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## How the Über-Wealthy Benefit from Investing Outside Retirement Plans (And How You Can Too)

Sergio Pareja

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## How the Über-Wealthy Benefit from Investing Outside Retirement Plans (And How You Can Too)

### Cover Page Footnote

Henry Weihofen Chair and Professor of Law, The University of New Mexico School of Law; The University of California at Berkeley, B.A., 1991; Georgetown University Law Center, J.D., 1996. Prior to entering academia ten years ago, Professor Pareja spent nearly a decade in practice representing the über-wealthy.

# HOW THE ÜBER-WEALTHY BENEFIT FROM INVESTING OUTSIDE RETIREMENT PLANS (AND HOW YOU CAN TOO)

*Sergio Pareja*<sup>+</sup>

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The following hypothetical illustrates the problem this Article seeks to address.<sup>1</sup> Bill Gates is currently worth approximately \$80 billion.<sup>2</sup> For purposes of illustration, assume that nearly all of that wealth consists of Microsoft stock in which he has no income tax basis. If Bill were to die today and leave all his stock to his wife, Melinda, she would inherit that stock with an income tax basis of \$80 billion.<sup>3</sup> Because of the unlimited marital deduction from the estate tax,<sup>4</sup> Bill's estate would not pay any estate taxes at that time. Additionally, not a penny of the value of the Microsoft stock would be included in Melinda's income for income tax purposes.<sup>5</sup> If Melinda were to sell all her inherited Microsoft stock immediately after receiving it, she would not pay any taxes on the sale because the sale price would equal her basis in the stock.<sup>6</sup>

Now consider a hypothetical situation involving a janitor named Victor Castro who works at Microsoft. Assume that Microsoft offers its employees a 401(k) plan, and Victor is a diligent contributor to the plan throughout his thirty-year career at the company. During that time, and at considerable sacrifice, he manages to set aside \$100,000 of his wages into the plan. Because he invests wisely, the stock in his 401(k) plan grows to a total value of \$1 million over the thirty-year period, at which time he retires. Unfortunately, he passes away shortly thereafter. His wife, Monica, inherits the full \$1 million, but she will be taxed on the full amount as ordinary income.<sup>7</sup>

The difference in outcomes in the two scenarios described above is that the stepped-up basis at death does not apply to what is known as "income in respect of a decedent" (IRD).<sup>8</sup> Generally, IRD is income that cannot be assigned from one person to another for income tax purposes.<sup>9</sup> This includes pre-tax income

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1. The idea for this Article originated with informal conversations the author had with tax colleagues about the disincentives to utilizing retirement plans. This Article is an attempt to analyze these alleged disincentives.

2. *Powerful People: #1 Bill Gates*, FORBES, <http://www.forbes.com/profile/bill-gates/> (last visited Mar. 31, 2015) (recording the real time net worth of Bill Gates as fluctuating between approximately \$78 billion and \$81 billion).

3. I.R.C. § 1014 (2012) (providing for a step-up in income tax basis at death). The Internal Revenue Code is codified at Title 26 of the U.S. Code. Tax lawyers commonly cite directly to the Internal Revenue Code rather than to the U.S. Code, and this Article follows that convention. For example, a reference to I.R.C. § 1014 is also a reference to 26 U.S.C. § 1014 (2012).

4. *Id.* § 2056(a).

5. *Id.* § 102(a)-(b) (excluding gifts and inheritances from the recipient's income for federal income tax purposes).

6. *Id.* § 1014(a).

7. *Id.* § 691(a)(1). Although she may defer taxes by taking payments from the plan over her life expectancy, there is no avoiding the fact that distributions from the plan will be ordinary income to her. *See id.* § 691(a)(3).

8. *Id.* § 1014(c).

9. *See* Treas. Reg. § 1.691(a)-1(b) (as amended in 1965).

set aside in a traditional employer-sponsored retirement plan,<sup>10</sup> such as a 401(k) plan, as well as contributions to a deductible individual retirement account (IRA).<sup>11</sup> Thus, stock held within a traditional employer-sponsored retirement plan or a deductible IRA is not eligible for the basis step-up at death, while stock held outside those plans is eligible for the unlimited stepped-up basis at death. Thus, über-wealthy families such as the Gates family (*i.e.*, the dynastically wealthy), who tend to own the great bulk of their assets outside of retirement plans,<sup>12</sup> will qualify for the basis step-up. On the other hand, middle class families who strive to improve their future by diligently saving through a deductible IRA or 401(k) plan will not qualify for the basis step-up at death. This Article attempts to redress this aspect of the inequitable income tax treatment of families' income.

