# RETIREMENT FUNDING AND THE CURIOUS EVOLUTION OF INDIVIDUAL RETIREMENT ACCOUNTS

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*When individual retirement accounts (IRAs) were originally created, their sole purpose was to set up personal retirement savings accounts for working taxpayers, whereby persons could invest funds tax free into the account during their employment years and then withdraw from the account during retirement. From this humble beginning, though, the uses to which IRAs may be put have burgeoned exponentially, turning them into all-purpose investment vehicles. As a result, IRAs often have little to do with their goal of providing retirement income for account holders.*

*In his article, Professor Richard Kaplan explores in detail the preretirement uses of IRAs. Although the tax code imposes a penalty for withdrawing IRA funds before a person reaches a certain age, it also provides various exceptions from this penalty. Specifically, Professor Kaplan examines three recently enacted withdrawal exceptions for home purchases, educational costs, and medical expenses. He argues that all three are inconsistent with the original intent of IRAs and contrary to public policy. First, by removing the tax penalty from these preretirement withdrawals, the exceptions contribute to financial myopia in account holders who may be willing to risk short-term gains for substantial, long-term economic losses. More importantly, these three exceptions conflict with the fundamental policy driving IRAs—they allow individuals to use IRAs for nonretirement purposes. For this same reason, Professor Kaplan also criticizes the joint beneficiary rules for Roth IRAs, which allow an account holder to appoint a child or grandchild as a joint beneficiary, thereby converting a retirement savings account into a multigenerational trust fund. To*

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*return to the primary goal of IRAs as retirement funding accounts, Professor Kaplan calls for the repeal of the three nonretirement use exceptions and the elimination of postdeath IRAs for the benefit of succeeding generations.*

## I. Introduction

Once upon a time, Congress created the "individual retirement account" (IRA).[1] This device was elegant in its simplicity: a taxpayer could set aside up to $2,000[2] of earned income[3] in a special account that would not be taxed until withdrawals were made from the account.[4] In exchange for a tax deduction[5] in the year the account was funded and the absence of current taxation of the account's investment profits, the taxpayer agreed to various restrictions[6] designed to preserve the account for its intended purpose—namely, to provide income to the taxpayer during his or her retirement.[7] The basic bargain was thus: the funds would not be taxed during a taxpayer's active employment years,[8] but would be taxed when they were withdrawn during that person's postemployment years.[9] In this manner, taxpayers were encouraged to establish these accounts to supplement their income received from the two other major sources of retirement funding—Social Security[10] and employer-provided pension plans.[11]

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1. I.R.C. § 408 (1999), *as amended by* Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2002(b), 88 Stat. 829, 959-64. *See generally* DONALD R. LEVY ET AL., INDIVIDUAL RETIREMENT ACCOUNT ANSWER BOOK (4th ed. 1998) [hereinafter IRA ANSWER BOOK].
2. *See* I.R.C. § 408(a)(1). The original limit of $1,500 was raised to $2,000 by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 311(g)(1)(A), 95 Stat. 172, 281, which amended section 408(a)(1) of the I.R.C.
3. *See* I.R.C. § 219(b)(1)(B).
4. *See* I.R.C. § 408(e)(1).
5. *See* I.R.C. § 219(a). This deduction is allowed in deriving "adjusted gross income" and is therefore available without regard to whether the taxpayer claims his or her "itemized deductions." *See id.* § 62(a)(7).
6. *See, e.g.*, I.R.C. §§ 72(t) (early distributions penalty), 408(a) (investment restrictions), 4974(a) (delayed distributions penalty).
7. *See* H.R. REP. NO. 93-779, at 124-25 (1974), *reprinted in* 1974-3 C.B. 244, 367-68.
8. *See* I.R.C. § 408(e)(1).
9. *See* I.R.C. § 408(d)(1).
10. *See generally* LAWRENCE A. FROLIK & RICHARD L. KAPLAN, ELDER LAW IN A NUTSHELL 270-315 (2d ed. 1999).
11. *See id*. at 344-78.

But recent developments have transmogrified these accounts into all-purpose investment kitties that can be used for purposes that have little connection to the holder's retirement.[12] As a consequence, taxpayers face a bewildering range of options that complicate their retirement planning[13] and can create demands from family members that jeopardize the IRA's function of providing retirement income for account holders. Moreover, these developments raise fundamental questions about the appropriateness of these accounts' tax deferral feature when they are not being used for their intended purpose.

This article begins by setting forth the basic structure of individual retirement accounts and their distribution restrictions,[14] including the recently created variation, the Roth IRA.[15] It then analyzes how these simple accounts have grown in recent years so that they often represent the bulk of a retiree's assets.[16] The article then examines the recent developments that allow IRAs to be used for nonretirement objectives.[17] Finally, the article considers what changes are needed to ensure that these accounts serve their intended purpose of funding retirement[18] and thereby keep the "R" in IRA.

## II. The Basic Structure of IRAs

### A. Eligibility to Establish Accounts

Created in 1974,[19] the IRA enables persons with earned income to set aside funds for their retirement to supplement Social Security and any employer-provided pension to which they might be entitled. In fact, IRAs were originally restricted to persons whose employers did not provide pension plans for their benefit.[20] This cohort was then, and still is, a significant portion of the working population—often half

12. *See infra* Parts IV, V.
13. *See generally* Stanley Baum, *IRA Planning After the Taxpayer Relief Act of 1997—More Choices Than Ever*, 87 J. TAX'N 204 (1997).
14. *See infra* Part II.
15. *See* I.R.C. § 408A, *as amended by* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 302(a), 111 Stat. 788, 825-28.
16. *See infra* Part III.
17. *See infra* Parts IV, V.
18. *See infra* Part VI.
19. *See* Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2002(b), 88 Stat. 829, 959-64 (codified as I.R.C. § 408).
20. *See* 2 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 62.3.2, at 62-43 (2d ed. 1990).

or more, depending upon the industry and size of the firm.[21] The idea was that these employees should have the ability to set up personal retirement savings accounts without regard to what their employers chose to provide.[22] During a brief period from 1982 through 1986, IRAs could be established by anyone with earned income, even participants in employer-provided pension plans.[23] But the Tax Reform Act of 1986[24] restricted IRAs to persons who did not participate in such pension plans[25] or whose income was relatively modest—i.e., persons with "adjusted gross income" (AGI)[26] of less than $25,000 for single taxpayers and less than $40,000 for married taxpayers.[27]

The Taxpayer Relief Act of 1997 liberalized the eligibility for an IRA in several ways. First, it raised the AGI threshold from $25,000 to $30,000 for single taxpayers,[28] and from $40,000 to $50,000 for married

21. *See* FROLIK & KAPLAN, *supra* note 10, at 345.

22. *See* H.R. REP. NO. 93-779, at 124-25 (1974), *reprinted in* 1974-3 C.B. 244, 367-68. Self-employed persons have similar but more generous options via so-called Keogh plans and other devices. *See* I.R.C. §§ 404(a)(8), (e) (1999) (Keogh plans); *see also id*. § 08(p) ("simple" plans). *See generally* IRA ANSWER BOOK, *supra* note 1, at 15-1 to 15-78.

23. *See* 2 BITTKER & LOKKEN, *supra* note 20, at 62-43.

24. *See* Pub. L. No. 99-514, § 1101(a)(1), 100 Stat. 2085, 2411-13 (codified as I.R.C. § 219(g)).

25. *See* I.R.C. § 219(g). Pension plan participants may establish nondeductible IRAs regardless of their income. *See id*. §§ 408(o)(1), 408(o)(2)(A), 408(o)(2)(B)(i). These IRAs are similar to regular IRAs, except that no deduction is allowed for the account holder's contributions to the accounts. *See id*.

26. *See* I.R.C. § 219(g)(2)(A)(i)(I). The phrase "adjusted gross income" is a major tax law parameter and is defined as gross income minus certain deductions that are specified in section 62(a)(1)-(17). For purposes of the IRA deduction phase-out, this definition is modified as indicated in section 219(g)(3)(A).

27. *See* I.R.C. § 219(g)(3)(B), *as amended by* Taxpayer Relief Act of 1997 § 301(a)(1), 111 Stat. at 824-25. Under the previous framework, IRA contributions of less than $2,000 were allowed to single taxpayers whose AGI exceeded $25,000 but was less than $35,000, and to married taxpayers whose AGI exceeded $40,000 but was less than $50,000. *See id*.

28. *See* I.R.C. § 219(g)(3)(B)(ii), *as amended by* Taxpayer Relief Act of 1997 § 301(a)(1), 111 Stat. at 824-25. This $30,000 threshold is, in turn, being increased gradually to $50,000 as follows:

| YEAR | THRESHOLD |
|---|---|
| 1999 | $31,000 |
| 2000 | 32,000 |
| 2001 | 33,000 |
| 2002 | 34,000 |
| 2003 | 40,000 |
| 2004 | 45,000 |
| 2005 | 50,000 |

taxpayers,[29] even if they participated in a pension plan at work. Second, the spouse of a participating employee could set up his or her own IRA, even though this spouse had no earned income, as long as the couple's AGI was less than $150,000.[30] The employee's spouse in that situation, however, remained ineligible for an IRA if the couple's AGI exceeded the now raised, but still much lower, AGI threshold of $50,000.[31] Finally, both the employee and that employee's spouse could set up a new variant of the IRA, called a Roth IRA,[32] even though the employee participated in a pension plan at work, as long as the couple's AGI did not exceed $150,000.[33] Persons who could set

*See id*. IRA contributions of less than $2,000 are allowed, pro-rata, to taxpayers with an AGI of no more than $10,000 over the applicable threshold for the year in question. *See* I.R.C. §§ 219(g)(1), (2)(A). For example, a single taxpayer in the year 2000 with an AGI of $37,000 ($5,000 over that year's threshold of $32,000) could put $1,000 into an IRA. However, if that person's AGI was $42,000, no IRA contributions may be made because that person's AGI would then be $10,000 over the applicable threshold.

