3-1-1971

Retirement Plans for the Self-Employed: The Treasury's New Promise to Professionals

George E. Ray

Follow this and additional works at: http://scholarship.law.nd.edu/ndlr
Part of the Law Commons

Recommended Citation
Available at: http://scholarship.law.nd.edu/ndlr/vol46/iss3/2

This Article is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.
RETIREMENT PLANS FOR THE SELF-EMPLOYED: THE TREASURY'S NEW PROMISE TO PROFESSIONALS

George E. Ray*

I. Introduction

The perennial story of the battle for equality by unincorporated professional people who seek retirement plan benefits comparable to those afforded corporate employees brings to mind the plight of the heirs in the celebrated case of *Jardyce v. Jarndyce* in Dickens' *Bleak House*. While the heirs in Dickens' story had their inheritance wasted away over a period of a century, doctors, lawyers and other professional people have only suffered for little more than a quarter century. During all this time their efforts to achieve equality in the field of retirement benefits have fallen on deaf ears at the Treasury Department. Many professionals have, in this period, seen their entire careers pass by without the opportunity to provide for their own old age, or to provide adequate protection for their widows and families. At the same time they have seen their professional patients and clients adequately cared for through corporate retirement plans.

With the publication on August 8, 1969, of Technical Information Release (T.I.R.) No. 1019, in which the Justice and Treasury Departments finally acknowledged defeat in their court battles against professional corporations and associations, the long struggle for equality by professional people gave promise of an end. In T.I.R. No. 1019, the Treasury Department stated:

The Internal Revenue Service announced today, in response to recent decisions of the Federal courts, that it is conceding that organizations of doctors, lawyers, and other professional people organized under state professional association acts will, generally, be treated as corporations for tax purposes.

On March 2, 1970, T.I.R. No. 1019 was implemented by Revenue Ruling 70-101, which ruled that a professional service organization, organized and operated under specific statutes of the various states, would be treated as a corporation for federal tax purposes. Virtually all state laws which provide for professional corporations and associations were given blanket approval by this revenue ruling.

---

* Member, State Bar of Texas; A.B., Harvard, 1932; LL.B., Harvard, 1935; partner, McCulloch, Ray, Trotti & Hemphill, Dallas, Texas. Mr. Ray is the author of numerous articles on the taxation of professional corporations and associations.
1 G. Dickens, *Bleak House* (1852).
3 *Id.* While T.I.R. No. 1019 expressly refers only to professional "associations," it certainly must also apply to professional "corporations."
5 Revenue Ruling 70-101 stated, in addition, that a professional service organization which meets the organization and operation requirements for corporate classification under the Treasury Regulations will also be classified as a corporation. *Id.* at 16. The special problems of associations organized in Pennsylvania, Illinois and Texas were also pointed out in the ruling:

[An] organization formed under Purdon's Pennsylvania Statutes Annotated, Title
With the decks cleared by these Treasury pronouncements, many professional people proceeded to organize their professional practice into the corporate or association form. However, no wholesale shift from partnership and proprietorship to corporation or association took place. Nevertheless, it was not long before the Treasury Department began to cast doubts on the wisdom of organizing the professional corporation or association.

In an interview published July 20, 1970, K. Martin Worthy, Chief Counsel of the Internal Revenue Service, expressed concern at the tendency of professional people to form corporations:

As a professional man, I’m concerned about the tendency of doctors, dentists, lawyers, architects, and others to form corporations. I don’t think it’s necessarily in the public interest. The difficulty arose because sole owners and partners haven’t been treated like other taxpayers for retirement plan purposes, but the Treasury has a great deal of interest in making changes in the law relating to deferred compensation so that all similarly situated taxpayers will be treated alike, no matter what the form of their business. If the changes take place, incorporated doctors who decide to go back to practicing as individuals or partnerships could find themselves facing serious tax problems when they start breaking up the corporations they’ve formed.

Shortly thereafter, Mr. Worthy indicated what course the Treasury planned to take in order to have “similarly situated taxpayers . . . treated alike.” In a speech at the August 1970 annual meeting of the American Bar Association, he stated:

The Treasury Department is now preparing legislative proposals which would amend the law so as to remove the present discrimination between tax treatment of qualified plans for employees and qualified plans adopted for self-employed persons. It now appears likely that these legislative proposals will be introduced at the next session of Congress.

