opportunity to participate to the same extent. When a complete revision of the Internal Revenue Code dealing with retirement plans takes place, then all individuals with earned income could conceivably come under one set of rules and there would be no variation at all if individuals all had the opportunity to participate to the maximum extent allowed. Equity in taxation of retirement funds would then be achieved.

When any tax benefits are proposed, an inequity is created between the individuals who are allowed the benefits
and those who are not. The initial tax deferment on retirement funds was given because of the social good that would result. The inequity that was created was justified by the social good resulting from the encouragement of retirement savings. Also, since many times rights did not vest with the employee, there was difficulty in determining the amount that would be taxable. In the interests of the social good and simplicity, equity was sacrificed. Many individuals were excluded from the tax benefits. No action was taken until employees of tax-exempt institutions were extended benefits in 1942 and self-employed individuals were extended benefits in 1962. There are still many individuals who are not extended the tax benefits which are available to others.

Under the proposal presented, a broad group of individuals are given tax benefits—all those with earned income. The inequity charge might still be applied to the proposal presented in that tax benefits are not given to individuals with unearned income. Arguments supporting the proposal on this point have already been presented. 23

As the reader will note, form of organization no longer becomes the basis for classification. Equity requires a reasonable classification of taxpayers if differences in

23Supra, pp. 119-120.
taxation are to exist. Form of organization was not considered a reasonable classification since individuals similarly situated could be taxed differently as demonstrated in Chapter II. This classification also hindered tax neutrality since tax considerations could influence an individual's decisions with regard to the method in which he chose to operate, or the selection of an employer.

The proposal presented attains equity in that similarly situated individuals having the same amount contributed to a retirement fund would pay the same amount of tax; and, all similarly situated individuals who were contributing different amounts to a retirement fund would pay a different amount of tax based solely on the difference in the amount being contributed. The differences in amounts being contributed and allowed the tax benefits are determined by a fixed percentage of earned income.

In other words, each individual with the same amount of earned income would have the opportunity to gain tax benefits on the same amount contributed to the retirement fund. Each individual with a different amount of earned income would have the opportunity to gain tax benefits on a proportionate amount of earned income contributed to a retirement fund. The proportional effect obtained by applying a fixed percentage to earned income was considered

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\[24\text{ Supra, pp. 47-51.}\]
an equitable manner in which to recognize differences. It represents a systematic pattern which determines the degree of differences that should exist.

The question may arise as to the achievement of equity at the various salary levels. Should the tax benefits allowed an individual with $10,000 earned income be the same as the tax benefits allowed an individual with $100,000 earned income? If different amounts should be allowed, how much different should they be? The federal income tax rates are progressive in nature, i.e., the greater the amount of income, the greater the proportion of tax that must be paid. One author states:

The justification of progressive taxation must rest on a desire to achieve greater income equality through the fiscal process.\(^{25}\)

The proposal suggested employs a proportionate basis for the tax deferment, i.e., the same percentage is applied to the earned income base regardless of how large or small the base is. Each individual is treated the same, i.e., he is given a tax benefit on a stated percentage of earned income set aside for retirement. This meets the equity requirements as stated in the definition presented earlier. The degree of difference is determined by a systematic pattern which, in this case, is proportional to the base.

Progressive or regressive rates were not used in this case since they could not be justified in the matter of retirement funds. An individual in a very high income category would need a larger amount to meet satisfactory retirement needs than would an individual in a low income category. The question of how much larger an amount is needed seems best answered by a proportional amount of income. This would be a reasonable classification and would meet equity requirements. Equity is satisfied when the overall classification into categories is reasonable and there is equal treatment for equals within each category. The proportionate basis for the tax benefit is an equitable solution.

In a case where an individual failed to contribute the maximum amount given tax benefits (i.e., the 15 percent of earned income), he may not carry the difference forward to gain the tax benefits in a future tax year. To allow amounts to be carried forward could lead to abuse of the provision, increased compliance costs, and increased administrative complexity. The carryover provision is only allowed in the case of an individual who is unable to use the tax credit because his tax payable is less than the amount of the credit.

Another problem which arises and which might affect equity is that of tax abuse. Although abuses are sometimes
difficult to foresee, any proposal should be carefully scrutinized to avoid loopholes which could result in unintended benefits. This would be in the interest of equity, since tax abuse hinders equity. This is also a problem of tax administration. In the proposal presented, an attempt has been made to eliminate any possibility for tax abuse.

