St. John's Law Review

Volume 60, Spring 1986, Number 3 Article 2

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THE INDIVIDUAL RETIREMENT ACCOUNT: RETIREMENT HELP FOR THE MASSES, OR ANOTHER TAX BREAK FOR THE WEALTHY?†

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The term Individual Retirement Account (IRA) may bring to mind thoughts of individuals of modest means trying to save $2000[1] per year to supplement their anticipated social security payments during their lean retirement years. Government statistics and recent changes in the Internal Revenue Code, however, suggest that IRAs may become another tax tool used primarily to reduce the tax burden of wealthy taxpayers.

This article will discuss IRA provisions that favor wealthy taxpayers. The desirability of these provisions in light of the federal government's budget deficit will also be examined, and changes in IRA rules to reduce the negative revenue impact of the present

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† The author would like to acknowledge that this article was prepared and accepted prior to the enactment of the Tax Reform Act of 1986 and does not reflect any changes contained therein.

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[1] *See* I.R.C. § 219 (1982). Section 219 allows an annual individual deduction for "qualified retirement contributions," I.R.C. § 219 (a), in an amount not to exceed the lesser of $2,000, I.R.C. § 219 (b)(1)(A), or the amount of an individual's "gross income for such taxable year," I.R.C. § 219 (b)(1)(B). A worker may set up such a plan, whether or not covered by an employee retirement plan. *See* Goldberg, *Individual Retirement Accounts*, 43 INST. ON FED. TAX'N 56:01, 56:02 (1985). These accounts are typically set up by employers, unions, or the taxpayers themselves, and are tax deductible. *See id.* When IRAs were enacted in 1974, however, this was not the case. Workers who were participants in their employers' qualified pension plans at the time of their contribution were deemed ineligible to claim these contributions as tax deductions. *See, e.g.*, Orzechowski v. Commissioner, 592 F.2d 677, 678 (2d Cir. 1979) (no deduction for taxpayer who contributed to IRA, and participated in employer's pension plan). This requirement was eliminated by 1981 amendments, and workers can now claim deductions even though they participate in their employers' pension plans. *See* § 219 (b) (1982) (no such limitation contained). *See generally* Goldberg, *supra*, at 56:02. Employers are also allowed to deduct their contributions to IRA's. *See* Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 419 (1984) (citing I.R.C. § 404 (a) (1982)).

provisions will be suggested.

HISTORICAL PERSPECTIVE

When the deduction for contributions to an IRA originally became part of the Internal Revenue Code in 1974,[2] the deduction was limited to the lesser of $1500 or 15% of taxable compensation.[3] Even more restrictive in terms of taxpayer utilization was the statutory provision that disallowed IRA participation for wage earners who were active participants in qualified employer provided retirement plans.[4] Because most employers provided some type of qualified retirement plan,[5] many taxpayers could not take advantage of the IRA provisions.

The public clamor for favorable tax benefits, such as limited current income tax deduction for contributions,[6] tax-free accumu-

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[2] *See* Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829, 952-94 (1974) (codified in scattered sections of Titles 5, 18, 26, 29, 31 & 42 U.S.C.). The "phenomenal" growth in the number of employers participating in private pension and welfare plans after World War II prompted Congress to enact ERISA. *See* H.R. REP. No. 533, 93rd Cong., 2d Sess., *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4639, 4641. The declared Congressional objective in enacting ERISA was to create uniformity in the pension and welfare arena to protect "the interests of participants in employee benefit plans . . . by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans . . . ." 29 U.S.C. § 1001(b) (1982). Another objective in enacting ERISA was to "establish a vehicle for the tax-sheltered accumulation" of pension fund accounts. *See* Stanger & Mills, *Individual Retirement Accounts, Individual Retirement Annuities, and Retirement Bonds*, 38 INST. ON FED. TAX'N 32, 32.01 (1980). To meet these objectives, Congress permitted workers to establish individual retirement plans. *See id.*

[3] *See* I.R.C. § 219 (b)(1) (1975); Stanger & Mills, *supra* note 2, at 32.01 (prior to 1982 amendment of I.R.C. § 219(b)(1)(c), individuals allowed to contribute lesser of 15% of wages or $1,500 to IRA).

[4] I.R.C. § 219 (b)(2)(A)(i) (1976) (prior to 1982 Amendments). *See* Orzechowski v. Commissioner, 592 F.2d 677, 678 (2d Cir. 1979) (purpose of section to disallow tax deductions for contributions to IRAs if simultaneously participating in employer's pension plan). The objective of Congress in restricting active participants in pension plans from receiving tax benefits was to prevent a double recovery of tax benefits after the rights in their employer's plan vested. *See* H.R. REP. No. 807, 93d Cong., 2d Sess., *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4670, 4794; *see also Orzechowski*, 592 F.2d at 678.

[5] *See* D. POSIN, FEDERAL INCOME TAXATION OF INDIVIDUALS 400 (1983) (prior to amendments, IRA's of marginal interest to most taxpayers).