---

15, Chapter 41, Sections 12601-12619 (Professional Association Act) effective 1961; Illinois Annotated Statutes, Chapter 106 1/2, Sections 101-110 approved August 9, 1961, and Vernon’s Annotated Civil Statutes, Article 1528f, Sections 1-20 (Texas Professional Act) effective June 18, 1969, may or may not so qualify for classification as a corporation in a given case. Id.

6 The growing minority of lawyers who had incorporated was noted in the Wall Street Journal:

They’re still a minority, but more lawyers are incorporating because of the tax advantages. An American Bar official guesses that between 20,000 and 30,000 of the nation’s 212,000 privately practicing lawyers have incorporated. California, Florida, Texas, Michigan, Minnesota lead other states, says Lawyers World, a professional journal. Wall Street Journal, Jul. 29, 1970, at 1, col. 5 (E. ed.). These figures appear to be entirely too high, and informal estimates by the Internal Revenue Service officials have indicated that the figure is considerably lower.

7 Id. at 36. In August, 1970, Mr. Worthy was again quoted in words promising a better solution than that provided by professional corporations:


The Treasury Department’s objectives were later stated by another Treasury Department official: “What we are working toward is to change the law so that persons similarly situated will be taxed alike on pension contributions, regardless of position or occupation.” U.S. News & WORLD REPORT, Sep. 14, 1970, at 33.
This is a consideration which I think should be taken into account by any professional person who is thinking of incorporating now or in the near future, particularly since it may be difficult for the professional person to withdraw from his incorporated form of doing business, should he desire to do so at some time in the future, without experiencing adverse tax consequences.

John S. Nolan, Deputy Assistant Secretary of the Treasury, has also noted that “existing law involves serious inequity and discrimination against self-employed persons so far as pension benefits are concerned.” He added, “The law needs to be rectified and we ought to be able to develop tax rules that will end the discrimination.” In accord with Mr. Worthy’s admonition, Mr. Nolan further stated:

The advantages gained by professional people in incorporation are likely to be, at most, temporary.

Either Congress will eventually go along with the Treasury and put everyone on an equal footing so far as tax rules on pensions are concerned, or else it will cut back on retirement-plan benefits for incorporated organizations to the levels applying to nonincorporated professional people.

Since these statements of the Treasury’s position, there have been reports that the Treasury Department’s proposals include a uniform limitation on contributions to all retirement plans. The limit reported was fifteen percent of annual compensation or $10,000, whichever is less. Along with the limitation on contributions would come more restrictive treatment of other aspects of corporate retirement plans, including restrictions of vesting, lump sum distributions and the estate and gift tax exclusion of benefits at death. Certainly it would be hard to quarrel with the Treasury’s desire for equalization in this area, particularly after a quarter century of disparity and inequality for the unincorporated professional.

With the above suggestions in mind, it now appears that perhaps the Treasury plan for equalization between retirement plans for professional people and those for corporate employees will be based, at least in substantial part, on the basic elements of those retirement plans presently allowed the self-employed individual under the Internal Revenue Code—Keogh (or H.R. 10) plans. Accordingly, a careful analysis of such plans would appear to be in order, not only to foresee what the Treasury may have in mind, but also to try to assist in the formulation of an equitable solution to the problem. This analysis will con-
consider the Keogh plan in some detail, first, as to its basic advantages, and, second, by comparing it to the alternative afforded by the professional corporation.

II. Tax Advantages of Keogh Plans

The tax advantages of Keogh plans are few in number but nevertheless real.

The most obvious advantage of the Keogh plan, taxwise, is the fact that contributions to such a plan, while limited to ten percent of the earned income of an "owner-employee" or $2,500, whichever is less, constitute a valid deduction for income tax purposes. An "owner-employee" is an owner who is also an employee and who has a ten percent interest in capital or profits. To a taxpayer who is desperately seeking some form of legitimate deduction, this is certainly better than nothing at all.

