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Recommended Citation

Doris R. Hauth, Retirement Plans for Self-Employed Individuals, 18 Clev.-Marshall L. Rev. 610 (1969)

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Retirement Plans For Self-Employed Individuals

*Doris R. Hauth**

TODAY'S TAXPAYER is more conscious than ever of the heavy tax burden he must bear as he reaps the rewards of prosperous years in a business or profession. The graduated tax scale contained in the Internal Revenue Code[1] obviously takes a larger percentage as an individual's income increases, and the surcharge[2] enacted during 1968 serves to amplify the tax burden.[3]

The self-employed individual has long sought a method of escaping the high tax assessed on his earnings during his most productive years. He looks with envy at his counterpart employed by a corporation who is enjoying tax benefits through the deferment of the recognition of certain income until later tax years. One way in which this has been accomplished is by corporations offering their employees stock, under qualified stock option plans,[4] which often results in a twofold benefit to the employee. The first is that if the option meets the requirements of the Internal Revenue Code, the employee is not taxed when a qualified stock option is granted, nor when it is exercised, unless the fair market value of the stock was underestimated. The employee is taxed on the gain in the value of the stock only when he sells it which, of course, allows him to defer the recognition of the income until a year in which his income, thus his tax bracket, is lower. The second advantage of qualified stock options results because any gain received when the stock is sold is treated as a long-term capital gain if the stock is held at least three years beginning on the day after the day of transfer of such share to the employee.

Employee stock purchase plans[5] which a corporation may offer its employees also qualify for special tax treatment. Under these, the option price can be as low as eighty-five percent of the market price at the time the option is granted or at the time the option is exercised. If the option is held for at least two years before being exercised and the stock is held for more than six months, the employee realizes ordinary income to the extent of the excess of the fair market value of the stock at the

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1 Internal Revenue Code of 1954.

2 *Id.* at sec. 51.

3 *Supra* note 1. Current tax rates vary from 14% in the lowest bracket to 70% in the highest. The basic surcharge rate is 10% of the tax before credits (except retirement income credit) but since it was not effective until April 1, 1968, it was apportioned resulting in a rate for 1968 of 7.5%.

4 *Id.* at sec. 422.

5 *Id.* at sec. 423.

Published by EngagedScholarship@CSU, 1969

time the option was granted over the option price. Any further gain is taxed as a long term capital gain.

A further benefit which corporations have been able to offer is a pension or profit-sharing plan. Section 401 of the Internal Revenue Code sets forth the requirements for qualifying such a plan and allows a complete tax deferment of the payments made thereunder for employees and a current tax deduction for such payments to the corporation. An amendment to this section first permitted self-employed individuals to participate in qualified pension and profit-sharing plans beginning in 1963.[6] The act is frequently referred to as the Keogh Act and retirement plans covering the self-employed individuals are referred to as Keogh Plans or H.R. 10 Plans.[7] Generally, this law applies to all self-employed individuals subject to self-employment taxes.

Since a plan covering self-employed individuals is formed under the same sections of the Code which authorize plans covering only common law employees, it must meet all of the requirements of the corporate plans.[8] In addition, plans covering self-employed individuals must meet the following special requirements:

1. If an owner-employee adopts a retirement plan in which he is a participant, the plan must cover all full-time employees who have been employed for three years or more,[9] including each partner who does not qualify as an owner-employee.[10]
2. The rights of all common law employees participating in the plan, and the rights of all partners who are not owner-employees, must be vested from the time contributions are made on their behalf.[11]

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[6] The Self-Employed Individuals Tax Retirement Act of 1962; P.L. 87-792; 76 Stat. 809.

[7] The bill was initially introduced in the House of Representatives as H.R. 10 by Eugene J. Keogh (D-N.Y.) in 1957 but was not enacted until 1962.

[8] *Supra* note 1, at secs. 401-404 require the following for all plans:

(a) The plan must be for the exclusive benefit of employees, or their beneficiaries.
(b) The sole purpose of the plan must be to offer the employees or their beneficiaries either a share of the profits of the business, or an income after retirement.
(c) The contributions or benefits provided under the plan must not discriminate in favor of employees who are officers, shareholders, supervisory employees, or highly paid employees.
(d) The employer intends the plan to be permanent.
(e) The plan must be in writing and communicated to the employees.
(f) The plan must provide nonforfeiture of benefits when it ends.