[6] *See* I.R.C. § 408(e)(1) (1982), which provides:

> 1) **Exemption from tax.** Any individual retirement account is exempt from taxation under this subtitle unless such account has ceased to be an individual retirement account by reason of paragraph (2) or (3). Notwithstanding the preceding sentence, any such account is subject to the taxes imposed under section 511 (relating to imposition of tax on unrelated business income of charitable, etc. organizations).

Id. Thus, this treatment of qualified retirement plans has the effect of deferring taxation on lation of income, and favorable distribution rules,[7] resulted in a liberalization of the IRA rules in 1981.[8] The annual IRA contribution deduction limit was raised to the lesser of $2,000 or 100% of the taxpayer's taxable compensation.[9] More importantly, the provision restricting active participants in qualified plans was amended so that all wage earners could participate in IRAs.[10] As a result, in 1982, the number of taxpayers contributing to IRAs quadrupled.[11] Although these amendments were designed to provide retirement help for the broad spectrum of working taxpayers, IRS statistics indicate a much greater utilization of IRAs by taxpayers with adjusted gross incomes exceeding $100,000 (82.2%), than by taxpayers with adjusted gross incomes under $30,000 (8.7%).[12] This disparity can be explained not only by differences in ability to save, but also by the relatively stiff penalties for early withdrawal from an IRA,[13] compared with other saving alternatives. Both these factors tend to favor IRA participation by high income taxpayers rather than by lower income taxpayers. The dollar magnitude of IRA contributions by high income taxpayers is also skewed to that group. In 1983, even though only 0.8% of eligible returns reported adjusted gross incomes in excess of $100,000, this group of returns accounted for 5.2% of the $32 billion in IRA

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the contributions of the employee received as retirement benefits, thereby reducing current tax expenditures. *See* Wolk, *supra* note 1, at 421.

[7] *See* I.R.C. § 408(d)(1), (d)(2) (1982) (accumulated IRA benefit taxable only *when distributed* to individual); *see also* Treas. Reg. § 1.408-4(a) (1985) (amount paid becomes gross income upon distribution).

[8] *See* Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, 95 Stat. 274 (1981) (codified in sections of Title 26 U.S.C.).

[9] *See supra* note 1.

[10] *See* P. METZER, FEDERAL INCOME TAXATION OF INDIVIDUALS 122 (1984); D. POSIN, *supra* note 5, at 400; *supra* note 1; *see also* Goldberg, *supra* note 1, at 56:02.

[11] *See* Hira & Swanson, *Individual Retirement Accounts: An Update After the DRA*, 16 TAX ADVISER 285, 285 (1985); *see also IRA, Keogh Assets Continue to Grow in 1983*, 23 TAX NOTES 458, 458 (1984) (1982 growth rate of 71% over previous year).

[12] *See* STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 1ST SESS., TAX REFORM PROPOSALS 8 (Comm. Print 1985) (statistics for 1983 tax year).

[13] *See* I.R.C. § 408(f)(1) (1982), section 408(f)(1) requires that an additional 10% of the amount of the IRA distributed be taxed, but only to the extent that the IRA is distributed to the taxpayer before the age of 59½. *See id.* Thus, high income individuals are more likely to be able to afford a non-liquid investment such as an IRA than are low income individuals, who cannot amass the requisite savings/disposable income ratio that would afford the luxury of putting money away until the age of 59½. The net-present value penalties inherent in section 408(f)(1) are, therefore, clearly disincentives to low income taxpayers, who must keep a higher level of liquidity in their savings because their income levels cannot support the section 408 penalties.

contributions.[14] In the same year, even though only 23.1% of eligible returns reported adjusted gross incomes exceeding $40,000, this group of returns accounted for 66.9% of the total IRA contributions.[15] Therefore, both the percentage usage and amounts contributed are greater for high bracket taxpayers.

SIGNIFICANT IRA ACCOUNT BALANCES

One might suppose that the maximum balance in an IRA account after a possible twelve years of existence would total less than $50,000 ($1,500 or $2,000 per year contribution plus earned income). In actuality, many IRAs contain hundreds of thousands of dollars; some contain in excess of one million dollars. This situation is the result not of a fortuitous investment, but of statutory provisions favoring wealthy taxpayers.

One method of obtaining a significant IRA accumulation is the utilization of a Simplified Employee Pension (SEP),[16] an arrangement in which an employer makes a contribution directly into an employee's IRA, normally in lieu of maintaining a more conventional qualified pension or profit-sharing plan.[17] The employer receives a current deduction in the amount of the SEP contribution.[18] The employee recognizes income to the extent of the employer contribution, but is also allowed a deduction in the amount of the qualified employer contribution.[19] The general requirements of an IRA are applicable in a SEP situation,[20] along

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[14] *See supra* note 12.