Part I of this Article focuses on the stepped-up basis at death, describing the history and policies behind the adjustment of income tax basis to its fair market value on a decedent's date of death.<sup>13</sup> Although the phrase as it is commonly used refers to a basis "step-up," the adjustment can actually cause an asset's income tax basis to be either stepped up or down to the asset's date of death value.<sup>14</sup> One key exception to this adjustment is for assets that qualify as IRD.<sup>15</sup>

Part II focuses on the meaning of IRD and the historical reason for including IRD in the recipient's income as well as the historical reason for exempting IRD from the basis step-up at death. This section also analyzes one potential effect of treating retirement plan assets as IRD: the likely increase of resistance to the

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10. I.R.C. § 408(c). "Traditional employer-sponsored retirement plan" is a narrower term that includes plans such as 401(k) plans, but does not include most IRAs. *See id.* As a general matter, "retirement plan" is a broad term that includes, among other things, Keogh plans, profit sharing plans, stock bonus plans, tax-sheltered annuities, 403(b) plans, and IRAs. *See infra* text accompanying note 86.

11. *See* MFS INV. MGMT., IRD: A TAX RULE BENEFICIARIES NEED TO KNOW 2 (2007).

12. A key reason for this is because there are, by über-wealthy family standards, very low annual contribution limits to retirement plans. Said differently, if a person's net worth fluctuates by millions of dollars daily, as was the case with some of the author's clients, a \$52,000 annual retirement plan contribution limit is extremely small. If the person bothers to contribute at all, it will be a very small portion of his or her net worth. In addition, a deductible contribution would potentially come at a high price. Future distributions would all be taxable as ordinary income to the recipient. I.R.C. § 691(a)(1). Because top rates are very low by historical standards, it is easy to speculate that future rates will be much higher. This assessment makes Roth-type retirement plans more appealing to the wealthy. *See infra* Part V (explaining Roth-type retirement plans and their advantages and disadvantages from a tax perspective for the wealthy).

13. If the alternate valuation date is used, then the basis is stepped up to its value on the date six months after the decedent's date of death. I.R.C. §§ 1014, 2032(a)(1)–(2).

14. Office of the Press Sec'y, *Fact Sheet: A Simpler, Fairer Tax Code that Responsibly Invests in Middle Class Families*, THE WHITE HOUSE (Jan. 17, 2015), <https://www.whitehouse.gov/the-press-office/2015/01/17/fact-sheet-simpler-fairer-tax-code-responsibly-invests-middle-class-fami>.

15. I.R.C. § 1014(c).

estate tax because many people erroneously assume that the income taxation of IRD is the same as the estate tax.<sup>16</sup>

Part III of this Article analyzes traditional employer-sponsored retirement plans and deductible IRAs. This section spells out the distribution rules governing traditional employer-sponsored retirement plans and explains the policy goals behind them. Contributions by employers to this type of retirement plan are excluded from the employee's income, and contributions to deductible IRAs are deductible by the person making the contribution.<sup>17</sup>

Part IV analyzes how traditional retirement plan assets currently are taxed at death under the standard measures of a tax law's desirability: administrative efficiency, equity, and neutrality. This section concludes that, while our current system may be administratively more efficient than alternate systems, it fails miserably in terms of equity.

Part V of this Article discusses some ways, apart from that proposed herein, by which to remedy the equity problem with the tax treatment of traditional retirement plans. Part V focuses on Roth-type retirement plans as an alternative to traditional retirement plans and concludes that none of the remedies, whether real or proposed, is satisfactory.

Part VI analyzes this Article's proposal. Although certain aspects of the proposal are necessarily complex, the core proposal is quite simple: capital assets held inside a deductible IRA or qualified retirement plan should qualify for the unlimited basis step-up in the same way that they would qualify if they were owned outside an IRA or retirement plan. The primary problem with this proposal is that it is administratively more complicated than our current system because assets originally placed into a qualified retirement plan or deductible IRA have not been taxed to the account owner. In order to treat the Gates and Castro families equally with respect to the basis step-up, it is necessary to ensure that the assets originally placed into the plan will not escape tax altogether. Fortunately, this can be done without significant complexity.