[9] *Id.* at sec. 401(d)(3); "Employee" does not include any employee whose customary employment is not more than 20 hours in any one week or is for not more than 5 months in calendar year.

[10] *Id.* at sec. 401(c)(3) defines "owner-employee" as an employee who owns the entire interest in an unincorporated trade or business, or in the case of a partnership, is a partner who owns more than 10% of either the capital interest or profits in such partnership.

[11] *Id.* at sec. 401(d)(2)(A). A corporate plan may provide that employees will acquire nonforfeitable rights to contributions only at a gradual scale.

3. If owner-employees are covered under a profit-sharing plan, there must be a definite formula for determining contributions to be made on behalf of all employees other than owner-employees.[12]
4. If the plan is funded through a trust, a bank must be appointed as trustee. However, if the trust purchases only annuity, endowment, or life insurance contracts, it is not necessary to appoint a bank trustee.[13]
5. Contributions or benefits may not be provided for any owner-employee under a plan unless the owner-employee consents to be covered.[14]

It should be noted that a plan that does not cover owner-employees is far less restrictive since it must meet only the qualifications established for corporations. This situation may exist in the large partnership where none of the partners owns more than ten percent of either the capital interest or profits of the firm.

The contributions made to a qualified pension or profit-sharing plan are tax deductible by the employer when arriving at his taxable income. No special restrictions are imposed on the amount of contributions which may be made for common law employees or self-employed persons who are not owner-employees. There are, however, restrictions on the contributions made on behalf of the owner-employee. The original Keogh Act, effective for tax years after December 31, 1962, allowed a maximum contribution of ten percent of earned income[15] of a business, but not to exceed $2,500 per year. However, only fifty percent of the contribution on behalf of an owner-employee was deductible in determining taxable income. Thus, the maximum deduction was only $1,250 for these contributions. The 1962 Act also provided that where personal services and capital were both a material income-producing factor in a business, not more than thirty percent of the net income could be considered earned income.

These qualifications severely restricted the effectiveness of the Keogh Act in affording the self-employed individual a tax benefit. As a matter of fact, although the Keogh Act received much publicity, it encouraged few participants.[16]

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[12] *Id.* at sec. 401(d)(2)(B). This requirement is in sharp contrast to the rules applicable to plans which cover only common law employees. These regulations clearly state that no definite formula is necessary for the determination of the employer's annual contribution.

[13] *Id.* at sec. 401(d)(1).

[14] *Id.* at sec. 401(d)(4)(A).

[15] Earned income means net earnings derived from self-employment. It includes professional fees and other amounts received as compensation for personal services, but does not include investment income such as dividends, interest, rents, and capital gains.

[16] The number of Keogh plans approved by the Internal Revenue Service each year declined from approximately 11,000 in 1964 to about 7,400 in 1966.

The Act was amended for tax years beginning after December 31, 1967,[17] and now affords much more liberal benefits in regard to contributions made on behalf of the owner-employee. The first change was to increase the maximum deduction to $2,500 if the self-employed individual has earned income of $25,000 or more.[18] Second, earned income now includes the entire net income of a business if performance of personal services is a material income-producing factor.[19]

An individual operating a business in 1965 which required both personal services and capital and having a net income of $25,000 received a tax deduction of only $375 for contributions made to a qualified plan on his behalf. His earned income for purposes of the plan was $7,500 (30% of $25,000) and his contribution at 10% was limited to $750. His deduction for tax purposes was 50% of the contribution, or $375. Under the present regulations, the same individual is able to take a tax deduction of $2,500, assuming net income of $25,000 or more, since his entire net income, up to $25,000 is eligible and the full contribution is deductible.