A second advantage of Keogh plans lies in the fact that whatever is earned on the contributions which have been made to the Keogh plan trust fund will accumulate tax free. This is true whether the accumulation consists of dividends, interest, rent, or other earnings which would ordinarily be ordinary income, or whether it consists of capital gains on sales or exchanges. This accumulation, over a period of a number of years, may, of course, add up to a considerable amount.

If at least one employee other than an owner-employee is participating in the plan during the tax year and if such employee has the right to make voluntary contributions under the plan, the owner-employee may also make such voluntary contributions. This is advantageous because the earnings on these contributions will also accumulate tax free until distribution.

A further advantage of Keogh plans lies in the fact that lump sum distributions of benefits to self-employed individuals, whether or not owner-employees, will be taxed on a five year forward-averaging basis. Under the averaging rule the tax on the distribution will be the greater of:

(i) 5 times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income, or
(ii) 5 times the increase which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the excess of the aggregate of the amounts so received and includible in gross income over the amount of the deductions allowed the recipient for such taxable year under section 151 (relating to deductions for personal exemptions).

This averaging rule alleviates, at least to some extent, the tax burden involved in receiving all of the income as ordinary income in one taxable year. In evaluating

17 INT. REV. CODE OF 1954, § 404(e) (1).
18 INT. REV. CODE OF 1954, § 401(c) (3). For further refinement of this definition see Treas. Reg. § 1.401-10(d) (1963).
20 Id.
22 INT. REV. CODE OF 1954, § 72(n).
the benefit from the five year forward-averaging rule, one might note that, had the individual made investments outside the Keogh plan trust with after-tax dollars, the increase in value of those investments would be given capital gain treatment when sold. The benefits to be derived from the five year forward-averaging rule must, therefore, be weighed against these possible capital gain advantages. Moreover, investments made outside the Keogh plan trust could be sold, with capital gain treatment, at any time after six months had expired, whereas the distribution of benefits to the owner-employee from the Keogh plan trust could only come at the time of his retirement, between the ages of 59½ and 70½, unless he died or was totally disabled prior to that date.24

A further tax advantage of sorts should be noted in the fact that the amount of the contributions to a Keogh plan, to the extent deductible, is treated as a deduction from gross income in computing adjusted gross income.25 Accordingly, an owner-employee may avail himself of this deduction on his individual income tax return and still qualify for the standard deduction.

The above-listed advantages of Keogh plans are, perhaps, “better than nothing,” but they certainly are not nearly as imposing as the benefits to be derived from professional corporations, as will be seen from a comparison of Keogh plans with corporate plans.

III. Comparison of Keogh with Corporate Plans

Keogh plans, when compared with corporate plans, come out second best in seven major respects. These areas of comparison relate to (1) contributions, (2) coverage, (3) vesting, (4) distributions, (5) integration, (6) trustees, and (7) estate tax.

1. Contributions Probably the most serious disadvantage of a Keogh plan is the limitation placed upon the amount of contributions which the owner-employee may make to the plan and the limitation on the deductibility of such contributions. As previously stated, the basic limitation on the annual contribution and the annual deduction under H.R. 10 is ten percent of “earned income” or $2,500.00, whichever is less.26 Prior to 1968, although the basic limitation on the annual contribution was the same, the owner-employee could not deduct more than $1,250 against his taxable income.27

In the case of a professional corporation or association, the contributions which may be made to retirement plans are not subject to limitations nearly as stringent as those of H.R. 10. In the case of a pension plan, contributions may be made in such amounts as may be actuarially determined to be necessary to adequately fund the plan.28 In the case of a profit-sharing plan, contributions may be made up to fifteen percent of the payroll of the covered employees.29

---

26 INT. REV. CODE OF 1954, §§ 401(e)(1)(B), 404(e).
27 Act of October 10, 1968, Pub. L. No. 87-792, § 3, 76 Stat. 819. This provision is discussed in Ray, supra note 16.
28 See INT. REV. CODE OF 1954, § 404(a).
29 Id.
the case of a combined pension and profit-sharing plan, contributions up to twenty-five percent of the payroll of the covered employees may be made.\textsuperscript{30} Contributions to plans of Subchapter S corporations in excess of ten percent of compensation or $2,500, whichever is less, on behalf of a shareholder-employee owning five percent or more of the corporate stock, were made taxable to him under the Tax Reform Act of 1969 for years after 1970.\textsuperscript{31}

Under Keogh plans, if an owner-employee is in control of a business (\textit{i.e.}, if he owns more than fifty percent of either the capital or profits interests, either alone or in conjunction with other persons who are owner-employees and participants under the plan), all his plans must form a single plan which qualifies for all employees.\textsuperscript{32} In the case of corporate plans there is no such requirement.