29. *See* I.R.C. § 219(g)(3)(B)(i), *as amended by* Taxpayer Relief Act of 1997 § 301(a)(1), 111 Stat. at 824-25. This $50,000 threshold is being increased to $80,000 as follows:

| YEAR | THRESHOLD |
|---|---|
| 1999 | $51,000 |
| 2000 | 52,000 |
| 2001 | 53,000 |
| 2002 | 54,000 |
| 2003 | 60,000 |
| 2004 | 65,000 |
| 2005 | 70,000 |
| 2006 | 75,000 |
| 2007 | 80,000 |

*See id*. IRA contributions of less than $2,000 are allowed, pro-rata, to taxpayers with an AGI of no more than $10,000 over the applicable threshold for the year in question. See *supra* note 28 for an example of the pro-rata contribution. In the year 2007, however, the partial contribution range changes for married taxpayers from $10,000 to $20,000. *See* I.R.C. §§ 219(g)(1), (2)(A). As a result, the applicable AGI range for married taxpayers in that year will be between $80,000 and $100,000.

30. *See* I.R.C. § 219(g)(7), *as amended by* Taxpayer Relief Act of 1997 § 301(b)(2), 111 Stat. at 825. IRA contributions of less than $2,000 are allowed, pro-rata, to taxpayers with an AGI of no more than $10,000 over the $150,000 threshold (i.e., less than $160,000). *See* I.R.C. § 219(g)(1), (7)(B).

31. *See* I.R.C. §§ 219(g)(1), (2)(A)(i)(II), (3)(B)(i). See *supra* note 29, regarding scheduled increases in this $50,000 threshold.

32. *See* I.R.C. § 408A. *See generally* GARY S. LESSER ET AL., ROTH IRA ANSWER BOOK (1999) [hereinafter ROTH IRA ANSWER BOOK].

33. *See* I.R.C. § 408A(c)(3)(C)(ii)(I). Roth IRA contributions of less than $2,000 are allowed, pro-rata, for married taxpayers with an AGI of no more than $10,000

up either a regular IRA or a Roth IRA were allowed to establish both types of accounts, but the sum placed in these two accounts could not exceed the $2000 annual limitation for IRAs.[34]

The Roth IRA, however, represents a very different tax bargain. No deduction is allowed for the taxpayer's annual contributions,[35] unlike a regular IRA.[36] When withdrawals are made from a Roth IRA, they are free of federal income tax,[37] again unlike a regular IRA,[38] as long as the Roth IRA has been in existence for at least five years[39] and the account holder is at least fifty-nine and one-half years old.[40] Most other features of the regular IRA, including the absence of current taxation of the account's investment profits, apply with equal force to Roth IRAs.[41]

### B. Distribution of IRA Funds

When an account holder withdraws funds from a regular IRA, these funds are subject to the federal income tax in their entirety.[42] The withdrawal is not bifurcated into components representing the taxpayer's contributions and the account's investment profits; instead, the entire amount withdrawn is taxed.[43] Moreover, the withdrawal is taxed entirely as ordinary income,[44] even if the investment profits of the IRA actually derived from securities or other assets that would typically generate capital gains.[45]

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over the $150,000 threshold (i.e., less than $160,000). *See id.* §§ 408A(c)(3)(A)(ii), (C)(ii)(I). The full $2,000 Roth IRA is allowed to unmarried taxpayers with an AGI of no more than $95,000; Roth IRAs of less than $2,000 are allowed to unmarried taxpayers with an AGI of no more than $15,000 over this threshold (i.e., less than $110,000). *See id.* §§ 408A(c)(3)(A)(ii), (C)(ii)(II). Married taxpayers filing separate returns may not establish Roth IRAs at all. *See id.* §§ 408A(c)(3)(A)(i), (C)(ii)(III).

34. *See* I.R.C. § 408A(c)(2).
35. *See* I.R.C. § 408A(c)(1).
36. *See* I.R.C. § 408(a).
37. *See* I.R.C. § 408A(d)(1).
38. *See* I.R.C. § 408(d)(1).
39. *See* I.R.C. §§ 408A(d)(1), (2)(B).
40. *See* I.R.C. §§ 408A(d)(1), (2)(A)(i).
41. *See* I.R.C. § 408A(a).
42. *See* I.R.C. § 408(d)(1).
43. If nondeductible contributions were made to a regular IRA, however, the portion of the amount withdrawn that is attributable to these nondeductible contributions is excluded from gross income. *See* I.R.C. §§ 72(b)(1), (4), (c)(1), 408(d)(1). *See generally* FROLIK & KAPLAN, *supra* note 10, at 356-59.
44. *See* I.R.C. §§ 72(a), 408(d)(1).
45. *See* I.R.C. §§ 1221 (definition of capital asset), 1222 (classification of gains and losses from "capital assets"); *see also id.* § 1(h) (lower tax rates applicable on certain capital gains). *See generally* JOHN K. MCNULTY, FEDERAL INCOME TAXATION

In contrast, withdrawals from a Roth IRA *are* bifurcated into amounts representing a taxpayer's contributions and the account's investment profits, with the taxpayer's contributions treated as coming out first.[46] These amounts, moreover, are always received tax free[47] because they were not deducted when they were made.[48] In addition, if the conditions described above are met (i.e., the account has existed for five years and the holder is at least fifty-nine and one-half years of age), the portion of the withdrawal attributable to investment profits is received tax free as well.[49]

## III. The Emergence of Substantial IRAs

From such modest beginnings, IRAs have grown to truly significant proportions, despite the $2,000 limit on annual contributions remaining unchanged since 1981.[50] The American Bar Association's Section of Taxation has even recently sponsored a program entitled "Humongous IRAs."[51] Attendees at that session described the multimillion dollar IRAs they have seen and one lawyer described a client with an IRA balance of $35 million.[52] Obviously, such IRAs do not originate from merely setting aside $2,000 per year in some bank account. IRA balances of this magnitude derive instead from three major factors.

First, retirees are increasingly taking the balance in their employer-provided pension plans and rolling these amounts into self-directed IRAs.[53] These so-called qualified plan rollovers or cash-outs often constitute six figure amounts or more, even for nonexecutive employees.[54] As a result, retirees who never even contributed to a

OF INDIVIDUALS IN A NUTSHELL 451-54, 458-64 (6th ed. 1999).

46. *See* I.R.C. § 408A(d)(1)(B).

47. *See* NEIL DOWNING, MAXIMIZE YOUR IRA 125 (1998).

48. *See* I.R.C. § 408A(c)(1).

49. *See* I.R.C. §§ 408A(d)(1)(A), (2)(A)(i), (B)(i).

50. *See* I.R.C. § 408(a)(1), *as amended by* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 311(g)(1)(A), 95 Stat. 172, 281.

51. *See* Audio tape of Section of Taxation, American Bar Association, A Practical Guide to Humongous IRAs (May 1, 1999) (on file with author) [hereinafter Humongous IRAs].

52. *See id*.

53. *See* I.R.C. §§ 408(a)(1), (d)(3); *see also* Ellen E. Schultz, *Leaving Your Job? Think Twice Before Stuffing Retirement Money into an IRA*, WALL ST. J., June 20, 1997, at C1.

54. *See* Humongous IRAs, *supra* note 51.

regular IRA may find themselves with rather significant balances in their IRA.

Second, many retirees choose to consolidate various retirement accounts that they may have accumulated during their working years.[55] As more workers change jobs during their work lives, it is not unusual to accumulate an unruly collection of qualified plan accounts,[56] 401(k) salary reduction plans,[57] simplified employee pension plans,[58] Keogh plans from some side business,[59] tax-sheltered annuities,[60] and other tax-favored retirement-funding vehicles.[61] As retirement approaches, it often makes sense to bring these accounts into a single IRA to simplify account administration, coordinate distribution planning, and take advantage of economies of scale, particularly with regard to account maintenance fees.[62] The consequence, once again, may be substantial IRA balances.