The liberalization caused widespread interest in Keogh Plans as was evidenced by the number of plans submitted to the Internal Revenue Service for approval. The number soared to 66,400 for the first nine months of 1968,[20] compared to 29,400 in 1967[21] and 7,400 in 1966.[22]

A self-employed person may establish either a pension plan or a profit-sharing plan. The pension plan has some disadvantages for the self-employed individual since the intended benefits are usually predetermined and the employer makes annual contributions, computed on an actuarial basis, sufficient to finance the benefits. This is not very suitable if the plan covers self-employed individuals subject to a percentage limitation on contributions. Under a profit-sharing plan, however, the benefits would not have been predetermined but would be based on the employer's contributions plus the earnings of the fund.

As pointed out earlier,[23] if a profit-sharing plan is adopted which covers owner-employees as well as common law employees, a definite formula must be established for determining the contribution to be made on behalf of all employees other than the owner-employee. This requirement, however, does not limit participation to a fixed percentage con-

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17 P.L. 89-809, November 13, 1966.

18 *Supra* note 1, at sec. 404(e)(1). Contributions on behalf of the owner-employee are still limited to 10% of earned income with a maximum of $2,500.

19 *Id.* at sec. 401(c)(2)(A).

20 "Tax Report: A Special Summary and Forecast," Wall Street Journal, February 5, 1969, at 1.

21 *Ibid.* The increase in 1967 can be attributed to the passage of the act late in 1966, effective for tax years beginning after January 1, 1968.

22 *Ibid.*

23 *Supra* note 12.

tribution plan but rather was intended to avoid the abuse of the plan by the employer in making larger or smaller contributions based upon the tax rates in effect during a particular year or the tax bracket in which he was placed for the year.[24]

The self-employed individual can greatly reduce his contribution expense and protect his tax advantage under the Keogh Act by adopting a variable formula. This can be done by specifying that each year the employer shall contribute on his own behalf that percentage of his earned income which represents the maximum contribution allowable under the law and the contribution for covered employees shall be that same percentage of their earned income (salary).

This language would automatically reduce the dollar amounts which are contributed for employees as the employer's income increases. To illustrate, assume an employer has earned income of $25,000 for the year. His maximum contribution is $2,500 or 10%. If the salaries of all his covered employees are also $25,000, he would contribute $2,500 to the plan on their behalf. If the net income of the business rose to $50,000, the employer's contribution is still $2,500, the maximum allowed under the law, but this represents only 5% of his earned income. Therefore, his contribution on behalf of his employees would also be 5% for the year. Assuming salaries remained at $25,000, the employer's contribution on behalf of his employees would be $1,250 for the year.

A pension or profit-sharing plan which includes an owner-employee must be funded through one of the methods specified in the Internal Revenue Code. The Code provides, as one choice, for direct cash contributions to be made to a trust created to administer the plan.[25] In most instances the trustee must be a bank; however, control over investments may be retained by the employer or turned over to an investment advisor. Thus, the trustee-bank often functions primarily in a safe-keeping capacity. If none of the participants in the plan is an owner-employee, an individual trustee can be used. Also, if the only investments of the trust are in annuity, endowment, or life insurance contracts issued by a life insurance company, any individual qualified to act as a trustee may be used and this includes the owner-employee and members of his family.

A second method of funding is through the purchase of non-transferable annuity contracts.[26] These may be held with or without the intervention of a trust or bank custodial account. An annuity contract is transferable if the owner can sell, assign, discount or pledge his interest in the contract to any person other than the insurance company which

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[24] Based upon the Senate Finance Committee's comments on the Keogh Act, "Keogh Today—Answer for Self-Employed Businessmen," *Commercial and Financial Chronicle,* June 29, 1967, at 24.

[25] *Supra* note 13.