In addition to these differences between H.R. 10 and corporate plans, there may be differences in treatment of different individuals under the same H.R. 10 plan. H.R. 10 distinguishes between those owners of a business who own more than ten percent and those who own less than ten percent, that is, between the "owner-employees" and the "self-employed." The self-employed individuals, who are not owner-employees, in that they are not sole proprietors, or do not own more than ten percent capital or profits interest in a partnership of which they are members, are not subject to the $2,500 limitation which applies to contributions.\textsuperscript{33}

Thus, if they have sufficient earned income to permit a contribution in excess of $2,500, it may be made. For example, if two partners each earn $40,000 per year, but one of them owns ten percent or more in the firm and the other owns less than ten percent, then the firm may contribute $4,000 for one of the partners, but only $2,500 for the other. In the case of each partner, however, only a $2,500 tax deduction may be taken. The advantage in being able to contribute amounts in excess of $2,500 is that the increment on such amounts will not be taxable until actual distribution is made at the end of the accumulation period.

Penalties are provided under H.R. 10 for excessive contributions. If the self-employed person receives notification from the Internal Revenue Service that his contribution was excessive, he must retrieve the excess within six months, together with the income earned on it.\textsuperscript{34} For this purpose, an excess contribution is an amount which exceeds the total of (1) allowable contributions, upon which the deductible amount is based, and (2) permitted voluntary contributions, which in no case are deductible.\textsuperscript{35} If the excess contribution is "willfully made," then the individual's entire interest will be returned to him and he will be disqualified from participating in any plan for a five-year period.\textsuperscript{36} An exception to this rule is provided where the plan is funded by a level premium insurance or endowment policy.\textsuperscript{37} Under such a plan, the self-employed person could contribute each year the amount of the level premium, even though his earned income declined, so long as it did not exceed his average earned income for the three years preced-
ing the issuance of the last policy under the plan. Also, bond purchase plans are not subject to the excess contributions rules. Likewise, amounts paid for life insurance protection and disability benefits, which are, of course, not deductible, would not be considered "excess" contributions. Penalties similar to these do not exist for qualified corporate plans.

2. Coverage The basic rule of H.R. 10 plans as to coverage is that all regular employees with three or more years of service must be included in the plan.

In the case of retirement plans outside H.R. 10, there are rules against discrimination in favor of officers and higher compensated employees. Corporate retirement plans may qualify if they cover a specified percentage of employees, or if the classification does not discriminate in favor of the officers or higher paid, supervisory, or stockholder employees. Under corporate retirement plans, it is possible to require up to five years' service to be eligible for the plan, as well as to set minimum ages for qualification. In addition, plans may exclude certain classes of employees, such as hourly-paid workers, or those covered by a union-negotiated plan, but not if this constitutes discrimination against them.

The coverage requirements of H.R. 10 will always apply to small partnerships, but in a larger partnership where there is no partner with a ten percent or greater interest, the eligibility requirements of H.R. 10 will not apply. Instead, the general eligibility requirements applicable to corporate plans will be the standard. Another provision with respect to coverage is that, if any partner has more than a ten percent interest, and he alone, or with other partners, owns more than a fifty percent interest in the capital or profits of another partnership, then the first partnership cannot adopt an H.R. 10 plan unless the second partnership also adopts such a plan and provides benefits as favorable as those provided by the first partnership. This will prevent a partnership from splitting up its business into two partnerships and thereby providing H.R. 10 benefits for only one of them. One further provision with respect to Keogh plan coverage provides that a partner who has a ten percent or greater interest may not be covered by the plan unless he expressly consents to it.