The fact that relatively few individuals took advantage of the Self-Employed Individuals' Tax Retirement Act of 1962 after it was passed might raise a question with regard to the present proposal. How equitable is this proposal if the same result is obtained whereby few individuals take advantage of it? Equity extends as far as the opportunity being available to individuals. To publicize the law, to make individuals aware of it, to not make it unduly difficult to participate in, should be sufficient to satisfy the equity requirement. The individual should still have the freedom of choice as to whether or not he desires to participate and to what extent.

The tax proposal presented stresses the achievement of equity in the taxation of retirement funds. Equity will not be fully achieved until the entire Section 401 of the Internal Revenue Code is rewritten and all individuals are treated under one section. This proposal, in not undertaking such a vast change, sacrifices equity in order to gain.
simplicity, ease of administration, and less delay in correcting inequities against particular groups of individuals.

Neutrality

The principle of neutrality in taxation states that taxes should not interfere with the functioning of the market system. They should not be used to alter consumption, personal activity, or investment. The proposal presented does cause an interference and does alter personal activity and investment since individuals are encouraged to participate in retirement savings plans by the tax incentive.

This sacrifice of tax neutrality is justified by the social benefits derived from retirement savings. Society as a whole benefits from having fewer individuals depend on governmental assistance programs. Society also benefits from having the elderly self-sufficient, able to provide for their needs, and able to participate as consumers in the market system.

Viewing tax neutrality from the standpoint of an individual's decision-making process, the proposal comes

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closer to achieving neutrality in that taxation of retirement funds would not be a factor in his choice of form of business organization. Under the existing law, because of the differing tax treatment accorded retirement funds, taxation does become a factor in the selection of the form of business organization.

Under the proposal, an individual would not be limited in his selection of an employer if the tax benefits on retirement funds were an important consideration to him. He would be able to set up his own plan. Also, because of the required vesting, his mobility would not be restricted because of pension rights. The individual has more freedom of choice and taxation would not be a factor which would alter his course of action with regard to the decisions mentioned.

Individuals should not be able to escape the tax by readjusting the manner in which they conduct their activities. This enforces equity as does any prevention of tax abuse. The proposal presented achieves a greater degree of tax neutrality when viewed from the standpoint of an individual's decision making than exists at present, thereby adding to a more equitable tax law. As mentioned earlier, however, the individual's decisions are altered by the tax incentive to encourage retirement savings and neutrality is sacrificed for the social benefits derived.
Administrative Factors

The proposal is relatively simple and could be effectively administered. Amounts allowed the tax benefit are computed as a percentage of earned income and readily determinable with relative ease. The amount allowed the tax benefit is clearly defined. The only area in which some difficulty might be encountered is that of the individual who feels he is inadequately covered under his present pension arrangement. He must determine the contribution being made to the existing plan in order to compute the additional amount he may contribute for the tax benefit.

In order to make administration easier at the present time, equity is sacrificed since the proposal does not repeal Section 401 dealing with qualified corporate plans. For example, the immediate vesting provision would cause difficulties if it were required for plans existing under Section 401. Equity is sacrificed for ease of administration.

The conflict between administrative factors and equity is evident in the proposal. The provision that would be the easiest to administer would be the one that would allow all individuals the same amount of tax benefit regardless of any other considerations. This would be in conflict with what is generally regarded as equitable since individuals have different retirement needs.
Social Effects

Social effects of the proposal are in keeping with the "American way." Individual savings are encouraged and less dependence on government aid would result. Many more individuals are extended the tax benefits of providing for their retirement.

The proposal will also encourage (or at least not discourage) professions and self-employment which are also desirable in our society. Retirement savings will be promoted and individual initiative will be preserved—the resulting social good being desirable.

Flexibility

The present proposal is flexible enough to allow retirement objectives to be achieved by the greatest number of individuals with a maximum degree of individual choice. This is related to equity but merits special attention.