[15] *See id.*

[16] *See* I.R.C. § 408(k) (West 1982 & Supp. 1985) (added under Revenue Act of 1978, Pub. L. No. 95-600, § 152(b), 92 Stat. 2797 (1978)). With the Revenue Act of 1978, Congress sought to "create a vehicle for IRA contributions that would transform the IRA into a viable alternative to a tax-qualified retirement plan. This new vehicle [was the] simplified employees pension (SEP). . . ." Stanger & Mills, *supra* note 2, at 32.09. An SEP is an IRA in which employers contribute certain funds to the employees' accumulated contributions. *See infra* notes 17-19 and accompanying text. The employee may be eligible for employer contributions under an SEP if his employer's contributions satisfy the standards relating to participation, nondiscrimination, withdrawals, and a written allocation formula prescribed in section 408(k). *See* Stanger & Mills, *supra* note 2, at 32.09.

[17] *See* I.R.C. § 401(a) (West 1982 & Supp. 1985).

[18] *See* I.R.C. § 404(g)(3) (1982). "Any payment described in paragraph (1) [employer contributions to IRA] shall . . . be deductible under this section when paid." *Id.*

[19] *See* I.R.C. § 219(2)(A)(ii) (West 1982 & Supp. 1985); *see infra* note 23 and accompanying text. This allowable deduction for the employer contribution is in addition to the $2,000 deduction available for the employee's own contribution to the IRA. *See* I.R.C. §§ 219(b)(1)(A), 219(b)(2)(A).

[20] *See* I.R.C. § 408(k)(1) (West Supp. 1985).

with some participation and contribution restrictions on the employer.[21]

Although contributions are limited to 15% of compensation,[22] those employees earning significant wages can receive and deduct as much as $30,000 per year in SEP contributions to their IRAs.[23] With the employee contribution also available, highly paid employees could contribute and deduct $32,000 per year.[24] Obviously, this opportunity is available only to those employees whose employers adopt a SEP plan. In many cases, however, the decision to adopt a SEP is in the hands of the highly paid employees who would benefit most.

While some of the significant dollar balance IRAs may be SEP-related, the most common source of funds in such an IRA is the rollover of funds from a qualified pension or profit-sharing plan.[25] A tax-free rollover of an employee's entire account balance,[26] or of a partial distribution[27] from a qualified plan, may in-

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[21] *See* I.R.C. § 408(k)(1)(A) (West Supp. 1985). *See generally* Stanger & Mills, *supra* note 2, at 32.09.

[22] I.R.C. § 404(h)(1)(C) (1982 & West Supp. 1985) provides:

> The amount deductible in a taxable year for a simplified employee pension shall not exceed 15 percent of the compensation paid to the employees during the calendar year .... The excess of the amount contributed over the amount deductible for a taxable year shall be deductible in the succeeding taxable years in order of time, subject to the 15 percent limit of the preceding sentence.

Id.

[23] *See* I.R.C. § 219(b)(2)(A)(ii) (West Supp. 1985). This section was modified by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 713(d)(2), 98 Stat. 505, which amended the deductible amount from $15,000, *see* I.R.C. § 219(b)(2)(A)(ii) (1982), to the amount not in excess of the limitation in effect under section 415(c)(1)(A). *See* § 219(b)(1)(A)(ii) (West Supp. 1985). The current amount expressed in section 415 is $30,000. *See* I.R.C. § 415(c)(1)(A). An individual earning $200,000 per year could take advantage of the 30,000 deduction by contributing 15% of his or her income into IRA funds. Obviously, lower income individuals could not take advantage of this maximum deduction benefit.

[24] *See* I.R.C. § 219(b)(1)(A) (1982). The statutory limit to the amount of employee contributions to an IRA is $2,000. *See id.*; *supra* note 1.

[25] *See* I.R.C. § 408(d)(3)(A)(ii) (1982). Individuals with IRA plans may "rollover" funds in their accounts to tax-qualified retirement plans. *See id.* This is a benefit to taxpayers because a tax-qualified retirement plan is subject to more flexible rules than IRA accounts. *See* Stanger & Mills, *supra* note 2, at 32.05[3]. For instance, "the tax-qualified plan estate tax exclusion rules allow more flexible modes of distribution than IRA estate tax exclusion rules; tax-qualified retirement plans generally do not have to commence distribution at age 70½; and lump-sum distributions for tax-qualified retirement plans are eligible for special income tax treatment." *Id.*; *see also* Rev. Rul. 82-153, 1982-2 C.B. 86 (no prohibition against persons over 70½ rolling over qualified fund into IRA). For qualification requirements of qualified pension, profit-sharing, and stock bonus plans, *see* I.R.C. § 401(a) (1982 & West Supp. 1985).

[26] *See* I.R.C. § 402(a)(5)(A)(i) (West 1982 & Supp. 1986). "If . . . the balance to the

fuse the IRA with significant funds accumulated over the entire working career of the taxpayer. Highly compensated employees' accumulations in qualified plans can easily reach six or seven figure amounts because the allowable annual deductions are more generous than those of IRAs,[28] and because for a longer period of time qualified plans have been available.[29]

An appreciation of the tax benefits forfeited by the taxpayer who elects a tax-free IRA rollover from a qualified plan is a prerequisite to understanding why wealthy taxpayers are the prime users of the IRA rollover provision. Assuming that the distribution from the qualified plan is a qualifying lump sum distribution,[30] three special tax benefits are available. First, if employer's securi-

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credit of an employee in a qualified trust is paid to him [in a qualified rollover distribution] . . . such distribution . . . shall not be includible in gross income . . . ." *Id.* If an individual receives a distribution from an IRA, he can reduce his current tax liability by transferring the distribution into an individual retirement account or annuity "by the 60th day after he received the payment or distribution. This 60 day rollover is strictly adhered to by the Service and the courts." Goldberg, *supra* note 1, at 56.11[1].