3. Vesting H.R. 10 requires that contributions made under an H.R. 10 plan be nonforfeitable when made. In the case of a partnership which does not have any ten percent partners, the vesting provisions do not apply. On the other hand, under qualified corporate plans there need be no vesting.

until retirement. Therefore, in the case of pension plans, it is general practice to provide that an employee must remain employed for a specified period of years before his interest in the plan becomes nonforfeitable. Although there are no stated requirements as to vesting prior to the participant's retirement, a qualified profit-sharing plan will generally provide a graduated scale over a period of years, during which time a specified portion of such employee's interest vests and becomes nonforfeitable. Where there is a minimum vesting period provided under a corporate retirement plan, the forfeitures resulting may provide a considerable advantage to those employees who stay with the employer. The forfeitures may not, however, be allocated on a basis which discriminates in favor of the officers or higher paid, shareholder, or supervisory employees.

The vesting provisions of H.R. 10 appear to run counter to one of the principal reasons for retirement plans—namely, to encourage employees to stay with the employer. Once an employee under the H.R. 10 plan has accumulated some interest under the plan, the existence of this interest, providing a ready source of money to the employee if he leaves the employer, can become an inducement to leave, rather than to stay with the employer. In the case of a corporation, the vesting provisions with respect to profit-sharing plans can sometimes work this way as well, and the author knows of instances where corporate employees have used their vested interest under a profit-sharing plan to provide them with the starting capital to enter a new business in competition with their old employer.

4. Distributions Under H.R. 10 an owner-employee may not be paid any benefit prior to the time he reaches the age of 59\(\frac{1}{2}\), except in the case of death or total disability. Benefit payments must, in any event, begin before he reaches the age of 70\(\frac{1}{2}\). In the case of all other persons covered under an H.R. 10 plan, the distribution of such employee's interest must be made or begun not later than the year he reaches 70\(\frac{1}{2}\) or the year in which he retires, whichever is later.

With an H.R. 10 plan, there can be no provision for distributions to owner-employees in case of emergency, nor can there be provisions for their early retirement or for distribution on termination of the plan before the owner-employee reaches the age of 59\(\frac{1}{2}\) years. Premature distributions are subject to penalty. In the case of a premature distribution, no further contributions may be made for the self-employed individual for five years thereafter, and, in addition, a tax penalty is imposed on the self-employed person receiving the distribution.

In the case of ordinary corporate retirement plans, broad discretion is usually given to the trustee to determine the method of distribution which will best suit the needs of the individual employee. Provisions are generally made for early, normal or late retirement.
Another very important difference with respect to distributions rests in the fact that in the case of corporate plans, distributions of the entire interest to an employee in one taxable year are given preferred tax treatment. To the extent that a lump sum payout consists of employee contributions, it will, of course, be tax-free. To the extent that such a payout consists of earnings by the fund, it will be taxed at capital gains rates. Capital gain treatment will also be given to that portion of the payout representing employer contributions prior to December 31, 1969. However, to the extent the lump sum payout represents employer contributions after December 31, 1969, that portion will be taxed as ordinary income to the recipient.60 Under H.R. 10 such a lump sum distribution to a self-employed individual does not result in capital gain treatment, but such individual may compute his tax on the lump sum distribution by using the five year forward-averaging rule discussed above.61

In case of the death of the self-employed person, H.R. 10 provides that distributions must be made to his beneficiaries either (1) within five years from the date of his death or the death of his spouse, whichever is later, or (2) by purchasing within five years an immediate annuity payable over a period no longer than the beneficiary’s life or life expectancy, or (3) if payment started before his death, for a period not longer than the life expectancy of himself and his spouse.62 If the distribution is made under alternative (1), and is completed within a single taxable year, the distribution will be treated under the special rules of the law relating to lump-sum distributions and the special five-year averaging device will apply.63 On the other hand, if the distribution is made as permitted by alternative (2), there will be no tax due upon distribution of the annuity contract to the beneficiary, but he will be taxed under section 72 of the Internal Revenue Code (relating to annuities) on amounts actually received by him under the annuity contract.64 Distribution under alternative (3) is also taxable at the time payments are received by the beneficiary under the annuity contract.65 The third alternative was added in order to eliminate the needless cancellation of one annuity contract and the issuance of another one at the death of the self-employed individual which would pay out over the same period as the original.