[26] *Supra* note 1, at sec. 401(g).

issued the contract. But this restriction against transferability does not mean that the employee covered by the contract may not designate a beneficiary for death benefits under the contract, or elect to receive a joint and survivor annuity.[27]

A third funding method which is available is investment in stock of a mutual fund or other regulated investment company which issues only redeemable stock.[28] A bank custodial account may be used in lieu of a trust under this option but the bank must be the custodian and must be the shareholder of record. The requirement that all funds must be invested in mutual funds of regulated investment companies applies to all contributions under the plan as well as any earnings on such contributions. Therefore, all earnings in the form of capital gains realized from the sale of any shares, and capital gains and regular dividends must be re-invested. However, a custodian may make deposits in a bank savings or checking account while accumulating funds to make additional investments or while waiting for an appropriate time to make such investments.[29]

Another funding method which may be adopted is through direct investment in a special series of United States retirement plan bonds.[30] These bonds conform to the requirements of the Keogh Act with the following restrictions:[31]

1. Provide for the payment of interest only upon redemption;
2. Can be issued only in the names of the individuals;
3. Cease to bear interest not later than 5 years after the death of the named individual;
4. Are redeemable only upon the death of the named individual, his disability, or his attainment of the age of 59½;
5. Are nontransferable.

The bonds are available for investment only to bond purchase plans and to pension and profit-sharing plans. If a plan is to qualify as a "bond purchase plan" all contributions to the plan must be used for the purchase of retirement bonds.[32] The employee's right to the proceeds of a bond purchased in his name must be nonforfeitable, and no bond proceeds may inure to the benefit of the employer or be reallocated in any way.[33] The bonds may be distributed to the employees at any time but, by their terms, they cannot be redeemed by the person for whom they

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27 Treas. Regs. 1.401-9(b) (3).

28 *Supra* note 1, at sec. 401(f).

29 Treas. Regs. sec. 1.401-8(b) (3).

30 *Supra* note 1, at sec. 405(a).

31 *Id.* at sec. 405(b) (1).

32 *Id.* at sec. 405(a) (2).

33 Treas. Reg. 1-405-1(b) (2).

were purchased until he either reaches age 59½ or becomes disabled. The main advantage of this type of plan is that the bonds may be purchased without the intervention of a trust.

The fifth method of funding a pension or profit-sharing plan covering an owner-employee is through direct purchase from an investment company of face amount certificates.[34] The Investment Company Act of 1940 defines the term "face amount certificate" in the following manner:

> Face amount certificate means any certificate, investment contract, or other security which represents an obligation on the part of the issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates more than 24 months after the date of issuance, in consideration of the payment of periodic installments of a stated or determinable amount (which security shall be known as a face-amount certificate of the 'installment type'); or any security which represents a similar obligation on the part of a face-amount certificate company, the consideration for which is the payment of a single lump sum (which security shall be known as a 'fully paid' face amount certificate).[35]

As indicated by the above definition, this method of funding is very similar to investing in annuities.

The requirements for qualifying a retirement plan covering the self-employed individual are contained in Sections 404(c)-(e) of the Internal Revenue Code.[36] Custom-tailored plans may be adopted but the cost of establishing one of this type often proves prohibitive for the sole proprietor or small partnership with just a few employees. However, many mutual funds, regulated investment companies, banks and insurance companies have established economical and efficient master or prototype plans which are available.[37] In addition, some professional associations such as the American Bar Association and the American Medical Association have sponsored plans which may be adopted by their members without encountering the costs associated with a custom-made plan.

The Internal Revenue Service has established a method of approval of a master or prototype plan through use of a simplified application. Form 3672, when filed by the sponsoring organization, gives the District Director the required information to determine that the plan and trust qualify for acceptance if adopted by self-employed individuals or partnerships with owner-employees. However, the approval of the master or prototype plan does not constitute approval of such as a qualified plan when adopted by a sole proprietor or partnership. The person adopting

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[34] Supra note 26.

[35] 15 U.S.C. 80a-2(a) (15).

[36] Treas. Regs. 1.401-10—1.401-13 should be also consulted when qualifying a plan.

[37] Rev. Proc. 64-30, 1964-2 CB 944.

the plan must submit his own application to the Internal Revenue Service to establish his personal qualifications.[38]

The Code sets forth special rules which govern the time of payment of benefits and the way in which these benefits are taxed if a retirement plan covers an owner-employee. No benefits may be paid to the owner-employee until he reaches age 59½, unless he becomes disabled.[39] If this requirement is violated, no contributions may be made for him under the plan for five taxable years following the year in which a premature distribution was made.[40] In addition, benefits must begin to be paid to an owner-employee no later than age 70½.[41] In contrast, benefits may be distributed to common law employees and self-employed persons who are not owner-employees before they attain age 59½ if the plan so provides. Also, the payment of benefits to those who are not owner-employees must commence at age 70½ or retirement, whichever is later. Therefore, it is possible for all persons but owner-employees to defer the receipt of benefits, and thus the recognition of income, until he actually retires. The owner-employee, on the other hand, must start to receive benefits at age 70½ even though he continues to work.