Third, employees have increasingly funded their IRAs and other retirement accounts with stock market investments, equity mutual funds, and similar growth-oriented investment products.[63] For many years, when interest rates were high and stock market returns were lackluster or poor, people usually funded their IRAs with government bonds, guaranteed investment contracts, and other fixed-income securities.[64] Stock market investments were made, when they were made at all, in taxable accounts where they could enjoy the lower capital gains tax rates[65] for which these assets usually qualified.[66] More

55. *See* JONATHON D. POND, PERSONAL FINANCIAL PLANNING HANDBOOK ¶ 11.06[5][a], at 11-43 (2d ed.1999).
56. *See* I.R.C. § 401(a). *See generally* STEPHEN J. KRASS, THE PENSION ANSWER BOOK (1997 ed.) [hereinafter PENSION ANSWER BOOK].
57. *See* I.R.C. § 401(k); *see also id.* § 408(p) ("simple retirement account"). *See generally* STEVEN J. FRANZ ET AL., 401(K) ANSWER BOOK (1998 ed.).
58. *See* I.R.C. § 408(k).
59. *See* I.R.C. § 401(c). *See generally* RICHARD A. WESTIN, FEDERAL TAX PLANNING §§ 7.32-7.48 (Tax & Estate Planning Series No. 1, 1995).
60. *See* I.R.C. § 403(b) (salary reduction plan for employees of tax-exempt organizations). *See generally* DONALD R. LEVY ET AL., 403(B) ANSWER BOOK (3d ed. 1997).
61. *See* I.R.C. § 457 (deferred compensation plan for employees of state and local governments and tax-exempt organizations).
62. *See* DOWNING, *supra* note 47, at 52.
63. *See* Samuel F. Beardsley, *Deciding Which Funds to Hold in Taxable vs. Tax-Deferred Accounts*, J. RETIREMENT PLANNING, July-Aug. 1998, at 33.
64. *See, e.g.*, C. COLBURN HARDY, DUN & BRADSTREET'S GUIDE TO $YOUR INVESTMENTS$ 1985, at 199 (1985); EDWARD MALCA & SANDRA CHORON, EVERYBODY'S INVESTMENT BOOK 65-68 (1984).
65. From 1978 through 1986, capital gains received a 60% deduction, with the result being that only 40% of these gains were subject to tax. See I.R.C. § 1202(a),

recently, however, taxpayers have placed such assets into retirement-oriented accounts like IRAs, despite the fact that, by doing so, they forfeit the capital gains advantage that these assets would otherwise receive.[67] In addition, putting stock market investments in a retirement savings vehicle, rather than a taxable account, eliminates the possibility of receiving a complete income tax exemption of the accrued gain when the taxpayer dies.[68] In any case, recent stock market performance has produced larger IRA balances than continued reliance on fixed-income securities would have produced.[69]

To be sure, these developments have less obvious drawbacks. Rolling over pension plan balances into an IRA, for example, eliminates the possibility of applying the ten-year forward averaging tax computation methodology to any lump-sum distribution that subsequently may be made.[70] This special methodology is available to persons born before 1936 who withdraw their entire pension plan balance[71] but does not apply to IRAs.[72] Similarly, certain required distributions can no longer be forestalled by continuing to work past the age of seventy and one-half if funds are held in an IRA, even though they could be so forestalled in a standard pension plan.[73] Further, although pension plan balances are protected from creditors under the Employment Retirement Income Security Act of 1974,[74] the protection for IRAs is less comprehensive and depends upon state bankruptcy laws.[75] Although a few states protect IRAs, most do not.[76]

before it was repealed by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 100 Stat. 2085, 2216.

66. *See* I.R.C. § 1221. *See generally* MCNULTY, *supra* note 45, at 458-64.

67. *See* I.R.C. § 408(d)(1); *see also* IRA ANSWER BOOK, *supra* note 1, at 1-5.

68. *See* I.R.C. § 1014(a)(1) (providing a "step-up" in the basis of assets held at death to their fair market value on that date).

69. *See* T. ROWE PRICE, RETIREES FINANCIAL GUIDE, PART 3: INVESTING YOUR RETIREMENT ASSETS 3, 7 (1993).

70. *See generally* FROLIK & KAPLAN, *supra* note 10, at 368-73.

71. *See* DIANNE BENNETT ET AL., TAXATION OF DISTRIBUTIONS FROM QUALIFIED PLANS ¶¶ 4.01, at 4-3, 4.04[13][a] at 4-45 (2d ed. 1998).

72. *See* I.R.C. § 402(e)(4)(D)(i); *see also* IRA ANSWER BOOK, *supra* note 1, at 5-6.

73. *See* I.R.C. § 401(a)(9)(C)(i)(II), (ii)(II); *see also* IRA ANSWER BOOK, *supra* note 1, at 5-2; Kenneth A. Hansen, *Maximizing the Deferral of IRA Required Minimum Distributions*, 74 TAXES 622, 622 (1996).

74. *See* I.R.C. § 401(a)(2); *see also* KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶ 14.02[3][f], at 14-8 (1998).

75. *See* IRA ANSWER BOOK, *supra* note 1, at 1-27.

76. *See id*. at 1-27 to 1-29. Roth IRAs are currently protected in only a few states. *See* ROTH IRA ANSWER BOOK, *supra* note 32, at G-5 to G-6.

The bottom line is that IRAs have grown in size and often represent an owner's largest single asset.[77] This development is a dramatic change from historical patterns, when a person's largest asset was usually his or her home.[78] As a result, the use and misuse of the IRA is an increasingly critical issue in the provision of retirement income.

## IV. Preretirement Uses of IRAs

To ensure that funds in an IRA are available to finance an account holder's retirement, a 10% penalty is imposed on withdrawals made before the holder is fifty-nine and one-half years old.[79] This early withdrawal penalty applies to both regular and Roth IRAs in equal measure.[80] In addition, federal income tax is assessed on the withdrawal itself in the case of a regular IRA[81] and, in the case of a Roth IRA, on withdrawals that represent the investment earnings component.[82] As a result, tapping an IRA for preretirement expenditures is a very expensive source of funds.[83] But if an account holder is willing to pay the premature withdrawal penalty and lose the financial benefit of further deferral of taxes, this planning option does exist. In contrast, neither Social Security nor most employer-provided pension plans have early payment options prior to age sixty-two,[84] although employer-provided pension plans often permit borrowing on a limited basis.[85] Loans from IRAs, however, are not allowed.[86]

In any case, like most provisions of the ever-more-complicated U. S. tax code, the early withdrawal penalty has exceptions. When these exceptions apply, the 10% penalty is waived, although the

77. *See* Lynn Asinof, *Oops . . . How a Variety of Basic Foul-Ups Are Bedeviling the Beneficiaries of IRAs*, WALL ST. J., Mar. 29, 1999, at C1.

78. *See* FROLIK & KAPLAN, *supra* note 10, at 183.

79. *See* I.R.C. § 72(t)(1), (2)(A)(i). *See generally* FROLIK & KAPLAN, *supra* note 10, at 360-63.

80. *See* I.R.C. §§ 72(t)(1), 408A(a).

81. *See* I.R.C. § 408(d)(1).

82. *See* I.R.C. §§ 408A(d)(1)(B), (2)(A)(i).

83. *See* FROLIK & KAPLAN, *supra* note 10, at 360 (example of 43% of an early withdrawal being consumed by taxes and penalties).

84. *See id.* at 279-81; *see also* Rev. Rul. 78-331, 1978-2 C.B. 158; Rev. Rul. 78-120, 1978-1 C.B. 117.

85. *See generally* PENSION ANSWER BOOK, *supra* note 56, at 13-33 to 13-41.

86. *See* I.R.C. §§ 408(e)(3), (4); *see also* HENKEL, *supra* note 74, ¶ 14.02[3][b], at 14-7; IRA ANSWER BOOK, *supra* note 1, at 1-25; JACK E. STEPHENS, AVOIDING THE TAX TRAPS IN YOUR IRA 218 (2d ed. 1999).

withdrawal itself remains subject to income taxation,[87] except Roth IRA withdrawals that represent the account holder's contributions, of course.[88] These penalty exceptions cover what might roughly be considered retirement surrogates: death[89] or disability[90] of the account holder or commencement of periodic payments representing the annuitization of the IRA (i.e., paying out the balance of the IRA over the account holder's remaining life expectancy).[91]

Recently, though, Congress added three more exceptions that cannot by any means be considered retirement surrogates. These exceptions apply to withdrawals made to cover home purchases,[92] educational costs,[93] and medical expenses.[94] Each of these exceptions will be analyzed in turn.

### A. Home Purchases

The first new penalty exception to be examined covers a withdrawal from an IRA to buy a principal residence for a "first-time homebuyer."[95] This exception enables someone who has not owned a home within the preceding twenty-four months to use up to $10,000 of IRA funds for this purpose.[96] Taking such a sum out of a tax-sheltered vehicle like an IRA is almost always a disservice to the prospective retiree because these funds cannot later be restored to the IRA.[97] In other words, the account holder's retirement fund is permanently short-changed to the extent of the withdrawal and the years, or even

87. *See* I.R.C. § 408(d)(1).
88. *See* I.R.C. §§ 408A(d)(1)(B), (2)(A)(i).
89. *See* I.R.C. § 72(t)(2)(A)(ii); *cf. id.* § 408A(d)(2)(A)(ii) (no tax on Roth IRA distribution due to the account holder's death).
90. *See* I.R.C. § 72(t)(2)(A)(iii); *cf. id.* § 408A(d)(2)(A)(iii) (no tax on Roth IRA distribution due to the account holder's becoming disabled).
91. *See* I.R.C. § 72(t)(2)(A)(iv).
92. *See* I.R.C. § 72(t)(2)(F), *as amended by* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 303(a), 111 Stat. 788, 829.
93. *See* I.R.C. § 72(t)(2)(E), *as amended by* Taxpayer Relief Act of 1997 § 203(a), 111 Stat. at 809.
94. *See* I.R.C. § 72(t)(2)(B). This provision was made applicable to IRAs by the Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, § 361(a), 110 Stat. 1936, 2071 (codified as I.R.C. § 72(t)(3)(A)).
95. *See* I.R.C. § 72(t)(2)(F).
96. *See* I.R.C. §§ 72(t)(8)(A), (B), (D)(i)(I).
97. *See* IRA ANSWER BOOK, *supra* note 1, at 1-25 (absence of loan features in an IRA); *see also* I.R.C. §§ 408(e)(3), (4).

decades, of earnings that would otherwise accumulate on the amount withdrawn.[98]

For example, assume that Sarah is thirty-five years old with $40,000 in her IRA. If she takes $10,000 out of this IRA to buy a home, her remaining IRA balance of $30,000 would grow to $595,122 when she is sixty-five years old, assuming a 10% annual growth rate and no additional contributions to her IRA.[99] But if she had left her IRA intact, its balance when she turned sixty-five would have been $793,496 under the same assumptions.[100] In other words, the current usage of $10,000 in IRA funds translated into a loss of $198,374 in eventual retirement funds[101]—truly a case of short-term gain offset by long-term pain.