[27] *See* I.R.C. § 402(a)(5)(D) (West 1982 & Supp. 1986). The Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 505, altered the definition of a "rollover" to allow a rollover of a *partial* distribution of funds to be tax free. *See* Goldberg, *supra* note 1, at 56.12. This partial disbursement must consist of at least 50% of the employee's total balance in the qualified plan prior to distribution. *See* I.R.C. § 402(a)(5)(D)(i)(I) (West Supp. 1985).

[28] *Compare* I.R.C. § 415(c)(1) (West Supp. 1986) (annual limitation for defined contribution plans is lesser of $30,000 or 25% of compensation) *with* I.R.C. § 219(b)(1) (1982) (lesser of $2,000 or amount of gross income for year deductible).

[29] *See* STAFF OF JOINT COMM. ON TAXATION, 99th CONG., 1st SESS., TAX REFORM PROPOSALS 2 [*hereinafter* Comm. Print 1985]; Wolk, *supra* note 1, at 426. The Revenue Act of 1921, ch. 136, § 219(f), 42 Stat. 227, 241, specifically provided that certain employee trusts forming part of a qualified profit-sharing or stock bonus plan were exempted from federal income tax. Comm. Print 1985 at 2. The Act contained the first specific statutory reference to retirement plans. Wolk, *supra* note 1, at 426. The 1926 Code contained a similar exemption for qualified pension trusts and established deduction limits, which were designated to set appropriate limits on the extent to which tax favored treatment would be available under qualified pension plans. Comm. Print 1985 at 2. Since then, standards for qualified plans have been revised and expanded to reflect Congress' interest in the expansion of pension, profit-sharing, and stock bonus plans, and its concern over tax abuse. *See id.* ERISA substantially revised the rules regulating qualified pension plans, adding minimum coverage, vesting, benefit, accrual, and funding requirements, as well as overall limits on contributions and benefits. *See id.*

[30] I.R.C. § 402(e)(A) (West Supp. 1985). A lump sum distribution is a distribution or payment within one taxable year of a recipient's full interest in a tax qualified retirement plan. *Id.* This is allowed only by reason of the employee's death, reaching the age of 59½, separation from service, or disability. *Id.* at §§ 402(e)(A)(i) to 402(e)(A)(ii). *See* Stanger & Mills, *supra* note 2 § 32.05[2][a] at 32-42 (discussion of lump-sum distribution in rollover situations); *see also* Sacher, *How and When a Rollover IRA Should be Used to Receive a Lump-Sum Distribution*, 8 TAX'N FOR LAW. 288, 290 (1980) (noting negative aspects of lump-sum distribution).

ties are distributed in a qualifying lump-sum distribution, the employee is not taxed currently on the unrealized appreciation of the securities.[31] Second, amounts of the lump-sum distribution attributable to pre-1974 years of participation can qualify for capital gains treatment.[32] Third, portions of the lump sum distribution subject to tax as ordinary income are eligible for an advantageous ten-year averaging calculation.[33] In addition, the $5,000 death benefit exclusion is available for qualified plans, but is not available when an IRA passes to the owner's heirs.[34]

All of these tax benefits are lost to the taxpayer who rolls over his qualified plan lump sum distribution into an IRA,[35] because the IRA distribution rules are applicable to all distributions from an IRA. Therefore, those persons who elect an IRA rollover must not currently need the funds and must prefer the IRA distribution rules, which maximize deferral of income recognition. Considering the magnitude of the lost tax benefits and the probable need (or desire) of middle and lower bracket taxpayers to utilize the funds,

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[31] I.R.C. § 402(e)(4)(J) (1985) provides in part:

> [T]here shall be excluded from gross income the net unrealized appreciation attributable to that part of the distribution which consists of securities of the employer corporation. . . .

Id. This realized appreciation will not be taxed until the securities are sold or otherwise disposed of in a taxable transaction. *See* Treas. Reg. § 1.402(a)-1(b)(1)(i) (1986); P. METZER, *supra* note 10, at 21. Capital gains treatment is afforded such disposition. *See* Treas. Reg. § 1.402(a)-(b)(1)(i); P. METZER, *supra* note 10, at 21.

[32] *See* I.R.C. § 402(e)(2) (West 1982 & Supp. 1986).

[33] *See* I.R.C. § 402(e) (West 1982 & Supp. 1986). The effect of an averaging calculation is to tax the lump sum distribution as if it had been received in equal installments over a ten-year period. This reduces the progressive rate structure effect of receiving the total sum in one year.