The taxation of distributions made to common law employees under a retirement plan are the same as the treatment afforded corporate employees. Lump sum distributions are taxable as long-term capital gains if paid in one taxable year.[42] If the distribution is made by reason of the employee's death, his beneficiary is entitled to exclude an amount up to $5,000 as a death benefit.[43] Installment benefits, however, are taxed as ordinary income under the annuity rules.

Benefits received by the self-employed individual, whether or not he is an owner-employee, are taxable in all cases as ordinary income. Of course, any amount previously taxed, such as the non-deductible portion of the owner-employee's contribution for years before 1968, may be withdrawn tax free. One relief measure has been afforded the self-employed individual receiving a lump-sum payment. In lieu of capital gains treatment, they are permitted to compute their tax under a special averaging formula intended to limit the impact of the high tax bracket on lump sum distributions. The tax paid is limited to the greater of (1) five times the increase in tax which would result from including one-fifth of the taxable part of the distribution in gross income, or (2) five times the

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38 Form 3673 is a simple one-page form with questions concerning the business, covered and excluded employees and the type of plan adopted. It serves to verify that the individual adopting a master or prototype plan has met the code requirements as an employer.

39 *Supra* note 1, at sec. 401(d)(4)(B).

40 *Id.* at sec. 401(d)(5)(C).

41 *Id.* at sec. 401(a)(9).

42 *Id.* at sec. 72.

43 *Id.* at sec. 101(b).

increase in tax which would result if taxable income were equal to one-fifth of the taxable part of the distribution minus personal exemptions.[44]

The self-employed individual contemplating the adoption of a "Keogh Plan" is, of course, interested in the tax advantage to be afforded him. The establishment of a retirement plan which also covers employees requires contributions on their behalf. Although these payments constitute a business expense, the tax savings is not equal to the cash outlay. On the plus side, however, is the savings which result from contributions made by the owner-employee on his own behalf.

First of all, he is allowed a deduction for his contribution in arriving at his taxable income. This is treated as an adjustment to income[45] rather than an itemized deduction and therefore, it is allowed even if he takes a standard deduction. The recognition of this part of his income is then deferred until such time as he begins to receive benefits under the plan.

Second, these funds will earn income from the time they are contributed until they are paid out and this income also will be deferred until benefits are received. Thus, the self-employed individual is able to save tax-free dollars and also defer the recognition of any income on this investment until he is in a lower tax bracket.

Another tax benefit may accrue if the plan qualifies for voluntary contributions. If provision is made, self-employed participants as well as common law employees may make additional contributions subject to the same limitations that apply to plans covering corporate employees. However, in the case of an owner-employee, the voluntary contribution may not exceed ten percent of his earned income with a ceiling of $2,500.[46] The right of the owner-employee to make voluntary contributions is also limited to years in which contributions are made on behalf of common law employees.[47] This option, then, is not available to the self-employed individual operating without employees.

Although there is no tax deduction for voluntary contributions, they constitute a tax deferment since the earnings on the contributions are not taxed until distribution from the retirement fund is made. The opportunity to plough back the tax-free investment income does constitute a significant advantage.

The self-employed individual has not yet gained the status of the corporate employee in his ability to defer income, but the Keogh Act, as amended in 1967, does afford him substantial tax savings. The benefits should be thoroughly considered by all who qualify.

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[44] *Id.* at sec. 72(n) (1),(2)

[45] Adjustments are deductions in arriving at adjusted gross income. Itemized or standard deductions are treated separately as deductions from adjusted gross income.

[46] *Supra* note 1, at secs. 401(d) (5) (A), 404(e) (1).

[47] *Id.* at sec. 401(d) (5) (B).