If a self-employed individual becomes disabled, so that he cannot engage in "substantial gainful activity,” and the disability is expected to be “of long-continued and indefinite duration,” then a distribution may be made to the self-employed individual at the time of the occurrence of the disability.66

60 INT. REV. CODE OF 1954, § 402(a)(2), 402(a)(5).
61 See text accompanying notes 22-24, supra.
63 See generally INT. REV. CODE OF 1954, § 72(n).
64 See INT. REV. CODE OF 1954, §§ 72, 401(d)(7).
65 See id.
66 INT. REV. CODE OF 1954, § 401(d)(4)(B). “Disabled” is defined in § 72(m)(7) of the Internal Revenue Code as follows:

[An individual shall be considered disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary or his delegate may require.
In the case of death or disability of the corporate employee, the broad discretion of the trustee will determine whether or not a distribution will be made.\textsuperscript{67}

5. Integration  H.R. 10 provides that where owner-employees are included, the plan may be integrated with the Social Security System only if the contributions for the owner-employees do not exceed one-third of the total contributions under the plan.\textsuperscript{68} The plan is given credit only for the actual Social Security contributions made by the employer. This requirement can, of course, eliminate integration of a plan with Social Security in cases such as a law partnership, where the contributions for the lawyers will generally be considerably in excess of one-third of the total contributions under the plan. Thus, the integration requirements of H.R. 10 will in many cases limit, if they do not eliminate altogether, any possible integration of the plan with Social Security.

6. Trustee  Under H.R. 10 plans, a bank is generally named as trustee unless the fund is invested exclusively in annuity, endowment, or life insurance contracts.\textsuperscript{69} There are, however, exceptions to this general rule. Where the fund is invested exclusively in (1) regulated investment company stock, or (2) annuity, endowment, or life insurance contracts issued by an insurance company, then a bank may be named as custodian rather than as trustee.\textsuperscript{70} An additional exception to the requirement that there be a bank trustee is where the fund is invested in special United States Government bonds issued for that purpose.\textsuperscript{71} These bonds are nontransferable and cannot be cashed until the individual has reached the age of 59\(\frac{1}{2}\) years, has died, or has become disabled.

In the case of a corporate retirement plan, on the other hand, there is considerable choice as to who might be selected to act as trustee.\textsuperscript{72} Even where a fund under H.R. 10 is allowed a corporate trustee, transactions by the trustee with owner-employees are severely restricted, and loans from the fund to such owner-employees, as well as any property transactions between them and the trust fund, are prohibited.\textsuperscript{73}

7. Estate Tax  In the case of a corporate retirement plan, distributions on an employee's death to his beneficiaries, other than his executor or his estate, are exempt from federal estate tax to the extent that they are attributable to contributions made by the employer.\textsuperscript{74} This estate tax exemption is not available in the case of distributions at death under H.R. 10, as to the self-employed, whether they own a ten percent interest or not.\textsuperscript{75} With respect to ordinary employees, however, the estate tax exemption does apply.\textsuperscript{76}

\textsuperscript{68} Int. Rev. Code of 1954, § 401(d) (6).
\textsuperscript{69} Treas. Reg. § 1.401(12)(c) (1963).
\textsuperscript{70} Int. Rev. Code of 1954, § 401(f).
\textsuperscript{72} The requirements of Treasury Regulation Section 1.401(12)(c) relating to bank trustees apply only to plans benefiting owner-employees. No similar provision appears in the regulations dealing with corporate retirement plans.
\textsuperscript{73} Int. Rev. Code of 1954, § 503(g).
\textsuperscript{74} Int. Rev. Code of 1954, § 2039(c).
\textsuperscript{75} See id.
\textsuperscript{76} Int. Rev. Code of 1954, § 2039(c).
In addition, under H.R. 10 the self-employed cannot qualify for the $5,000 death benefit which, in the case of corporate retirement plans, may be made free of estate tax to the widow, estate, or designated beneficiaries of an employee. 77