## I. THE STEPPED-UP BASIS AT DEATH

### A. *In General*

Internal Revenue Code (I.R.C.) § 1014 generally provides that the basis of property acquired from a decedent is "the fair market value of the property at the date of the decedent's death."<sup>18</sup> If, however, the estate elects to use the alternate valuation date, then the valuation date is that which applies under I.R.C.

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16. See *Icing on the Inheritance Cake: No Federal Tax on Most Inherited Assets*, CRI CARR RIGGS & INGRAM (Aug. 2011), <http://www.cricpa.com/inheritanceandincometaxes.aspx>.

17. I.R.C. § 408(d)(7).

18. *Id.* § 1014(a)(1).

§ 2032.<sup>19</sup> Additionally, rather than fair market value, a different (generally lower) value must be used if the estate primarily consists of a farm or small business and if the estate elects to use “special use valuation” under § 2032A.<sup>20</sup> Furthermore, a lower value also must be used if the property is subject to a “qualified conservation easement.”<sup>21</sup>

“Property acquired from a decedent” generally includes “[p]roperty acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent.”<sup>22</sup> In addition, “property acquired from a decedent” includes certain lifetime transfers by the decedent to a trust if the decedent reserved the right to revoke the trust<sup>23</sup> or reserved the right to control the beneficial enjoyment of trust property.<sup>24</sup> Furthermore, the term includes property over which the decedent had a general power of appointment at death if the decedent exercised that power in his or her will without receiving “full and adequate consideration” for the property.<sup>25</sup> Interestingly, a surviving spouse’s share of community property also is treated as “property acquired from a decedent” if at least one half of the total value of the community property was included in the decedent’s gross estate for estate tax purposes.<sup>26</sup> This provision gives a decided tax advantage to community property states over non-community property states because it means that community property gets a full basis step-up, while non-community property that spouses own jointly only gets a half basis step-up.<sup>27</sup> Finally, apart from a handful of special rules applicable to decedents who died during very limited historical time periods, property generally will be eligible for the basis step-up if it is included in the decedent’s gross estate for estate tax purposes.<sup>28</sup> It is worth noting that the focus is on the decedent’s gross estate,

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19. *Id.* § 1014(a)(2). This alternate valuation date is normally six months after the decedent’s date of death or a date within the six-month period following the decedent’s date of death on which the property is “distributed, sold, exchanged, or otherwise disposed of” during that six-month period. *Id.* § 2032(a)(1)–(2). The election may only be made if it would reduce the total value of the gross estate and the amount of federal estate tax owed. *Id.* § 2032(c).

20. *Id.* § 1014(a)(3).

21. *Id.* §§ 1014(a)(4), 2031(c)(2). Qualified conservation easements are permitted under § 2031(c)(1).

22. *Id.* § 1014(b)(1).

23. *Id.* § 1014(b)(2).

24. *Id.* § 1014(b)(3).

25. *Id.* § 1014(b)(4).

26. *Id.* § 1014(b)(6).

27. Currently, nine states have community property schemes of property ownership: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Ronald A. Giller, Lisa K. Gamer & Adam L. Sheps, *Yours, Mine, Ours, and Theirs: The Role of Spousal Guaranties and Consents in the Franchise Relationship*, 33 *FRANCHISE L.J.* 71, 78 n.19 (2013). Alaska allows couples to elect property to be classified as community property. See Thomas M. Featherston, Jr., *His, Her or Their Property: A Primer on Marital Property Law in the Community Property States*, A.B.A. 1 (July 14, 2014), <http://www.baylor.edu/law/faculty/doc.php/205011.pdf>.

28. I.R.C. § 1014(b)(9)–(10).

rather than taxable estate, which means that property that qualifies for the marital deduction generally will be eligible for the basis step-up.<sup>29</sup>

There are two notable exceptions to the basis step-up. First, very significantly for purposes of this Article, no basis step-up is permitted for “property which constitutes a right to receive an item of income in respect of a decedent under section 691.”<sup>30</sup> The meaning of “income in respect of a decedent” will be explored in detail below. Second, appreciated property acquired by a decedent by gift within one year of death does not qualify for the basis step-up.<sup>31</sup> This is an anti-avoidance provision that prevents people from transferring appreciated property to a near-death friend or family member with the expectation that the property will be returned to the transferor with a much higher income tax basis from the transferee’s estate.<sup>32</sup>

### B. History

Internal Revenue Code § 1014, which allows for the basis step-up, has received significant criticism over the years because it allows unrealized appreciation to escape income tax permanently and tends to benefit high-income taxpayers.<sup>33</sup> As a result of this criticism, Congress attempted to repeal the

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29. *Marital Deduction Trust*, WEALTH COUNS., LLC, [http://www.thewealthcounselor.com/uploads/1\\_Marital\\_Deduction\\_Trust.pdf](http://www.thewealthcounselor.com/uploads/1_Marital_Deduction_Trust.pdf) (last visited Apr. 1, 2015).