[34] *See* I.R.C. § 101(b) (1985), which states the general rule that "amounts up to $5,000 which are paid to the beneficiaries or the estate of an employee, or former employee, by or on behalf of an employer and by reason of the death of the employee shall be excluded from the gross income of the recipient." Treas. Reg. § 1.101-2(a)(1) (1986). This exclusion from gross income applies whether the payment is made to the estate of the employee or to any beneficiary, whether it is made directly or in trust, and whether or not it is made pursuant to a contractual obligation of the employer. *Id.* However, the exclusion "does not apply to amounts constituting income payable to the employee during his life as compensation for his services, such as bonuses or payments for unused leave or uncollected salary, nor to certain other amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amount while living." Treas. Reg. § 1.101-2(a)(2) (1986). Thus, an IRA is not included within the death benefit exclusion. *Cf. id.*

[35] I.R.C. § 402(a)(5)(D)(iii) (West Supp. 1985) (denying ten year averaging and capital gains treatment for distributions subsequent to partial distribution); *id.* at § 402(a)(5)(D)(iv) (including unrealized appreciation in gross income when partial distribution rollover has been elected); *id.* at 101(b) (including $5,000 death benefit in gross income when partial distribution is elected).

the IRA rollover appeals primarily to the wealthy.[36]

MAXIMIZING DEFERRAL WITH AN IRA

The basic rule with regard to the income taxation of distributions from an IRA is that the total amount of any distribution is included in the gross income of the distributee.[37] Therefore, maximum deferral is achieved by delaying distributions. Assuming that the taxpayer has reached the mandatory distribution age, current taxation of the entire IRA balance may be avoided by the use of alternatives related to annuity-type distributions.[38] Changes made by the Deficit Reductions Act of 1984 (DRA) have recently increased the deferral potential of allowable annuity-type distributions.[39]

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[36] *See supra* note 35. The special lump-sum distribution tax benefits are available only to distributions directly from a qualified plan trust, and are not available subsequently on a lump-sum distribution from an IRA. *See* I.R.C. § 402(a)(1) (West Supp. 1985) (limiting favorable treatment to employee trusts described in I.R.C. § 401(a)); *id.* at § 402(c)(4)(A) (defining lump sum distribution and limiting it to employee trusts under I.R.C. § 401(a)); *accord* Boggs v. Commissioner, 83 T.C. 132, 151-52 (1984) (only distributions from valid, qualified profit-sharing plan and trust could receive lump-sum tax benefits). *But see* Sacher, *Planning Techniques to Minimize the Total Tax Impact of Different IRA Rollover Accounts*, 8 TAX'N FOR LAW. 334, 335 (1980) (suggesting that benefits lost in rollover to IRA could be recaptured in rollover to qualified trust).

[37] *See* Hubbard, *Do IRAs and Keoghs Increase Saving?*, 37 NAT'L TAX J. 43, 45 (1984). "In general, individual retirement saving plans lead to an increase in the effective net return when (a) the individual has a high marginal tax rate, [or] (b) the probability of withdrawing the contribution before retirement is low. . . ." *Id.*

[38] I.R.C. § 408(d)(1) (1985) (amounts received from IRA distributions includable in gross income in year received); *see also* PRENTICE-HALL 1986 FEDERAL TAX COURSE, ¶ 3027(b), at 836 (1985) (IRA distributions generally treated as ordinary income in year payments received).

[39] I.R.C. § 408 permits a taxpayer to establish an "Individual Retirement Annuity" contract with an insurance company. I.R.C. § 408(b) (1985). Annuities are sold by insurance companies and provide a tax-sheltered retirement fund, since the income earned on premium contributions is not taxed until actually distributed to the annuitant. D. POSIN, FEDERAL INCOME TAXATION § 3.07 (1983); G. REJDA, PRINCIPLES OF INSURANCE 344-45 (1982). Only the earnings of the annuity are taxed, not the principal. *Id.*, at 344-45. Since annuity funds are not taxed until distribution, the earnings remaining in the fund may be invested by the insurance company, while the fund grows unimpeded by tax consequences. *Id.* When the taxpayer receives installment distributions, only the earnings of the fund are taxable, not the premium payments. *See* I.R.C. § 1035(b)(1) & (2) (1982) (annuity is insurance policy payable "only in installments"). However, in an Individual Retirement Annuity the premium payments, specifically the investment in the contract, are considered to be zero, making all IRA distributions taxable. I.R.C. §§ 408(d)(1) & (2) (1985). *See generally* D. POSIN, *supra*, at § 3.07; G. REJDA, *supra*, at 345-48 (general discussions of various types of annuities available).

Beginning in 1985,[40] required distributions must begin by April 1 of the calendar year following the calendar year in which the employee reaches the age of 70½ [41] to avoid a 50% penalty on prohibited IRA accumulations.[42] This provision, along with the other distribution alternatives discussed below, is located in IRC section 401(a)(9), rather than in section 408, which deals with many of the IRA tax provisions. IRC section 408(a)(6) connects section 408 to section 401(a)(9) with the following interesting language:

> Under regulations prescribed by the Secretary, rules similar to the rules of section 401(a)(9) (relating to required distributions) shall apply to the distribution of the entire interest of an individual for whose benefit the trust is maintained.