From the above discussion of the seven major areas of comparison of retirement plans, it is obvious that Keogh plans have many disadvantages when compared to corporate plans. Thus, it is clear that the Keogh plan, as a basis for improving the tax treatment of professional people, leaves much to be desired. The deficiencies of Keogh plans with respect to contributions are of major dimensions. While of lesser dimensions, the disadvantages of the Keogh plans with respect to coverage, distributions, integration and the estate tax may be of considerable, if not prime, importance. Less important, generally, are the deficiencies of Keogh plans with respect to vesting and the choice of trustee. In evaluating the choice that the Treasury proposals will afford to professional people, careful attention will need to be given to how the new Treasury plan treats professional people in the seven major areas of comparison, and particularly so with respect to the five major deficiencies of Keogh plans.

IV. Shaping the New Proposal

The big question now confronting professional people is "what lies in the future?" Which way should they jump? 78

On the one hand, they are aware of the long history of professional corporations since the Kintner case 79 in 1954, the Galt case 80 in 1959 and the Foreman case 80 in 1964, in which the courts recognized professional corporations for federal income tax purposes; they are conscious of the Treasury Department's constant refusal to acknowledge these decisions; 81 they are also aware of the passage of the Keogh Bill in 1962, 82 and the issuance of new regulations with respect to professional associations and corporations in 1965; 83 and, finally, they are cognizant of the 1969 pronouncement in T.I.R. No. 1019 84 that the Treasury would no longer contest professional corporations and associations in court. Following the publication of T.I.R. No. 1019 came the struggle in the United States Senate to include in the Tax Reform Act of 1969 a provision crippling, if not eliminating altogether, professional corporations and associations. 85 By final vote in the Senate, 65 to 25, however, the onerous provision was eliminated. 86 But left in its wake was a provision taxing a five percent or more shareholder-employee of a Subchapter S corporation on contributions to retirement plans in excess of $2,500 or ten percent of compensation, whichever is less. 87 Then, as previously stated, in March 1970,

---

77 INT. REV. CODE OF 1954, § 101'(b).
78 U.S. v. Kintner, 216 F.2d 418 (9th Cir. 1954).
87 INT. REV. CODE OF 1954, §§ 1379(b)(1), 1379(d).
with the issuance of Revenue Ruling 70-101, the Internal Revenue Service clearly specified that professional corporations and associations, formed in accordance with state statutes providing therefor, would be granted corporate tax treatment. This would seem to have put the matter to rest, but, as shown above, in the months that followed, various officials of the Treasury and Internal Revenue Service, in speeches and interviews, made it clear that the Treasury, in early 1971, will submit proposals to Congress which will, in substance, give unincorporated professional people equal treatment with corporate employees. With all this in mind, the question readily comes to mind, "what lies ahead?"

As previously noted, it appears that the main format of the Treasury plan would be the Keogh plan with modifications. The first and foremost modification would be as to the amount of contribution permitted. It appears that fifteen percent of compensation, rather than the present ten percent, and with an overall limit of $10,000, rather than $2,500, would be suggested. Certainly a proposal along these lines would appear to be reasonable and acceptable to most professional people interested in the subject.

While a proposal along the above lines might appear reasonable and feasible to the Treasury and to professional people, the question arises as to whether the proposal will appear reasonable to certain other interested parties. One doubts whether those members of Congress, particularly of the United States Senate, who, in connection with the Tax Reform Act of 1969, sought to limit the use of professional corporations and associations, would be willing to accept the fifteen percent and $10,000 limits. One must also consider whether a limitation along these lines should be imposed upon all corporate plans, that is, regardless of whether the corporation involves professional people. One can obviously foresee opposition to this on the part of executives in large corporations whose retirement plans would be considerably diminished by such limitations. This would then bring up the question of whether the proposal should be limited to closely held corporations only, so that the large corporations, which for the most part are publicly held, would be exempt from the limitation.

In determining what lies ahead, one must also recall that when the Keogh plan was originally proposed, it was known as the "Silverson" plan and that the original proposal allowed a contribution limit of $10,000. In the legislative process this amount was whittled down to $2,500, with only $1,250 actually deductible. With the inroads of inflation during the intervening years, it appears that the original $10,000 proposed in the "Silverson" plan would, in today's money, be more like $12,500. One must ask if the Treasury's present proposal faces the same "whittling" as the "Silverson" plan.