Individuals are more likely to participate since the proposal is simple and allows flexibility as to amounts contributed up to the limits stated. There are no rigid limitations which would discourage participation. The greater the participation, the greater the social benefit that will result since individuals will provide for their own retirement security and will depend less on governmental assistance.
The most flexible proposal would be one which allows the greatest latitude in the selection of a retirement fund medium. A tradeoff is made in order to assure compliance and to make administration simple. Some flexibility is sacrificed to assure ease of administration. For example, if savings accounts were allowed as a retirement medium, difficulty would arise in controlling withdrawals. The proposal presented limits the selection of a retirement fund medium in order to attain a more simple administration of the law; i.e., flexibility is lost but simplicity is gained.

The proposal also gives flexibility to the taxpayer in the matter of the amount of contribution. There is no dollar limitation placed on contributions to the retirement fund; however, there is a limit on the amount allowed the tax benefits. The taxpayer has the opportunity to provide for a retirement which he believes will meet his needs.

Revenue Loss

The revenue loss consideration was one of the major objections to the passage of the Self-Employed Individuals' Tax Retirement Act throughout its legislative history. This should not have been the case. Tax policy should be determined by factors other than revenue loss, and the practical matter of a revenue loss should be treated as a
separate issue. Because our tax law is based on self-compliance, taxpayers must feel the law is equitable. This should be given primary emphasis. If, in order to improve equitable treatment among groups, revenue will be lost, the revenue loss consequence should be accepted and dealt with separately—even if an over-all increase in tax rates would be necessary.

Some remarks by former Internal Revenue Commissioner Sheldon S. Cohen reflect this attitude. At an address in 1967, he stated that a new philosophy of tax administration began to emerge several years ago in which emphasis is placed on encouraging voluntary compliance. Stress is placed on the need for objectivity and integrity in interpretation. He stated: "We met head-on the temptation to let the amount of revenue at issue color the interpretation of the tax law." If this attitude had been applied to the interpretation in administering the tax law and also to the drafting of the law itself and any proposed changes, the long delay in passage of legislation to give tax benefits on retirement funds to self-employed individuals might have been avoided.

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The revenue loss incurred with the tax credit is not entirely a "loss." The tax credit will bring a reduction in tax revenue currently; however, taxes will be paid on amounts received in later years. Some of the taxes may be truly "lost" because some taxpayers will be entitled to a double exemption and may also be in a lower tax bracket in later years; however, if the total effect is considered, future years may also bring a reduction in the number of individuals requiring governmental welfare assistance. When these factors are put in perspective, the revenue loss may not be as great as would otherwise be expected.

Summary

As was noted earlier, the Internal Revenue Code is a highly complex piece of legislation. One of the major reasons for the complexities has been evident in this study. When a change in the tax law is proposed, many factors must be considered. In order to effect a change and prevent abuses, each possibility must be considered and frequently provided for in the provisions of the Code. Unanticipated abuses of the tax law also occur. In order to eliminate the abuses, the tax law must be modified, added to, and made even more complex. The tax law seems to be added to when changed, but seldom subtracted from. Each change adds to the complex volume of Code provisions.
The problem with which this study was concerned could ideally have been resolved by the elimination of the entire section of the Code dealing with taxation of retirement plans. In its place, a simple provision could have been substituted in order that all individuals would be treated alike under the same section. Since the study initially set out to deal only with taxation of retirement plans for self-employed individuals, this approach was not taken. In order to effect this complete change, a study of much greater magnitude would have to be conducted.

The objectives of this study have been accomplished. The definition of inequity as it applies to tax legislation was explained and the existence of an inequity in the taxation of self-employed individuals' retirement funds was indicated. The considerations which become important when a change in the tax law is proposed were determined and their relative weights were discussed.

A proposal was developed which gives tax benefits on retirement funds to self-employed individuals. Certain other individuals were also included under the proposal in order to avoid the creation of new inequities. Greater equity is achieved since all individuals, other than adequately covered corporate employees, come under the same provision of the tax law.
A recommendation was made to repeal certain sections of the tax Code and, in their places, substitute a simplified provision that would have a much broader coverage. Eventually, perhaps, the entire Code sections dealing with qualified corporate retirement plans could be replaced by a section similar to the proposal presented and all individuals could be covered under the same provision. This would greatly simplify a complex area of the present tax Code. It would further the socially desirable objective of encouraging retirement savings. Also, it would provide equity in the taxation of retirement funds.

Perhaps in the future a major reform or change in the tax law will occur. This study should provide a guide for any future legislative changes in the area of taxation of retirement funds.
BIBLIOGRAPHY

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Other Sources