Moreover, this penalty exception for home purchases applies similarly to withdrawals that are used to purchase a home for the account holder's child or grandchild.[102] Thus, fifty-six-year-old Abe can withdraw $10,000 from his IRA to buy a condominium for his son, Isaac, or even his grandson, Jacob. This possibility creates additional temptation to exploit the short term and raid Abe's IRA at a long-term detriment to his future retirement security. Indeed, should either the child or grandchild demand funds for this purpose, the penalty exception removes a barrier that Abe could have used to resist their pressures. This exception consequently makes the prospective retiree more vulnerable to the pleadings of his or her lineal descendants.

It must be remembered that the account holder must still pay tax on the withdrawal and that tax liability might act as a deterrent to some degree.[103] But taxes on IRA balances must be paid in any event.[104] The early withdrawal penalty is an additional, but avoidable cost.[105] And if the account in question is a Roth IRA, the withdrawal

98. *See infra* text accompanying notes 99-101.

99. $30,000 multiplied by 19.8374, which is the growth factor for a sum earning 10% per year, compounded monthly, over 30 years (age 65 minus Sarah's current age of 35 years). *See* MICHAEL SHERMAN, COMPREHENSIVE COMPOUND INTEREST TABLES 11 (1986).

100. $40,000 multiplied by 19.8374. *See id.*

101. $793,496 minus $595,122 equals $198,374.

102. *See* I.R.C. § 72(t)(8)(A). On the other hand, the $10,000 cap is a cumulative limitation for the IRA holder, not a per-buyer limitation. *See id.* § 72(t)(8)(B)(ii).

103. *See infra* text accompanying notes 121-33.

104. *See* I.R.C. § 408(d)(1); *see also* FROLIK & KAPLAN, *supra* note 10, at 354-55.

105. No early withdrawal penalty applies if the recipient is at least 59.5 years old. *See* I.R.C. § 72(t)(2)(A)(i); *see also* FROLIK & KAPLAN, *supra* note 10, at 361-63 (explaining other exceptions to the early withdrawal penalty).

itself is tax free in its entirety in addition to being penalty-free.[106] As a result, the temptations and pressures jeopardizing the retiree's long-term retirement security in that situation are even greater than for a regular IRA.

This increased retirement jeopardy is particularly bad policy because home acquisition is already a heavily tax-favored activity. The interest expense on home mortgages up to $1,100,000 is deductible if the mortgages apply to a taxpayer's principal residence or one other residence of the taxpayer,[107] property taxes paid on residential property are deductible almost without limitation,[108] and gains from the disposition of a principal residence are exempt from income taxation up to $250,000 for single taxpayers or $500,000 for married couples.[109] The gain exemption, moreover, is not a one-time deal—as long as the homeowner uses the home as his or her principal residence for at least two years, the exemption can apply again and again.[110]

With such unusually favorable tax treatment already in place, does home acquisition really merit another incentive? Particularly in light of the potential mischief that this IRA penalty exception can cause, it should be repealed forthwith.

**B. Educational Costs**

Another recently enacted penalty exception applies to "higher educational expenses."[111] As was the case with the home purchase exception described above, this exception creates inappropriate temptations and spawns pressures to use a retirement asset for immediate consumption.[112] And, once again, funds withdrawn from an IRA for educational costs cannot be subsequently restored.[113] As a

106. *See* I.R.C. §§ 72(t)(2)(F), 408A(d)(1)(A), (2)(A)(iv), (5).
107. *See* I.R.C. §§ 163(h)(1), (2)(D), (3)(A), (B)(ii) ($1 million limit on "acquisition indebtedness"), (C)(ii) ($100,000 limit on "home equity indebtedness"), (4)(A)(i).
108. *See* I.R.C. § 164(a)(1).
109. *See* I.R.C. § 121(b)(1), (2). *See generally* FROLIK & KAPLAN, *supra* note 10, at 188-94.
110. *See* I.R.C. § 121(a).
111. I.R.C. § 72(t)(2)(E).
112. *See supra* text accompanying notes 95-101.
113. *See* IRA ANSWER BOOK, *supra* note 1, at 1-25.

result, the loss of future tax-sheltered earnings caused by such withdrawals can be substantial.[114]

Like the home acquisition exception, the educational costs exception applies to costs incurred by an IRA holder's children or grandchildren.[115] Even worse, there is no dollar limit on the amount of withdrawals that can be used for this purpose, unlike the home acquisition exception's $10,000 cap.[116] As long as the withdrawal in question is less than the eligible person's tuition, room and board charges, fees, and books,[117] no early withdrawal penalty is applied.[118] In fact, this provision may be used more than once, or even annually, if so desired.[119]

To be sure, the amount withdrawn remains subject to federal income tax, unless it represents the account holder's contributions to a Roth IRA.[120] But many prospective retirees may not fully appreciate how much tax will in fact be due. In the context at hand (i.e., IRA holders under age fifty-nine and one-half), the account holder is usually employed and may even be in his or her peak earnings years. The IRA withdrawal, therefore, will face federal income tax at that person's *highest* marginal rate.[121] For example, if Jill's taxable income was $130,250 before withdrawing $25,000 from her IRA, the additional $25,000 of taxable income moves her from the 31% tax bracket into the 36% tax bracket.[122] As a result, the tax on the $25,000 IRA withdrawal is not $7,750 ($25,000 multiplied by 31%) as she might have thought, but is actually $9,000 ($25,000 multiplied by 36%).

Including the withdrawn amount in Jill's income has other tax effects as well. Because her AGI already exceeds the threshold for losing itemized deductions ($126,600 in 1999),[123] the extra $25,000 of

114. *See supra* text accompanying notes 99-101; *see also* Karen Damato, *Using IRAs for College Gets Low Grades*, WALL ST. J., Aug. 19, 1997, at C1.

115. *See* I.R.C. § 72(t)(7)(A)(iii).

116. *See* I.R.C. § 72(t)(8)(B)(i).

117. *See* I.R.C. §§ 72(t)(7), 529(e)(3)(A).

118. *See* I.R.C. § 72(t)(2)(E).

119. *See* I.R.C. § 72(t)(7)(A) (no absolute limit).

120. *See* I.R.C. §§ 408(d)(1), 408A(d)(1)(B). The investment earnings portion of the Roth IRA withdrawal is taxable, unlike the treatment accorded Roth IRA withdrawals that are used for home acquisition costs. *See id.* §§ 72(t)(2)(F), 408A(d)(1)(A), 408A(d)(2)(A)(iv), 408A(d)(5).

121. *See* I.R.C. § 1(a)-(d) (five-rate income tax schedules).

122. *See* I.R.C. § 1(c), *as indexed for 1999 by* Rev. Proc. 98-61, 1998-52 I.R.B. 18, § 3.01 tbl.3.

123. *See* I.R.C. § 68(b)(1), *as indexed for 1999 by* Rev. Proc. 98-61, 1998-52 I.R.B. 18, § 3.06.

income will make her lose $750 of itemized deductions.[124] In effect, she will owe an additional $270 of tax[125] due to the lost deductions triggered by the IRA withdrawal. Her now elevated AGI will also reduce the amount of her personal exemption deductions[126] because of the phase-out provision that applies to such deductions.[127] This reduction translates into still more tax being owed because of the withdrawal of funds from her IRA.[128] In addition, other collateral consequences of increasing her AGI will follow, such as raising the 7.5%-of-AGI floor for deducting medical expenses,[129] raising the 10%-of-AGI floor for deducting casualty losses,[130] and raising the 2%-of-AGI floor for deducting "miscellaneous itemized deductions."[131] All things considered, the immediate financial impact of withdrawing funds from an IRA may be significantly greater than anticipated.[132] Finally, Jill still might owe *state* income tax on the IRA withdrawal.[133] Quite an education indeed!

Beyond lost future retirement income and current taxes due, still other economic consequences of withdrawing funds from an IRA exist. When a student applies for financial aid, the parents' retirement assets, including any IRAs, are almost always ignored in determining

124. $25,000 multiplied by 3%. *See* I.R.C. § 68(a)(1). *See generally* Calvin H. Johnson, *Simplification: Replacement of the Section 68 Limitation on Itemized Deductions*, 78 TAX NOTES 89 (1998); William D. Popkin, *Phantom Tax Rates*, 78 TAX NOTES 1409 (1998).

125. $750 multiplied by 36%. *See supra* text accompanying note 122.

126. *See* I.R.C. § 151(a), (c).

127. *See* I.R.C. § 151(d)(3). In 1999, the personal exemption phase-out begins for single taxpayers with an AGI of $126,600. *See id.* § 151(d)(3)(C)(iii), *as indexed by* Rev. Proc. 98-61, 1998-52 I.R.B. 18, § 3.08(2).

128. The reduction of personal exemptions is 2% for each $2,500 of AGI over the applicable threshold. *See* I.R.C. § 151(d)(3)(B). Because Jill's income already exceeds the applicable threshold, an IRA withdrawal of $25,000 will trigger a loss of 20% of the personal exemptions that Jill can claim for herself and her dependents ($25,000 additional income divided by $2,500 equals 10, multiplied by 2 equals 20%). As a consequence, Jill's taxable income increases by more than just the amount of the IRA withdrawal. *See generally* Calvin H. Johnson, *Simplification: Replace the Personal Exemptions Phaseout Bubble*, 77 TAX NOTES 1403 (1997).

129. *See* I.R.C. § 213(a).

130. *See* I.R.C. § 165(h)(2)(A)(ii).