In spite of the disadvantages of Keogh plans and in spite of the foreseeable arguments against the Treasury's proposing a plan patterned after Keogh plans, this author feels that an acceptable plan can be attained by modifying the Keogh rules. On the whole, it would seem that if the contribution question can be acceptably answered, that is, if an amount can be agreed to, then the other complaints with respect to Keogh plans could easily be remedied. Certainly

89 See text accompanying note 16, supra.
some of the strict limitations of the law with respect to Keogh plans should be eased. For the most part, this would not be a problem of major dimensions. One quick remedy would be to do away with the category of owner-employees and give to them the treatment accorded the self-employed under the Keogh plans.91

The penalties for excessive contributions should be removed, but the general provisions of the Internal Revenue Code with respect to discrimination and prohibited transactions under corporate retirement plans should apply.

As to coverage, the general corporate rules should be adequate. Similarly, the corporate rules with respect to vesting and distributions should be made applicable, rather than the strict requirements presently applicable to Keogh plans. As previously stated,92 the treatment of lump sum distributions in corporate plans was substantially limited by the Tax Reform Act of 1969. This limitation would seem a reasonable limitation to adopt for the new Treasury proposals.

The choice of trustee might well be relaxed in order to permit trustees other than banks. Perhaps this might be resolved by requiring that there be at least one non-employee trustee, but with provision for employee co-trustees, in addition, if the parties wished.

The exemption from estate tax and the $5,000 death benefit, while substantial in the case of many employees, should be handled as in the case of ordinary corporate retirement plans.

The $2,500 contribution limitation imposed upon Subchapter S corporations should be eliminated and should at least be raised to the same level as the contributions permitted professional people under the new Treasury plan.

Finally, for those professional people who still wished to operate as a professional corporation or association, a further provision could be added. It would recognize that professional people should be permitted to select treatment either as a partnership or proprietorship, on the one hand, or as a professional corporation or association on the other. The provision should allow those who have formed professional corporations and associations to continue to operate in that form without having to liquidate their corporation or association. Those who wished to liquidate might well be permitted to do so without tax penalty during a moratorium, lasting perhaps until the end of their current taxable year, but in no event requiring them to liquidate prior to a date such as December 31, 1971, assuming the Treasury proposal was enacted by Congress sometime during the calendar year 1971.

This final provision recognizes that professional corporations and associations have advantages other than strictly tax advantages, and that many professional people, having now operated as a professional corporation or association, would choose to continue to operate as such. It also recognizes that professional people might well wish to adopt the professional corporation or association form, even though partnerships and proprietorships were given opportunity to set up retirement plans under the terms of the new Treasury proposal. Under the above proposals, there would still be tax advantages held by professional corporations and associations, as well as by ordinary corporations, which would not be granted

---

91 Self-employed individuals are treated substantially like corporate employees, except the deductible portion of their contributions is limited to $2500.

92 See text accompanying note 60 supra.
to professional people who did not incorporate or form an association. Those advantages include group life insurance, disability insurance, medical, health and hospitalization plans, all of which corporations may set up on a deductible basis, as well as the opportunity to accumulate funds in the corporation at low tax rates. Nevertheless, the new opportunities given to professional people who did not choose to incorporate or associate would be substantial and would permit professional people to have some retirement benefits which they do not now have. Substantial equality of treatment would be brought about. Professional people would still have a choice—to stay in partnership or proprietorship form, on the one hand, or, on the other hand, to incorporate or associate and thus achieve all of the benefits of incorporation.

It is time to resolve this matter in a sensible and equitable fashion. Certainly the Treasury has declared its intention toward that end. If the Treasury proposal, when presented to Congress, is tailored along sensible lines, and if Congress can be persuaded to pass legislation giving professional people substantial equality with respect to retirement plans, whether they remain in partnership or proprietorship form, or choose to form professional corporations or associations, our tax structure, at least in this area, will be more equitable. A large group of our citizens, the unincorporated professional people of the country, would then at least feel that they have some opportunity to provide for their own retirement, for the protection of their families, and for the welfare of their employees.