30. I.R.C. § 1014(c). According to Professor Joseph M. Dodge, the original rationale behind excluding income in respect of a decedent from the basis step-up “was that these amounts were income ‘of’ the decedent that avoided tax simply because the decedent was on the cash method of accounting but died before actual receipt.” Joseph M. Dodge, *What’s Wrong with Carryover Basis Under H.R. 8*, 91 TAX NOTES 961, 965 (2001). Professor Dodge ultimately raises the question analyzed in this Article, although he does so in the context of the limited basis adjustment of H.R. 8:

[T]he basis adjustment makes no sense in the first place. But if there must be such a basis adjustment, why not extend it to IRD rights? Not to do so only achieves discrimination against those whose wealth inheres in qualified pension rights and survivor annuities, as opposed to life insurance and the general run of “investments.” The beneficiaries of middle-class salaried employees—whose principal form of appreciated wealth (apart from the personal residence) is likely to be pension rights and annuities—would stand to be the big losers under the IRD-right exception.

*Id.* A similar point was made by Professor Richard L. Kaplan in his excellent article containing various proposals to reform the taxation of retirement income. See Richard L. Kaplan, *Reforming the Taxation of Retirement Income*, 32 VA. TAX REV. 327, 348–52 (2012). This Article attempts to explore these issues in greater detail.

31. I.R.C. § 1014(e).

32. See Lawrence Zelenak, *Taking Gains at Death*, 46 VAND. L. REV. 361, 409, 411 (1993).

33. See, e.g., 122 CONG. REC. 30,854 (1976) (statement of Rep. Corman); *Taxation of Interest on Debt Obligations Issued by State and Local Governments and on Withholding Federal Income Tax on Interest and Dividend Income: Hearing Before the S. Comm. on Finance*, 94th Cong. 172 (1976) (statement of Professor Stanley S. Surrey, Former Assistant Secretary of the Treasury for Tax Policy); see also 122 CONG. REC. 30, 546 (1976) (statement of Rep. Mills).

stepped-up basis at death in 1976.<sup>34</sup> At the time, most advocates for repeal argued that unrealized appreciation should be taxed at a taxpayer's death.<sup>35</sup> Those against repeal, on the other hand, argued that repeal combined with deemed realization at death would burden estates and inhibit capital formation because estates would need to have cash to pay taxes owed as a result of the deemed realization.<sup>36</sup>

Congress decided on a compromise between those advocating for deemed realization at death and those advocating for retention of the stepped-up basis at death: a carryover basis.<sup>37</sup> The conference committee wrote this provision,<sup>38</sup> and Congress narrowly approved it.<sup>39</sup> The provision went into effect in 1977,<sup>40</sup> but anti-carryover basis groups quickly mobilized, and a bill was introduced to repeal the new provision.<sup>41</sup> By 1978, the mood in Congress had started to change, and Congress voted to defer the carryover basis provision until 1980.<sup>42</sup> Congressional opposition to the carryover basis continued to increase, and both the Senate and the House voted for repeal in late 1979 by overwhelming majorities.<sup>43</sup>

Without the carryover basis, the stepped-up basis at death remained. What, one might wonder, came of the argument that the basis step-up is inequitable because it primarily benefits high-income taxpayers? Advocates for repeal of the carryover basis and re-implementation of the basis step-up argued that the

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34. See Comment, *The Tax Reform Act of 1976, Section 1023: Tax Reform Gone Awry?*, 37 MD. L. REV. 380, 381 (1977) [hereinafter *Tax Reform Gone Awry*].

35. See H. COMM. ON WAYS & MEANS & S. COMM. ON FINANCE, 91ST CONG., TAX REFORM STUDIES AND PROPOSALS: U.S. TREASURY DEP'T 334–35 (Comm. Print 1969).