131. I.R.C. § 67(a), (b).

132. Certain tax credits are phased out at specified levels of AGI, and these credits would therefore be affected by the additional AGI that an IRA withdrawal creates. *See, e.g.*, I.R.C. §§ 24(a), (b)(1), (2)(A), (B) ($500 child credit phased out starting at AGI of $75,000 for single taxpayers and $110,000 for married taxpayers), 25A(d)(1), (2)(A)(ii) (credits for higher education expenditures phased out starting at AGI of $40,000 for single taxpayers and $80,000 for married taxpayers).

133. *See* IRA ANSWER BOOK, *supra* note 1, at 16-3.

the "expected family contribution."[134] By withdrawing funds from an IRA, these funds lose this protective classification and are treated like any other asset of the parent. As such, they are available to pay college costs, 5.6% of which will be considered as part of the family's expected contribution.[135] Because a student's financial aid is generally the difference between anticipated expense needs and the "expected family contribution,"[136] increasing that "contribution" by withdrawing funds from the parent's IRA necessarily reduces the student's eligibility for financial aid. Using IRA funds to pay educational expenses is clearly a financially unappealing strategy.

This strategy becomes even more unappealing when one considers the many other options available for funding educational expenses. For example, persons who pay interest on student loans can deduct this interest expense[137] from their taxable income even if they do not "itemize" their deductions.[138] Home equity loans can be obtained to pay for education expenses, with the resulting interest expense being deductible as an itemized deduction.[139] Prepaid tuition contracts are given favorable treatment in the tax code through a combination of deferrals until the proceeds are used[140] and calculation of the tax eventually due at the student's presumably lower tax rate.[141] Certain government bonds can be used to pay college tuition costs,[142]

134. *See* Julie Creswell, *Tuition Trauma*, WALL ST. J., Dec. 1, 1997, at R13, R14.

135. *See* Kristin Davis, *College Aid: The Nitty-Gritty Guide*, KIPLINGER'S PERS. FIN. MAG., Jan. 1998, at 95, 98. The value of the principal residence is also ignored in the federal computation formula, although many private colleges and universities include this asset in determining their financial aid offers. *See id*. at 97. A grandparent's nonretirement assets are not considered in financial aid computations unless the grandparent is the student's guardian. If that is not the case, withdrawals from a grandparent's IRA would not affect a student's eligibility for financial aid.

136. *See* Mark Kantrowitz, *FinAid Page* (visited June 6, 1997) <http://www.finaid.org /finaid/calculators/estimate.html>.

137. *See* I.R.C. § 221(a). The maximum deduction for 1999 is $1,500, although this limit will increase to $2,500 by 2001. *See id*. § 221(b)(1).

138. *See* I.R.C. § 62(a)(17) (allowing the deduction in deriving AGI).

139. *See* I.R.C. § 163(h)(3)(C)(i) (no restriction on the use of home equity loan proceeds). But this interest expense is deductible only on home equity loans that do not exceed $100,000. *See id*. § 163(h)(3)(C)(ii).

140. *See* I.R.C. § 529(a); *see also* Lynn Asinof, *States' College-Savings Plans Go National*, WALL ST. J., Sept. 23, 1999, at C1; Stephanie Gallagher, *A Winning Way to Save for College*, KIPLINGER'S PERS. FIN. MAG., May 1998, at 50.

141. *See* I.R.C. § 529(c)(3)(A). *See generally* Kristin Davis, *Tomorrow's Tuition at Today's Prices*, KIPLINGER'S PERS. FIN. MAG., Nov. 1995, at 101; June Kronholz, *Prepaid Tuition Is Catching On in More States*, WALL ST. J., Nov. 13, 1997, at B1.

142. *See* I.R.C. § 135(c)(2)(A). Room and board expenses are eligible for favorable treatment under this provision. *See id.* § 135(b)(1)(A).

in which case the interest on these bonds may be exempt from federal income tax.[143] Finally, so-called Education IRAs, which are not IRAs in any real sense of the phrase, can be set up to pay the entire range of higher educational costs,[144] including room and board expenses.[145]

With all of these education-specific tax incentives already in place, educational costs hardly seem to warrant an IRA penalty exception, particularly one that might jeopardize an IRA holder's retirement security. This exception should also be repealed forthwith.

### C. Medical Expenses

A final penalty exception of recent vintage applies to medical expenses that qualify for the medical expense deduction.[146] In other words, this penalty exception covers medical expenses that exceed 7.5% of a person's AGI.[147] Unlike the housing acquisition expenditures and the education costs considered above,[148] medical expenses are often not discretionary expenditures; nor are they generally as susceptible to the type of advance planning that might avoid the need to withdraw funds from an IRA.

This is precisely why such expenditures should be funded via health insurance plans rather than through IRAs. Health insurance pays for medical expenses within the coverage limits of the applicable policy, and most active employees receive employer-provided health insurance as a tax-free fringe benefit.[149] As a result, such employees should have little need to withdraw IRA funds to pay for medical expenses. While most health insurance policies do not cover every medical cost, the amount of noncovered expenses (e.g., co-payments

143. *See* I.R.C. § 135(a). This bond interest income exemption is phased out starting at an AGI of $53,100 for single taxpayers and $79,650 for married taxpayers. *See id*. § (b)(2)(a), *as indexed for 1999 by* Rev. Proc. 98-61, 1998-52 I.R.B. 18, § 3.07.

144. *See* I.R.C. § 530(a) (no tax on earnings of an "education individual retirement account"), (d)(2)(A) (no tax on distributions that are less than the distributee's "higher education expenses"). Although eligibility to establish these accounts is limited by section 530(c)(1) to persons within specified AGI parameters, the ability of a student to self-fund an education IRA, even from unearned sources such as gifts, makes these accounts nearly universally available. *See* Notice 97-60, 1997-2 C.B. 310, § 3, Q&A 10.

145. *See* I.R.C. §§ 529(e)(3)(A), (B)(i), 530(b)(2)(A).

146. *See* I.R.C. § 72(t)(2)(B).

147. *See* I.R.C. § 213(a).

148. *See supra* Parts IV.A, B.

149. *See* I.R.C. § 106(a).

and annual deductibles) rarely exceed 7.5% of the insured's AGI,[150] which is the threshold that must be met for the IRA penalty exception to apply.[151] Therefore, the penalty exception is probably worthless for IRA holders with health insurance.

As to IRA holders who lack health insurance, the most sensible approach would be to provide such insurance rather than encourage the depletion of IRAs. The problem of uninsured Americans is a genuine health policy dilemma,[152] one that has bedeviled policymakers for years, and has actually worsened since the demise of the early Clinton administration proposal in this area.[153] But using an individual's IRA for such unpredictable and potentially catastrophic expenditures is the wrong approach.

Although most retirees have comprehensive health care coverage through Medicare,[154] this program generally does not enroll persons under the age of sixty-five.[155] People who retire before reaching that age need to obtain retiree health coverage from their former employers to fill the gap or purchase such coverage on their own. Such coverage is always expensive and may even be unavailable due to a particular person's medical profile.[156] Indeed, the current deficiency in this area was the reason that the Clinton administration

150. For example, a taxpayer whose AGI was $60,000 would need to incur $4,500 worth of out-of-pocket medical expenses—i.e., *after* insurance reimbursement and co-payment but before *any* medical expenses are deductible.

151. *See* I.R.C. §§ 72(t)(2)(B), 213(a).

152. *See* Steven A. Schroeder, *The Medically Uninsured—Will They Always Be With Us?*, 334 NEW ENG. J. MED. 1130 (1996); Barbara Markham Smith, *Trends in Health Care Coverage and Financing and Their Implications for Policy*, 337 NEW ENG. J. MED. 1000 (1997); *see also* Olveen Carrasquillo et al., *A Reappraisal of Private Employers' Role in Providing Health Insurance*, 340 NEW ENG. J. MED. 109 (1999); Robert Kuttner, *The American Health Care System: Employer-Sponsored Health Coverage*, 340 NEW ENG. J. MED. 248 (1999). Medical Savings Accounts were enacted in 1996 to address this need. *See* I.R.C. § 220; *see also* Richard L. Kaplan, *Taking Medicare Seriously*, 1998 U. ILL. L. REV. 777, 788-90.

153. *See* Health Security Act, H.R. 3600, S. 1757, 103d Cong., § 1001 (1993); *see also* Robert Kuttner, *The American Health Care System: Health Insurance Coverage*, 340 NEW ENG. J. MED. 163 (1999). *See generally* THEDA SKOCPOL, BOOMERANG: CLINTON'S HEALTH SECURITY EFFORT AND THE TURN AGAINST GOVERNMENT IN U.S. POLITICS (1995).

154. *See* 42 U.S.C. §§ 1395–1395ggg (1995). *See generally* FROLIK & KAPLAN, *supra* note 10, at 56-100.

155. *See* FROLIK & KAPLAN, *supra* note 10, at 57-59. Persons under age 65 may enroll in Medicare if they have received Social Security disability benefits for at least 24 months. In addition, persons with "end stage renal disease" may enroll in Medicare, regardless of age. *See id*. at 60.

156. *See* Deborah Lohse, *Early Retirees Get Healthy Dose of Reality*, WALL ST. J., Oct. 25, 1993, at C1, C23.

proposed making Medicare available to retirees as young as age fifty-five.[157] It is this group, after all, that would be most affected by the IRA penalty exception for medical expenses paid by persons before the age of fifty-nine and one-half. That proposal is apparently moribund, but the need to which it was addressed remains significant and continues to grow.[158] Encouraging people to raid their IRAs is a most inadequate alternative approach to this societal dilemma.