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[40] The Deficit Reduction Act of 1984 was comprised of two Divisions, the Tax Reform Act of 1984 and the Spending Reduction Act of 1984. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & ADMIN. NEWS (98 Stat.) 494. All provisions of the Deficit Reduction Act affecting the Internal Revenue Code were embodied in the Tax Reform Act of 1984. *Id.* at 494, 865-73; *see also* I.R.C. §§ 401-08 (1985); J. EUSTICE, THE TAX REFORM ACT OF 1984—A SELECTIVE ANALYSIS ¶ 1.01[2] (1984) (discussing legislative history of Tax Reform Act of 1984).

The new Tax Reform Act permits taxpayers to rollover into an IRA partial distributions from other qualified pension plans without tax implications. Tax Reform Act of 1984, Pub. L. No. 98-369, § 522, 1984 U.S. CODE CONG. & ADMIN. NEWS (98 Stat.) 494, 868-71 (codified at I.R.C. §§ 402 & 403). Prior tax law mandated that a rollover from a qualified pension plan into an IRA could be accomplished without tax implications only if all of such funds were transferred. *See* JOINT COMMITTEE ON TAXATION, 98th CONG., 2d SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 813-15 (1985); ANALYSIS OF THE TAX REFORM ACT OF 1984 ¶ 329 (Matthew Bender 1984).

Another provision favorable to the taxpayer is the new provision relating to after-death distributions to non-spouse beneficiaries. *See* ANALYSIS OF THE TAX REFORM ACT OF 1984, *supra*, at ¶ 328. Under prior tax law, "[i]f a participant died before the entire balance credited to his account had been distributed, amounts payable to a nonspouse beneficiary generally had to be paid within five years of the participant's death." *Id.* ¶ 328, at A-257. Under the new provisions, the nonspouse beneficiary may elect to receive the remaining IRA funds at the same rate as the deceased participant would have. Tax Reform Act of 1984, Pub. L. No. 98-369, § 521, 1984 U.S. CODE CONG. & ADMIN. NEWS (98 Stat.) 865-68 (codified at I.R.C. § 401(a)(9)); *see also* JOINT COMMITTEE ON TAXATION, *supra*, at ¶ 328.

[41] Because of a delay in promulgating regulations, the Internal Revenue Service has provided that initial distributions which would be required under the statute to begin on April 1, 1985, or April 1, 1986, can be delayed until December 31, 1986. Notice 86-1 IRB 1986-1, 33.

[42] *See, e.g.*, I.R.C. § 401(a)(9)(A)(ii) (West Supp. 1985). If the owner reaches the age of 70½ on March 1, 1987, mandatory distributions from his IRA are not required to commence until April 1, 1988. By that time he will actually be 71 years of age. Prior to the DRA, mandatory distributions were required to commence no later than the end of the taxable year in which the owner reached the age of 70½. *See* I.R.C. § 401(a)(9)(A) (1982), *repealed by* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 521(a)(1) (1984) (replacing § 401(a)(9)(A) with § 401(a)(9)(A)(i) & (ii)).

The regulations issued under this language will apparently have the force of law, as long as they are "similar" to the section 401(a)(9) provisions. Until these regulations are issued, the best guidance as to distribution alternatives for IRAs will be contained in section 401(a)(9).

As the magic April 1 mandatory distribution date approaches, one alternative available to an IRA owner is the purchase of a commercial annuity.[43] This alternative offers simplicity because the insurance company provides the administrative services. However, this advantage, which has the associated cost of a reduced return on the annuity, may be outweighed by several other factors. For example, without a cost payout guarantee as part of the commercial annuity,[44] the IRA owner may not recover the entire IRA account balance. On the other hand, the utilization of a self-directed IRA distribution plan will ensure that the entire IRA account balance plus income earned during the period of distribution will be distributed to the taxpayer or other designated ultimate beneficiary. In addition, a self-directed IRA plan will enable the owner to maintain distribution flexibility and investment control.

Three basic annuity alternatives are available to carry out a self-directed IRA distribution plan. Distribution can occur over: (1) the life of the owner; (2) the joint lives of the owner and surviving spouse; or (3) the joint lives of the owner and another designated beneficiary.[45] The maximum deferral opportunities presented by these alternatives are demonstrated by the following example: Tom has an $800,000 IRA account balance at the required distribution beginning date. Tom and his spouse are both 71 years of age. They have one daughter, age 45, and one granddaughter, age 20.

(1) *Single Life Annuity—Owner:* Initial year minimum distribution[46] divided by the life expectancy of a 71 year-old male[47]

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[43] I.R.C. § 4974 (1982). A 50% excise tax is imposed on the excess of the minimum amount required to be distributed during the tax year over the amount actually distributed during the year. *See id.*

[44] *See* Treas. Reg. § 1.408-2(b)(vi) (1985). The requirements of section 408(a)(6) are satisfied if the individual's interest is distributed in the form of an annuity contract that complies with the Code and regulations governing them. *Id.*

[45] A cost payout guarantee, however, will reduce the return.

[46] *See* I.R.C. § 401(a)(9)(A)(ii) (1982 & West Supp. 1985).