36. See, e.g., *Fed. Estate & Gift Taxes: Pub. Hearings & Panel Discussions Before the H. Comm. on Ways & Means*, 94th Cong. 1180 (1976) (statement of Charles M. Walker, Assistant Secretary for Tax Policy, Department of the Treasury).

37. *Tax Reform Gone Awry*, *supra* note 34, at 387–88 (noting that this compromise had been proposed several times before 1976); see also Bruce Bartlett, *Carryover Basis: A Cure Worse than the Disease?*, 129 TAX NOTES 361, 362 (2010) (highlighting the backlash from the reform's proposal as the major factor delaying its implementation).

38. See H.R. REP. NO. 94-1515, at 611–13 (1976) (Conf. Rep.), reprinted in 1976 U.S.C.C.A.N. 4118, 4250–52.

39. The House of Representatives did not vote directly on the carryover basis provision, but it voted 229 to 181 in favor of a test vote on the carryover basis provision. See 122 CONG. REC. 30,858–59 (1976). The Senate did not vote directly on the carryover basis provision. See 122 CONG. REC. 30,730–31 (1976).

40. Bartlett, *supra* note 37, at 362 (noting that the law was passed in 1976, but that implementation was delayed due to the estate tax bar, which “complained that the law was unadministrable”).

41. See *id.* See also 123 CONG. REC. 25,397 (1977).

42. Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2763, 2884 (1978) (codified as amended at I.R.C. §§ 1011, 1014–16, 1023, (2012)).

43. The Senate voted eighty-one to four in favor of repeal. 125 CONG. REC. 33,102–03 (1979). The House voted 326 to 77 in favor of repeal. 125 CONG. REC. 36,775 (daily ed. Dec. 18, 1979).

basis step-up was not really inequitable; under a stepped-up basis regime, they argued, unrealized appreciation generally is taxed because of the estate tax, which at the time had rates as high as seventy percent.<sup>44</sup>

As explained by Professor Lawrence Zelenak, there are two major problems with this argument: first, the basis step-up applies even to property not subject to the estate tax because of the unified credit<sup>45</sup> or the marital deduction;<sup>46</sup> second, the estate and income tax systems are separate tax systems, and property may be taxed under both systems.<sup>47</sup> The first of these two arguments is even more powerful today than when Professor Zelenak made his argument, given that apart from the unlimited marital deduction, the current amount shielded by the credit is \$5.34 million.<sup>48</sup> At the time, the amount shielded was only \$600,000.<sup>49</sup> Now amounts exceeding the amount shielded are now also subject to a much lower maximum estate tax rate of only forty percent.<sup>50</sup>

Another argument for a stepped-up basis is that the basis step-up eliminates the need to ascertain a decedent's adjusted basis in property that he or she owned for many years.<sup>51</sup> This same argument would apply to a deemed-realization-at-death approach because determining the amount of gain to recognize at death would require ascertaining the decedent's basis in the property. That approach, as mentioned, would also require the estate to come up with the cash to pay income taxes owed as a result of a deemed realization.

As the author has argued in the past, a superior approach that would eliminate all of these problems would be to step the income tax basis down to zero at the decedent's death.<sup>52</sup> Absent that, the next best solution is the one advocated by Professor Zelenak: a deemed realization approach.<sup>53</sup> Either of those approaches, were Congress to adopt one, would obviate the need for the changes proposed

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44. 125 CONG. REC. 33,101 (1979); 2 Boris I. Bittker & Lawrence Lokken, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 41.4.1 (2nd ed. 1990) (summarizing and criticizing the argument for repealing the carryover basis and reimplementing the basis step-up).

45. I.R.C. § 2010 (2012).

46. *Id.* § 2056.

47. Zelenak, *supra* note 32, at 364.

48. Rev. Proc. 2013-35, 2013-47 I.R.B. 537, 543. See I.R.C. § 2010(c). The amount shielded by the credit is referred to as the "exemption equivalent amount." STEPHEN L. SMITH, *TAKING THE MYSTERY OUT OF ESTATE PLANNING* 261 (2013).

49. Zelenak, *supra* note 32, at 364 n.12.

50. I.R.C. § 2001(c). When Professor Zelenak wrote *Taxing Gains at Death*, the maximum rate was fifty-five percent. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13208(a), 107 Stat. 312, 469 (1993) (codified at I.R.C. § 2001).