Using IRA funds to pay expenses of long-term care, which Medicare and private retiree health insurance do not cover,[159] is an even worse strategy. Nursing home expenses average $50,000 per year,[160] and the cost can be much higher in certain parts of the country and in particular facilities.[161] Assisted living care is less expensive, though its cost is still substantial,[162] and only a relatively small portion of the cost of such care would even qualify as eligible "medical expenses"[163] for purposes of the IRA penalty exception.[164] As a result, paying such costs out of an IRA could dissipate many IRAs in short order, particularly when associated costs of institutional care, such as prescription drugs and special supplies, are included.

The better alternative in these circumstances is private long-term care insurance.[165] Premiums for such policies are by no means trivial, but the cost of nursing home care can eclipse several years' premium outlays within a few months.[166] For example, a person aged sixty-five who obtains a long-term care insurance policy that pays nursing home benefits of $100 per day for four years, after an "elimination period" of

157. *See* Jane Bennett Clark, *Bridging the Work-to-Medicare Gap*, KIPLINGER'S PERS. FIN. MAG., Apr. 1998, at 56.

158. A related issue involves the ability of employers to terminate or modify health coverage of former employees who have retired. *See* William T. Payne, *Retiree Medical Benefits*, A.B.A. J., Dec. 1997, at 63; Robert L. Rose, *Firms' Attempts to Cut Health Benefits Break Calm of Retirement*, WALL ST. J., Feb. 24, 1993, at A1.

159. *See generally* FROLIK & KAPLAN, *supra* note 10, at 68-70, 95.

160. *See* John Greenwald, *Elder Care: Making the Right Choice*, TIME, Aug. 30, 1999, at 52, 55.

161. *See* LAWRENCE A. FROLIK, RESIDENCE OPTIONS FOR OLDER OR DISABLED CLIENTS ¶ 12.02 (1997).

162. *See* FROLIK & KAPLAN, *supra* note 10, at 177.

163. JOHN J. REGAN ET AL., TAX, ESTATE & FINANCIAL PLANNING FOR THE ELDERLY § 6.11[3][a], at 6-50 (1998). To qualify, the expenses in question must pertain to a resident who is "chronically ill," which is defined as someone who is unable to perform at least two "activities of daily living" (i.e., eating, toileting, transferring, bathing, dressing, or continence) "without substantial assistance." I.R.C. §§ 213(d)(1)(C), 7702B(c)(1)(A), (2)(A)(i), (B)(i)-(vi) (1999).

164. *See* I.R.C. § 72(t)(2)(B).

165. *See generally* FROLIK & KAPLAN, *supra* note 10, at 131-46.

166. *See infra* text accompanying notes 167-69.

twenty days, would pay $1,247 per year.[167] But only two months in a nursing home would generate $4,000 of benefits paid[168]—more than three years of annual premiums.[169] And long-term care policies obtained for persons under the age of fifty-nine and one-half—i.e., those persons who are affected by the IRA penalty exception for medical expenses—are significantly less expensive than policies acquired later in life.[170] Here too using IRA funds to meet the medical expenses of long-term care should be actively discouraged, not encouraged by means of a penalty exception.

As noted previously, withdrawing funds from an IRA has a detrimental long-term economic impact on the prospective retiree.[171] Amounts so withdrawn cannot be subsequently restored and the financial benefit of compounded earnings, accumulated free of current taxation, is consequently lost forever.[172] Moreover, the lack of a penalty does not mean that the withdrawal is tax free; rather, the withdrawal itself remains taxable,[173] except to the extent that it represents the account holder's contributions to a Roth IRA,[174] and the various tax law interactions described above can impose unexpectedly high costs on the account holder.[175] The deduction of the medical expenses[176] in question ameliorates this situation to some degree, but it does not eliminate the negative tax impact. The applicable 7.5%-of-AGI floor eliminates a significant portion of the potential medical cost deduction,[177] and the IRA withdrawal itself actually exacerbates this phenomenon by *raising* the taxpayer's AGI on which the 7.5% floor is calculated.[178] Accordingly, the IRA penalty exception for medical

167. *See* Nancy Ann Jeffrey, *Your Needs, Plus Your Budget, Equals What to Pay on Long-Term Care Policy*, WALL ST. J., Mar. 21, 1997, at C1.
168. Two months equals 60 days, minus elimination period of 20 days equals 40 days, multiplied by $100 daily benefit equals $4,000 benefits received. *See id*.
169. $1,247 per year multiplied by three years equals $3,741.
170. For example, the annual premium of the policy described in the text accompanying note 167 would be only $643 if the insured were 55 years old when the policy is first issued. *See* Jeffrey, *supra* note 167, at C1.
171. *See supra* text accompanying notes 99-101.
172. *See supra* text accompanying notes 99-101.
173. *See* I.R.C. § 408(d)(1) (1999).
174. *See* I.R.C. §§ 408A(d)(1)(B), (2)(A)(i).
175. *See supra* text accompanying notes 123-33.
176. *See* I.R.C. § 213(a).
177. *See id*.
178. A further portion of the medical expense deduction may be lost because this deduction is an "itemized deduction," the economic benefit of which is undercut to some degree by the "standard deduction" that is allowed by section 63(c)(2). *See* I.R.C. § 67(b)(5). In 1999, this deduction was $4,300 for single

expenses is bad financial strategy as well as poor public policy. It too should be repealed forthwith.

## V. An IRA for Subsequent Generations

The stupendous growth in IRAs in recent years has meant that some retirees find that they do not need all of the sums they have accumulated to sustain themselves in their retirement.[179] As a result, some IRA holders minimize their annual withdrawals to enable as much money as possible to stay in the IRA itself.[180] This strategy maximizes the amount that continues to accrue investment profits without owing any current tax on those profits.[181] Any balance remaining at the IRA holder's death can then be distributed to succeeding generations, thereby converting the IRA from a retirement funding mechanism into a device for accumulating bequests on a tax-sheltered basis.

Congress foresaw this possibility and enacted a delayed distribution penalty.[182] This penalty is 50% of what the "required minimum distribution" (RMD) would be[183] if the IRA holder began taking distributions starting in April of the year after he or she reached the age of seventy and one-half.[184] As a result, taxpayers begin withdrawing funds when they are seventy-one years old, if they have not already done so, to avoid this very harsh penalty.

This delayed distribution penalty does not, however, apply to Roth IRAs.[185] Thus, the holder of a Roth IRA need *never* take any withdrawals from that account during his or her lifetime.[186] This

taxpayers and $7,200 for married taxpayers. *See* Rev. Proc. 98-61, 1998-52 I.R.B. 18, § 3.05(1). Other "itemized deductions" might be available to offset part of the "standard deduction," but some deficiency would remain in many cases.

179. *See* Joseph Anthony, *Pass It On*, WORTH, July/Aug. 1999, at 83.

180. *See, e.g.*, Kenneth A. Hansen, *Maximizing the Deferral of IRA Required Minimum Distributions*, 74 TAXES 622 (1996)

181. *See id*.

182. *See* I.R.C. § 4974(a).

183. *See id*. The penalty is imposed on the difference between the RMD and the amount actually distributed, if any. In addition, the IRA might lose its tax-exempt status if it has a "pattern or regular practice of failing" to make the RMDs. *See* Prop. Treas. Reg. § 1.408-8, Q&A A-3A (1987).

184. *See* FROLIK & KAPLAN, *supra* note 10, at 364-67. *See generally* DIANNE BENNETT ET AL., TAXATION OF DISTRIBUTIONS FROM QUALIFIED PLANS ch. 14 (2d ed. 1998); DOWNING, *supra* note 47, at 71-85.

185. *See* I.R.C. § 408A(c)(5)(A).

186. *See* Ralph V. Switzer, Jr. & Tracey C. Webb, *New Roth IRA Provides Tax Planning Opportunities*, 79 TAX NOTES 76 (1998).

effective lack of required distributions is one of the most dramatic differences between Roth IRAs and regular IRAs and is regularly trumpeted as a planning opportunity of tremendous importance.[187] Indeed, the failure to require lifetime distributions of a Roth IRA undercuts the very notion that it is a retirement funding vehicle at all. What emerges instead is a tax-favored retirement savings account that need never be used to fund the account holder's retirement. Either the Roth IRA is a retirement funding mechanism or it is not. This feature of no-required-distributions is so completely incongruent with all other retirement savings devices[188] that it should be repealed.

More fundamentally, the ability to include younger beneficiaries[189] in *any* type of IRA, either the regular or Roth IRA, bestows tax benefits to succeeding generations that cannot be reconciled with the avowed purpose of these accounts. The problem originates with the RMD calculation methodology itself.[190] For example, assume that Urfan is seventy years old and has a regular IRA with an account balance of $300,000. He could divide this $300,000 account balance by his remaining life expectancy of sixteen years per the Internal Revenue Service's (IRS) unisex tables[191] and withdraw $18,750 in the first year ($300,000 divided by 16 years). The following year, Urfan will divide the remaining balance, including any growth in the IRA that accrued during the intervening year, by fifteen years (sixteen year life expectancy at age seventy, minus one year) and withdraw the result.[192] In this fashion, Urfan will withdraw

187. *See id.*; *see also* Anthony, *supra* note 179, at 83; James L. Budros, *The Best Inheritance in the World*, J. RETIREMENT PLANNING, July-Aug. 1998, at 45; Karen Hube, *IRA Rules' Complexity Can Bring Costly Errors*, WALL ST. J., Sept. 20, 1999, at C1, C20. A related advantage of the Roth IRA is the ability of the account holder to contribute to the IRA after reaching age 70.5. *See* I.R.C. § 408A(c)(4). The taxpayer must still have income from wages, salaries, or self-employment, but IRA contributions are allowed. *See* IRA ANSWER BOOK, *supra* note 1, at 5-30. Contributions to regular IRAs are not allowed at this stage. *See id*.