[47] *See* Treas. Reg. § 1.401-11(e) (1985). The formula for determining the initial year minimum distribution is as follows: The employee's entire interest to be distributed divided by "(i) the life of the employee, or (ii) the lives of the employee and his spouse, or (iii) a

(800,000 ÷ 11.6 = $68,965.52).

(2) *Joint and Survivor Annuity—Owner and Surviving Spouse:* Initial year minimum distribution divided by the joint life expectancy of a 71 year-old male and a 71 year-old female (800,000 ÷ 17.6 = $45,454.55).

(3) *Joint and Survivor Annuity—Owner and Daughter:* Initial year minimum distribution divided by the joint life expectancy of a 71 year-old male and a 45 year-old female (800,000 ÷ 34.4 = $23,255.81).

(4) *Joint and Survivor Annuity—Owner and Granddaughter:* Initial year minimum distribution divided by the joint life expectancy of a 71 year-old male and a 20 year-old female (800,000 ÷ 56.8 = $14,084.51).

Evaluation of Alternatives for the Wealthy IRA Owner

As demonstrated in the example above, the use of joint lives for annuity calculations significantly reduces the amount of required IRA distributions. The use of younger generation beneficiaries, or any designated beneficiary younger than the surviving spouse, further reduces the distribution requirements. While the stated goal for the wealthy IRA owner is to minimize distributions, the selection of the best alternative will depend upon consideration of the tax and non-tax factors discussed below.

The addition of the spouse as a joint life reduces the required distribution by approximately 34% in the situation in which owner and spouse are both 71 years of age. Assuming that the owner wants the undistributed balance of his IRA to pass to the spouse, this reduction of distribution is significant. Upon the owner's death, the surviving spouse will receive the remaining payments over her life. Because the payments are characterized as income in respect of a decedent,[48] they are subject to income tax. The fair market value of the IRA account at date of death will be included in the owner's gross estate,[49] but will have no estate tax effect because of the availability of the marital deduction.[50]

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period not longer than the life expectancy of the employee, or (iv) a period not longer than the joint life and last survivor expectancy of the employee and his spouse." *Id.* For the purposes of this calculation, all life expectancies are taken from Treas. Reg. § 1.72-9 (1985). *Id.* at § 1.401-11(e)(4).

[48] *See* Treas. Reg. § 1.72-9 (1985).

[49] *See* I.R.C. § 691 (1982 & West Supp. 1985).

[50] *See* I.R.C. § 2039 (1982 & West Supp. 1985).

Another advantage in the spousal joint annuity situation is that the joint life expectancy can be redetermined annually.[51] Since the premise of the life expectancy tables contained in the regulations[52] is that one is expected to live longer the longer he has lived, this redetermination will result in additional deferrals as the permitted distribution period is extended.[53]

The use of the daughter and granddaughter in the example above reduced the mandatory distributions even further. Assuming that the younger generation beneficiary would be in a lower income tax bracket than the surviving spouse, additional tax benefit would result by having the IRA income in respect of decedent taxed to the younger generation beneficiary.

Despite these significant advantages, other considerations may temper blanket advice to use a younger generation beneficiary as the joint life. The first hurdle is a practical one—does the owner want the IRA funds to pass to the younger generation beneficiary rather than to the surviving spouse? Assuming that that hurdle is cleared, the estate tax effect must be analyzed. If a younger generation beneficiary is used, the fair market value of the IRA account at date of death will still be included in the owner's estate, but no marital deduction will be available. To the extent the owner's unified credit equivalent[54] has been utilized, the transfer to the younger generation beneficiary may generate estate tax liability.

Additionally, to the extent that the balance in the IRA account represents community property in a community property state, the legally binding nonspouse beneficiary designation may constitute a gift by the surviving spouse to the beneficiary.[55] Possi-

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[51] *See* I.R.C. § 2056 (1982 and West Supp. 1985).

[52] I.R.C. § 401(a)(9)(D) (1982 & West Supp. 1985) provides in part: "[T]he life expectancy of an employee and the employee's spouse . . . may be redetermined but not more frequently than annually." *Id.*

[53] *See* Treas. Reg. § 1.72-9.

[54] For example, the life expectancy of a 71 year old man is 11.6 years, therefore his total life expectancy is 82.6 years (71 + 11.6). A 75 year old man, on the other hand, has a life expectancy of 9.6 years, so his total life expectancy, 84.6 years (75 + 9.6), is greater than that of the 71 year old.

[55] *See* I.R.C. § 2010(a) & (b) (1985). The unified tax credit is permitted as an offset against estate tax assessed pursuant to I.R.C. § 2001 (1985). The credit is similar to the estate tax exemption permitted by pre-1977 tax law. PRENTICE-HALL 1986 FEDERAL TAX COURSE, *supra* note 38, at ¶ 3940.