51. See SAMUEL A. DONALDSON, *FEDERAL INCOME TAXATION OF INDIVIDUALS: CASES, PROBLEMS AND MATERIALS*, 123 (2d ed. 2007) [hereinafter DONALDSON, *TAXATION OF INDIVIDUALS*] (defining the adjusted basis and its role in estate tax calculations).

52. See Sergio Pareja, *Taxation Without Liquidation: Rethinking "Ability to Pay"*, 2008 WIS. L. REV. 841, 890 (2008).

53. Zelenak, *supra* note 32, at 421.

in this Article. Assuming that Congress does not adopt either approach, however, equity demands that retirement plan assets be treated no differently than non-retirement plan assets with respect to the stepped-up basis at death. Furthermore, this change is necessary to remove a disincentive that currently exists for saving through a traditional retirement plan.

## II. INCOME IN RESPECT OF A DECEDENT

### A. In General

Internal Revenue Code § 1014(c) provides that the provision allowing for a stepped-up basis at death “shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.”<sup>54</sup> Section 691 does not define “income in respect of a decedent,” but the Treasury Regulations provide as follows:

In general, the term *income in respect of a decedent* refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes:

- (1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;
- (2) Income accrued solely by reason of the decedent’s death in case of a decedent who reports his income by use of an accrual method of accounting; and
- (3) Income to which the decedent had a contingent claim at the time of his death.<sup>55</sup>

Assets in a qualified retirement plan or IRA meet this definition.<sup>56</sup> In fact, it is well established that such assets constitute IRD.<sup>57</sup>

### B. History

Originally, amounts that a cash method taxpayer earned during life that were not received until after death escaped income taxation entirely.<sup>58</sup> This occurred because cash-method taxpayers are not taxed until they receive, or

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54. I.R.C. § 1014(c).

55. Treas. Reg. § 1.691(a)-1(b) (as amended in 1965).

56. Steven R. Lifson, *Practical Planning Ideas for Distributions from IRAs and Qualified Plans*, 37 J. MARSHALL L. REV. 807, 814–15 (2004).

57. See *Nichols v. United States*, 64 Ct. Cl. 241, 245 (1927); *Heller v. Comm’r*, 10 B.T.A. 53, 56 (1928).

58. See *Nichols*, 64 Ct. Cl. at 245.

constructively receive, cash.<sup>59</sup> With a receipt of wages after death, no receipt or constructive receipt occurs during life. In addition, the property was not taxed when received by the estates or heirs because it was treated as corpus.<sup>60</sup>

In 1934, Congress sought to close this loophole and amended I.R.C. § 42 to require that the decedent report income “accrued” to the date of death on his or her final income tax return.<sup>61</sup> In addition, deductions accrued to the date of death were also to be reported on the decedent’s final income tax return.<sup>62</sup> This provision was meant to have the effect of putting cash method taxpayers on the accrual method for the limited purpose of taxing income earned before death but not received until after death. However, Congress did not define “accrued,” leaving that task to the courts.<sup>63</sup>

The 1941 case of *Helvering v. Estate of Enright*<sup>64</sup> was the catalyst for the creation of the concept of “income in respect of a decedent.” The question at issue in the case was whether a deceased attorney’s final income tax return had to include his share of law partnership profits that had been earned, but not yet distributed, by the date of his death.<sup>65</sup> The Court held that the decedent’s final return had to include the undistributed income if it could be approximately valued.<sup>66</sup> The main problem with this holding is that it results in taxes being owed on income that has not yet been received and that might never actually be collected.

*Enright* motivated Congress, in 1942, to repeal the provisions causing accrual to occur at death and to enact the IRD rule.<sup>67</sup> The new IRD rule was, in effect, an extension of the judicial “assignment of income” doctrine, which already had been well established by 1942 through a series of Supreme Court decisions.<sup>68</sup>

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59. *Id.* at 245–46.

60. *Id.* at 245.

61. Revenue Act of 1934, ch. 277, 48 Stat. 680, 694.

62. *Id.*

63. See Stephen M. Farrand & Knox Farrand, *Treatment of Accrued Items in the Event of the Death of a Taxpayer*, 13 S. CAL. L. REV. 431, 437 (1940).

64. 312 U.S. 636 (1941).

65. *Id.* at 637.

66. *Id.* at 642–43, 645.