188. *See supra* note 184. After the Roth IRA account holder dies, distributions are required for beneficiaries of Roth IRAs in the same manner as beneficiaries of regular IRAs. *See* Treas. Reg. § 1.408A-6, A-14 (1999); *see also* ROTH IRA ANSWER BOOK, *supra* note 32, at 4-24; *infra* text accompanying notes 200-10.

189. *See* IRA ANSWER BOOK, *supra* note 1, at 5-12 to 5-14; *see also* Budros, *supra* note 187.

190. *See generally* FROLIK & KAPLAN, *supra* note 10, at 364-67.

191. *See* Treas. Reg. § 1.72-9 tbl.V. If *no* investment in the IRA was made after June 1986, the applicable table would be Table 1, which differentiates between male and female annuitants.

192. This methodology is variously described as the "Term Certain" and the "One Year Less" method. An alternative methodology allows Urfan to redetermine his life expectancy using the IRA table each year. This method

his entire IRA over his life expectancy. But this methodology is not Urfan's only option.

Instead, he could name a joint beneficiary and withdraw the IRA over their *joint* life expectancy.[193] Joint life expectancies are always longer than single life expectancies because of the high probability that one of the two beneficiaries will outlive the other.[194] So if Urfan names his sixty-five-year-old wife, Latisha, as a joint beneficiary, their joint life expectancy, per the IRS tables, is 23.1 years,[195] and the first year's IRA withdrawal will be $12,987 ($300,000 divided by 23.1 years). This amount is significantly less than the $18,750 calculated by using Urfan's life expectancy alone.[196] The following year, Urfan and Latisha would divide their remaining IRA balance, including any investment earnings accrued during the year, by 22.1 years (23.1 year joint life expectancy when the RMDs commenced, minus one year), and so on.[197]

Suppose instead that Urfan names his forty-year-old daughter, Linda, rather than his wife, as the joint beneficiary. Now the joint life expectancy would be significantly longer, resulting in much lower annual IRA withdrawals than in the preceding example because the IRA must persist over the combined life expectancy of Urfan (seventy years old) and Linda (forty years old). The applicable life expectancy is now 42.9 years,[198] and the corresponding first year withdrawal

minimizes Urfan's required distribution because life expectancies drop by less than one year each year. *See* Treas. Reg. § 1.72-9 tbl.V. For example, if Urfan adopts this approach, his remaining life expectancy in the second year would be 15.3 years, rather than 15 years (16 years minus one year). This so-called annual recalculation method, however, has various other tax consequences that are beyond the scope of this article. *See generally* IRA ANSWER BOOK, *supra* note 1, at 5-16 to 5-21, 9-24 to 9-26.

193. *See* I.R.C. §§ 401(a)(9)(A)(ii), 408(a)(6); *see also* FROLIK & KAPLAN, *supra* note 10, at 365; IRA ANSWER BOOK, *supra* note 1, at 5-13.

194. *See* IRA ANSWER BOOK, *supra* note 1, at 5-15. *Compare* Treas. Reg. § 1.72-9 tbl.V (1999) (life expectancy for a person age 70 is 16 years) *with id.* tbl.VI (life expectancy for two persons each age 70 is 20.6 years).

195. *See* Treas. Reg. § 1.72-9 tbl.VI.

196. *See supra* text accompanying note 191.

197. As was the case with single life annuitization, persons using joint lives may choose to recalculate the applicable divisor annually. *See supra* note 192. In this case, the life expectancy in the second year would be 22.2 years, rather than 22.1 years, if both lives are recalculated. *See* Treas. Reg. § 1.72-9 tbl.VI.

198. *See id.* If the joint beneficiary is not the IRA holder's spouse, the annual recalculation methodology described in *supra* notes 192-97 is not available. *See* IRA ANSWER BOOK, *supra* note 1, at 15-16.

would be $6,993 ($300,000 divided by 42.9 years), which is much lower than the $12,987 calculated above.[199]

Interestingly, the tax law limits this extended deferral technique via a cryptic rule called the "minimum distribution incidental benefit."[200] The upshot of this convoluted provision is that the age of a nonspouse joint beneficiary is treated as being no more than ten years younger than the IRA holder.[201] Accordingly, in the preceding example, Linda is treated as being sixty years old (Urfan's age of seventy years minus ten years), rather than her actual age of forty years old. As a result, their joint life expectancy is only 26.2 years,[202] and the first year's IRA withdrawal becomes $11,450 ($300,000 divided by 26.2 years). The corresponding numbers in the preceding paragraph, based on Linda's current age of forty years, would apply only if Linda were Urfan's spouse, not his daughter, because the ten-year rule does not arise when the spouse is the joint beneficiary in question.[203]

But here is the rub: the ten-year maximum age differential rule is effective only during the IRA holder's lifetime.[204] After Urfan dies, Linda can essentially use her remaining life expectancy to calculate subsequent mandatory withdrawals.[205] At that point, her significantly younger age works to her benefit, without the limitation of the ten-year rule, and she can accordingly minimize the required distributions and thereby maximize the IRA balance[206] that continues to grow free of current tax liability.

199. *See supra* text accompanying note 195.
200. Prop. Treas. Reg. § 1.401(a)(9)-2 (1999).
201. *See* IRA ANSWER BOOK, *supra* note 1, at 5-12.
202. *See* Treas. Reg. § 1.72-9 tbl.VI.
203. *See* FROLIK & KAPLAN, *supra* note 10, at 366; IRA ANSWER BOOK, *supra* note 1, at 5-12.
204. *See* IRA ANSWER BOOK, *supra* note 1, at 5-20.
205. If the IRA holder (Urfan) dies *before* reaching the date when the RMDs begin, the beneficiary (Linda) uses her own life expectancy in calculating RMDs. *See* IRA ANSWER BOOK, *supra* note 1, at 5-13, 5-19, 5-20. If the IRA holder dies *after* the RMDs begin, the beneficiary uses the original joint life expectancy, calculated without regard to the 10-year rule, minus the number of years that RMDs have been paid. *See* IRA ANSWER BOOK, *supra* note 1, at 5-13, 5-20, 5-45. Thus, the mechanics are slightly different but the result is basically the same in both circumstances: the IRA is distributed over a long period of time determined principally by the life expectancy of the surviving, presumably younger beneficiary. *See, e.g.*, JACK E. STEPHENS, AVOIDING THE TAX TRAPS IN YOUR IRA 88 (2d ed. 1999); Hube, *supra* note 187, at C1.
206. *See* STEPHENS, *supra* note 205, at 74.

Taking this strategy one step farther, Urfan could name his grandson, Joseph, age three, as a joint beneficiary. Once again, the ten-year rule would limit the deferral possibilities during Urfan's lifetime but, after Urfan dies, Joseph may elect to compute the RMD over his own much longer life expectancy.[207] When a minor child such as Joseph is involved, some special considerations apply, but trusts and custodians can usually take care of these issues.[208]

To illustrate this situation, assume that Urfan dies when he is seventy-five years old. At that time, Joseph is eight years old because five years have transpired since the RMDs first began. Joseph's remaining life expectancy is now 73.7 years,[209] so his annual withdrawal amount is 1.357% of the IRA's balance (100% divided by 73.7 years). Since this amount is almost certainly less than the IRA's annual earnings growth rate, the IRA's balance will actually *increase* during Joseph's lifetime. If he takes only the minimum amount required from his grandfather's IRA, Joseph could withdraw ever-larger amounts each year and still end up with an IRA balance at his death that is many times the balance with which he started.[210] Such is the power of tax-sheltered investing compounded with artificially reduced withdrawal rates!

As these examples demonstrate, it is possible to name a child, grandchild, or other nonspouse as a joint beneficiary of an IRA—regular or Roth—and thereby create a tax-sheltered mechanism to benefit successive generations. Perhaps this is a laudable goal, but it is not one intrinsic to the IRA's *raison d'être* of providing retirement

207. *See supra* note 205; *see also* Budros, *supra* note 187, at 47.

208. Distributions to minors may require appointment of a guardian, unless a custodian receives the distribution. Alternatively, a special IRA benefits trust can be designated the beneficiary of the IRA. Such a trust must be valid under state law, be irrevocable upon the IRA holder's death, and have identifiable beneficiaries, all of whom must be individuals. *See* Prop. Treas. Reg. § 1.401(a)(9)-1.D-5A(b) (1999); *see also* David W. Polstra, *The "Supercharged IRA": Naming a Grandchild as Beneficiary*, J. RETIREMENT PLANNING, Sept.-Oct. 1998, at 10. In any case, the strategy of naming a grandchild as an IRA beneficiary is most effective when no estate tax or generation skipping transfer tax is due. *See* I.R.C. §§ 2010(c) (estate tax exemption of $650,000 for 1999, rising to $1,000,000 in 2006), 2631(a) (generation skipping transfer tax exemption of $1,000,000). For 1999, the generation skipping transfer tax exemption is $1,010,000. *See* Rev. Proc. 98-61, 1998-52 I.R.B. 18, § 3.17.

209. *See* Treas. Reg. § 1.72-9 tbl.V (1999).

210. This example is drawn from Polstra, *supra* note 208, at 11 (IRA balance of $600,000 when beneficiary is three years old increases to $2,300,283 when beneficiary turns 31); *see also* Anthony, *supra* note 179, at 84 (IRA increases "by a factor of ten or more").

income to the account holder.[211] Nor is there any particular reason to provide tax subsidies for the accumulation of dynastic wealth.