After the deceased taxpayer's estate computes the amount of estate tax payable to the IRS, I.R.C. § 2001 (1985), the estate may reduce the amount due by the unified credit. PRENTICE-HALL 1986 FEDERAL TAX COURSE, *supra* note 38, at ¶ 3934, 3940. The amount of credit is dependent upon citizenship, the year of death, and the amount of certain gifts ble gift tax consequences could occur on this transfer.[56]

Using a nonspouse beneficiary prevents annual redetermination of the total joint life expectancy. In this situation the life expectancy of the owner can be redetermined, but the life expectancy of the nonspouse beneficiary cannot.[57] The current tables in the regulations do not provide for this bifurcated approach. The Treasury will, however, issue regulations that will detail the redetermination computation in the nonspouse beneficiary situation.[58]

Finally, under Revenue Ruling 72-241,[59] a nonspouse joint and survivor annuity is not qualifying unless the present value of the payments to be made to the participant, in this case the IRA owner, is more than 50% of the present value of the total payments under the annuity. Uncertainty about the exact applicability of this "incidental benefit rule" (even in spousal beneficiary situations) is one of the principal reasons for the administration delay in required mandatory distributions.[60]

ALTERNATIVES TO THE PRESENT SYSTEM

The above analysis clearly indicates that utilization of both current IRA contributions and IRA distribution alternatives favor wealthy taxpayers. This favoritism comes with a significant current governmental revenue loss caused by contribution deductions and deferral of income recognition on distributions. In light of current federal budget deficits, it may be time to examine alternatives to the broad range availability of IRAs.

If the goal for IRAs is to provide retirement assistance for middle and low income taxpayers, total abolition of IRAs does not

made prior to 1976. I.R.C. § 2010 (1985).

[56] Community property representing qualified employer contributions and related earned income would be excluded from gift taxation. I.R.C. § 2517(c) (1985).

[57] *See* I.R.C. § 2517(c) (1985) (spouse in community property state may be required to pay gift tax on transfer of annuity if certain conditions not met); *see also* Treas. Reg. § 25.2517-1 (1985) (transfer of annuity may result in gift tax).

[58] *See supra* note 51.

[59] *See* JOINT COMMITTEE ON TAXATION, *supra* note 40, at 811. "Congress intended that the method of recalculation in the case of a benefit payable for the joint lives of an employee and a nonspouse beneficiary is to be determined under Treasury regulations which will not permit changes in the life expectancy of the nonspouse beneficiary to be taken into account." *Id.*, *see also* H.R. REP. No. 861, 98th Cong., 2d Sess. 1137-38, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 1825-26 (Treasury regulations to require "minimum distribution rules"); ANALYSIS OF THE TAX REFORM ACT OF 1984, *supra* note 40, at ¶ 328 (regulations to limit rules on distribution).

[60] C.B. 1972-1, 108.

make policy sense, even though it would restore the largest amount of revenue to the federal government's coffers. A graduated approach such as phasing out $100 of annual IRA deduction for every $1,000 of compensation over $30,000 would accomplish the major objective, while limiting the availability of IRA deductions to high income taxpayers.[61] Any politically acceptable wage limit could be used, and should be indexed for inflation as are current personal exemptions and tax brackets.[62]

At the distribution end of the IRA continuum, there are several possibilities for reducing the benefits for wealthy taxpayers, while returning the intended benefits to middle and low income taxpayers. First, some limit could be set on lifetime rollovers to an IRA. All amounts distributed from a qualified plan in excess of this limitation would be taxed to the distributee in the taxable year of distribution. Again, the limit should be indexed for inflation.

Second, the mandatory distribution age could be lowered to a more frequently utilized retirement age, specifically 65 or 62. This change may have some adverse effect on the financial incentive for a taxpayer to work beyond any reduced mandatory distribution age. Any IRA distributions would be taxed at the distributee's high marginal tax rate during continued working years. The concern about the working disincentive should be analyzed in conjunction with the benefit of the increased revenues from the reduction in deferral period.

Third, the availability of joint annuity-type distributions with persons other than the spouse could be eliminated. This would compress the time over which IRA distributions could be structured, and correspondingly accelerate the income recognition for those wealthy persons utilizing the maximum deferral.[63]

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[61] *See supra* note 40.

[62] Taxpayers earning $30,000 or less annually would have the availability of the full $2,000 IRA deduction. Taxpayers earning $40,000 annually would have the availability of a $1,000 IRA deduction. Specifically, $40,000 exceeds $30,000 by $10,000; this divided by $1,000 equals 10. The reduction is, therefore, $100 multiplied by 10, or $1,000. Using the same calculation, taxpayers who earn $50,000 or more would not be entitled to an IRA deduction.

[63] *See* I.R.C. §§ 1(f) (adjustment made to tax tables); 63(d) (indexed to maximum amount of taxable income on which no tax is imposed by § 1); 151(f) (indexed by the cost of living adjustments) (1982 & West Supp. 1985).

CONCLUSION

IRAs have increasingly become a tool of the wealthy to defer current taxation. This is contrary to the avowed IRA purpose of benefitting low and middle income taxpayers. In light of the current federal budget deficit, the time is ripe to reduce IRA benefits for the wealthy. This reduction could be accomplished by reducing current contributions for high income taxpayers, limiting rollovers from qualified plans, and/or accelerating the taxation of distributions.