67. John G. Steinkamp, *Identification of Income in Respect of a Decedent: The Case for Using Assignment of Income Precedents*, 46 DEPAUL L. REV. 367, 369 n.7 (1997). See also Revenue Act of 1942, ch. 619, 56 Stat. 798, 830–34. The rule was initially found in I.R.C. § 126 (2012), which was subsequently changed to I.R.C. § 691. Steinkamp, *supra*. For convenience, this Article will refer only to I.R.C. § 691.

68. See, e.g., *Harrison v. Schaffner*, 312 U.S. 579, 583 (1941) (“Income which the donor gives away through the medium of a short term trust created for the benefit of the donee is nevertheless income taxable to the donor.”); *Helvering v. Horst*, 311 U.S. 112, 120 (1940) (refusing to allow income to escape taxation through methods that allow vesting in someone subsequent to the donor); *Helvering v. Clifford*, 309 U.S. 331, 335 (1940) (holding that income was still subject to taxation despite the wife being named as the beneficiary because the donor still had “retention of control over the corpus”); *Blair v. Comm’r*, 300 U.S. 5, 14 (1937) (holding the assignees of the interest in

The effect of the new IRD rule was that it extended the assignment of income doctrine, which only had been held to apply to lifetime transfers to include assignments of income that occurred at death.<sup>69</sup> Specifically, items of gross income that were not includable in a decedent's final income tax return would henceforth be taxed to the recipient when actually received by that person.<sup>70</sup> Although the income would be taxable to someone other than the person who had earned it, the income's character would continue to be determined by reference to the character it would have had if the decedent had survived and actually received the income.<sup>71</sup> This, in effect, put all recipients of items of IRD on the cash method of accounting with respect to the IRD.

The sequence of events, viewed as a whole, is quite interesting. In 1934, Congress sought to close the loophole that allowed earned-but-not-received-before-death income to escape taxation by including "accrued" income on the decedent's final income tax return.<sup>72</sup> That created a problem resulting from graduated income tax rates: the "bunching" of income in one year.<sup>73</sup> It also created liquidity issues because the estate could be taxed before actually receiving the money necessary to pay taxes. To remedy this problem, Congress enacted the IRD rule in 1942.<sup>74</sup> This new rule was aimed at taxing "[a]ll amounts of gross income which are not includible in the income of the decedent."<sup>75</sup> Perhaps unintentionally, this new rule broadened the categories of income that would be taxed. No longer was it the accounting concept of "accrual"; now it was "gross income in respect of a decedent," a potentially broader concept with, at least initially, an uncertain meaning.<sup>76</sup> For example, it would likely include income that was very speculative at the time of decedent's death and that likely would not have been accrued income at the time of the decedent's death because of the unlikelihood of receipt.

Since 1942, courts have struggled to define "gross income in respect of a decedent."<sup>77</sup> Judicial attempts to define the phrase have created multiple tests, including (1) the "it-would-have-been-income-to-the-decedent-had-he-lived"

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income responsible for the tax on the interest); *Lucas v. Earl*, 281 U.S. 111, 114–15 (1930) (finding that income tax could not be avoided by "anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it").

69. Steinkamp, *supra* note 67, at 404–06.

70. I.R.C. § 691(a)(1) (2012).

71. 56 Stat. 798, 830.

72. See *supra* note 61 and accompanying text.

73. See Steinkamp, *supra* note 67, at 378.

74. See *supra* note 67 and accompanying text.

75. H.R. REP. NO. 77-2333, at 84 (1942), *reprinted in* 1942-2 C.B. 372, 436; S. REP. NO. 77-1631, at 101 (1942), *reprinted in* 1942-2 C.B. 504, 580.

76. See Steinkamp, *supra* note 67, at 378.

77. *Id.* at 372–73, 384 (noting that courts have developed multiple tests for what constitutes gross IRD). For further analysis of this judicial history, see *id.* at 384–452.

test,<sup>78</sup> (2) the “economic-activities” test,<sup>79</sup> (3) the “right-to-income” test,<sup>80</sup> (4) the “substantial-certainty-of-receipt” test,<sup>81</sup> and (5) the “four-factor test.”<sup>82</sup> Although these judicial struggles to define IRD demonstrate how nuanced the issue can be, certain items of income are now, beyond question, well established as IRD. These items include amounts payable to survivors from qualified retirement plans, section 403(b) plans, and IRAs.<sup>83</sup>

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78. See *Latendresse v. Comm’r*, 26 T.C. 318, 324–26 (1956), *aff’d*, 243 F.2d 577 (7th Cir. 1957). Essentially, this approach includes the earned income that was not taxed to the decedent merely because of her accounting method within IRD. *Id.* at 325–26. The income would have been taxed at some point had the decedent not died at that point in time. *Id.* The problem with this approach is that it is overinclusive. It does not adequately distinguish between income that was earned by the decedent and income that was earned by the decedent’s estate after the decedent’s death. See *Estate of Davison v. United States*, 292 F.2d 937, 940 (Ct. Cl. 1961).