Creating intergenerational IRAs is also counter to the policies of the other major retirement income programs—Social Security and employer-provided pension plans. In Social Security, a surviving *spouse* succeeds to the deceased spouse's benefit,[212] unless the surviving spouse's own worker's benefit is greater.[213] But children who are over the age of eighteen and nondependent grandchildren of a deceased Social Security recipient generally receive nothing.[214] The purpose of Social Security, after all, is to provide retirement income for the retired worker and that person's spouse (and surviving dependents),[215] not to pass on a legacy to future generations.[216]

Similarly, employer-provided pensions mandate joint-and-survivor annuities for the retired worker and that person's spouse.[217] This feature can be waived only with the written consent of the spouse.[218] Lump sums may be payable to a surviving nonspouse beneficiary in certain circumstances,[219] but lifelong payout schemes and tax-sheltered accumulations are not part of the pension landscape after the retired worker and that person's spouse are no longer alive.

IRAs give comparable deference to the spouse by calling off the ten-year maximum age differential rule when the joint beneficiaries are married to one another.[220] In addition, a surviving spouse can rollover the remaining balance in the IRA on a tax-free basis,[221] unlike

211. *See* H.R. REP. NO. 93-779, at 124-25 (1974), *reprinted in* 1974-3 C.B. 244, 367-68.

212. *See* FROLIK & KAPLAN, *supra* note 10, at 293.

213. Social Security always pays the larger of two benefits when a recipient qualifies for more than one benefit. *See id*. at 292.

214. Unmarried children over the age of 18 can receive Social Security benefits if they are under age 19 and still attending elementary or high school or if they become mentally or physically disabled prior to reaching age 22. *See* 42 U.S.C. § 402(d)(1)(B) (1995). Grandchildren who were "dependents" of the deceased retiree receive the same Social Security benefits as children. *See generally* FROLIK & KAPLAN, *supra* note 10, at 295-97.

215. *See generally* FROLIK & KAPLAN, *supra* note 10, at 290-300.

216. *See id*. at 295 ($255 one-time payment to a surviving spouse or dependent children).

217. *See id*. at 354.

218. *See* I.R.C. § 417(a)(2) (1999).

219. *See* PENSION ANSWER BOOK, *supra* note 56, at 13-10 to 13-11.

220. *See supra* note 203 and accompanying text.

221. *See* I.R.C. §§ 402(c)(4), (9). *See generally* Mary Ann Mancini, *Spousal Issues That Arise When Planning for Qualified Plans and IRAs*, 34 TAX MGMT. MEMO. 67 (1993).

a surviving nonspouse beneficiary.[222] These policies are sound because they recognize that IRAs, like Social Security and employer-provided pensions, are part of the financial arrangements that married couples make for their sustenance when their working years have ended. But enriching subsequent generations beyond a lump-sum distribution of any unused balance that remains after both members of the married couple have died is unnecessary.

Extended payouts, accompanied by tax-sheltered growth, for nonspouse beneficiaries run counter to every other retirement funding mechanism and should be eliminated. The regular IRA represents a simple trade-off: no tax due during the account holder's working life in exchange for taxes on the account when the holder uses it during retirement. A Roth IRA represents a similar trade-off: no deduction for contributions to the account in exchange for no taxes due on withdrawals during the account holder's retirement. What should not be part of the deal is extending an IRA's tax deferral into the next generation, thereby creating what one prominent brokerage firm describes as "The Eternal IRA."[223]

## VI. Conclusion

After a quarter century, IRAs have veered somewhat off course. It is time to reconsider recent developments and return to first principles. The IRA is a tax-favored retirement savings vehicle that makes the income tax operate more like a consumption tax.[224] Investment earnings accumulate with no current tax liability, and tax is imposed when the saved funds are taken out. Moreover, whether the IRA is a regular or a Roth IRA, it is intended for the *retirement* of the account holder (and his or her spouse). It is not a general purpose savings account to fund home purchases, educational costs, or medical expenses. The recently enacted provisions[225] that encourage

222. *See* IRA ANSWER BOOK, *supra* note 1, at 1-19.
223. *See* SMITH BARNEY, INC., THE ETERNAL IRA (1997).
224. *See* STEPHEN G. UTZ, TAX POLICY 135-61 (1993); *see also* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 195-232 (1996); Alan Schenk, *The Plethora of Consumption Tax Proposals: Putting the Value Added Tax, Flat Tax, Retail Sales Tax, and USA Tax into Perspective*, 33 SAN DIEGO L. REV. 1281 (1996). *See generally* TAX SYSTEMS TASK FORCE, AMERICAN BAR ASS'N, A COMPREHENSIVE ANALYSIS OF CURRENT CONSUMPTION TAX PROPOSALS (1997); AMERICAN INST. OF CERTIFIED PUBLIC ACCOUNTANTS & MARTIN A. SULLIVAN, CHANGING AMERICA'S TAX SYSTEM: A GUIDE TO THE DEBATE (1996).
225. *See* I.R.C. § 72(t)(2)(B), (E), (F); *see also supra* Part IV.

the raiding of IRAs in pursuit of nonretirement purposes are misguided and should be repealed before they harm prospective retirees.

Similarly, the use of IRAs to build multigenerational trust funds is a serious miscarriage of the IRA's noble origins. IRAs represent a reasonable bargain: if holders set aside money for retirement and retain it for that purpose then taxes will be deferred until the funds are used for that purpose. To the extent that Roth IRAs do not require withdrawals during the account holder's retirement,[226] they mock the very concept of retirement-funding policy and cannot be reconciled with its lofty objectives. The required distribution regime[227] that applies to regular IRA account holders must be extended to Roth IRA account holders as well.

Finally, the ability to accumulate ever-larger sums for subsequent generations simply cannot be sustained in the context of retirement-funding mechanisms. If parents and grandparents want to ensure that their progeny never need work a day in their lives, that is their prerogative, but they hardly need additional tax subventions to help them achieve that goal. The significantly reduced tax rate on capital gains[228] and the unlimited step-up in value of assets held at death[229] provide tremendous tax benefits to accomplish that objective already.

In contrast, IRAs represent a targeted tax trade-off: no taxation while working, but the tax deferral ends when the account holder's retirement begins. If the IRA's funds are not needed for the retirement of the account holder or that person's spouse, their heirs are certainly entitled to the unused balance. But such balances should be distributed shortly after the death of the surviving spouse. This is an option presently available that many heirs adopt.[230] All should.

226. *See* I.R.C. § 408A(c)(5)(A).

227. *See* I.R.C. § 401(a)(9). *See generally* FROLIK & KAPLAN, *supra* note 10, at 364-67.

228. *See* I.R.C. § 1(h)(1)(E) (maximum capital gain tax rate of 20%). After the year 2006, this maximum rate drops to 18% on assets held at least five years if they were purchased after 2000. *See id*. § (2)(B).

229. *See* I.R.C. § 1014(a)(1). Although these assets might be subject to federal estate tax, that levy affects less than 2% of decedents. *See* Bruce Bartlett, *The End of the Estate Tax?*, 76 TAX NOTES 105, 105 (1997).

230. IRA beneficiaries can receive the balance of the account at the account holder's death or over five years following that event. *See* IRA ANSWER BOOK, *supra* note 1, at 5-40, 5-42.

It may be appropriate to create some sort of special averaging formula in computing the tax owed when a regular IRA is terminated to avoid the "bunching" aspect of subjecting significant sums to a graduated tax rate structure.[231] There is both precedent and a methodology already in place for such distributions in the context of qualified plans.[232] Alternatively, a special flat tax of 20-25% might be imposed on these amounts to avoid various income-based interactions[233] that might otherwise make the effective tax rate higher.

But the point remains that there is neither a need nor justification for continuing the tax-free accumulation of IRA past the lives of the account holder and that person's surviving spouse. When funding a retirement is no longer an issue, the IRA should terminate. Indeed, at a time when the distribution of wealth in this country is becoming increasingly skewed,[234] the maintenance of inherited IRAs, with their lack of current taxation of investment profits, is an anomaly that cannot continue. The solution is clear: when the intended beneficiaries of an IRA have ceased, so too should their IRA.

231. *See* I.R.C. § 1(a)-(d) (tax rates of 15%, 28%, 31%, 36%, and 39.6%).

232. *See* I.R.C. §§ 402(d)(1)(B), (C), *as amended by* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1401(a), 110 Stat. 1755, 1787; FROLIK & KAPLAN, *supra* note 10, at 368-73 (explaining the 10-year averaging method for lump-sum distributions received by persons born before 1936). Until the year 2000, a similar five-year averaging methodology was available for lump-sum distributions generally. *See* LAWRENCE A. FROLIK & RICHARD L. KAPLAN, ELDER LAW IN A NUTSHELL 372-77 (1st ed. 1995).

233. *See supra* text accompanying notes 123-33.

234. *See generally* EDWARD N. WOLFF, TOP HEAVY: THE INCREASING INEQUALITY OF WEALTH IN AMERICA AND WHAT CAN BE DONE ABOUT IT (1996); Jacob M. Schlesinger, *Wealth Gap Grows; Why Does It Matter?*, WALL ST. J., Sept. 13, 1999, at A1; Martha Starr-McCluer, *Stock Market Wealth and Consumer Spending*, *available in* <www.federalreserve.gov/pubs/feds/1998> (Fed. Reserve Bd., Fin. & Econs. Discussion Series No. 1998-20, 1998); Edward N. Wolff, *Recent Trends in the Size Distribution of Household Wealth*, 12 J. ECON. PERSPECTIVES 131 (1998); *see also* Martin J. McMahon & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1 (1998).