79. See *O’Daniel’s Estate v. Comm’r*, 173 F.2d 966, 968 (2d Cir. 1949). Under this test, some activity by the decedent that results in the post-death payment is necessary for the payment to be treated as IRD. *Id.* In *O’Daniel*, the decedent had been employed by a company that had an employee bonus plan, under which the employee had no legal right to the bonus until it was designated. *Id.* at 967. In the case, the designation occurred after the decedent’s death. *Id.* The court held the bonus was IRD, even though the decedent had no legal right to it at the time of death because it was the decedent’s economic activities that resulted in the post-death payment. *Id.* (calling the benefits “expectancies which later bore fruit”). Later, the Fifth Circuit Court of Appeals found the economic activities test to be “open-ended and somewhat inadequate.” *Trust Co. of Ga. v. Ross*, 392 F.2d 694, 695 (5th Cir. 1967) (per curiam).

80. See *Trust Co. of Ga.*, 392 F.2d at 695. Under this test, the decedent must have had a right to receive income at the time of death in order for it to constitute IRD. *Id.* This test, which has proven difficult to employ, depends on multiple factual circumstances that must be evaluated by the court, such as the nature of the defendant’s actions. See, e.g., *Estate of Sidles v. Comm’r*, 65 T.C. 873, 880–81 (1976), *acq. in result*, 1976-2 C.B. 2, *aff’d*, 553 F.2d 102 (8th Cir. 1977). One of the most difficult aspects of the test is establishing that the decedent had “enforcement rights” to the income at the time of death. See, e.g., *Claiborne v. United States*, 648 F.2d 448, 451 (6th Cir. 1981).

81. *Halliday v. United States*, 655 F.2d 68, 72 (5th Cir. 1981). Under this test, a payment is IRD “where the evidence shows a substantial certainty that benefits directly related to the decedent’s past economic activities will be paid to his heirs or estate upon his death, notwithstanding the absence of a legally enforceable obligation.” *Id.*

82. *Estate of Peterson v. Comm’r*, 667 F.2d 675, 677–78 (8th Cir. 1981). The U.S. Tax Court created this test by reviewing prior case law and extracting four basic factors to determine if sales proceeds were IRD:

[W]hether the decedent entered into a legally significant arrangement regarding the subject matter of the sale, (2) whether the decedent performed the substantive (nonministerial) acts required as preconditions to the sale, (3) whether there existed at the time of the decedent’s death any economically material contingencies which might have disrupted the sale, and (4) whether the decedent would have eventually received the sale proceeds if he or she had lived.

*Id.* (footnotes omitted)

83. See also *Treas. Reg. § 1.663(c)-5, Example 9* (as amended in 2000); *I.R.S. Priv. Ltr. Rul. 93-41-008* (July 14, 1993); *Rev. Rul. 92-47, 1992-1 C.B. 198*.

### C. Effect on Popular Perceptions of the Estate Tax

Although the author is unaware of any empirical studies analyzing the effect of the tax treatment of IRD on popular perceptions of the estate tax, it bears mentioning that anecdotal evidence demonstrates that there is some confusion regarding the difference between an income tax on IRD and the federal estate tax. In the author's personal experience, including nearly a decade of private practice and informal conversations with friends and family, many beneficiaries who inherit an IRA or retirement plan express dismay at the fact that they must pay income taxes on distributions. Often, this dismay is coupled with complaints about the evils of the "death tax." A comprehensive study regarding the perceptions of people who inherit retirement plan and IRA assets is beyond the scope of this Article. Nevertheless, it seems likely that such a study would reveal that the number of people who conflate the income taxation of IRD with the federal estate tax is probably not insignificant. This would at least offer an explanation for why so many Americans seem to believe that the federal estate tax directly affects a large number of people.<sup>84</sup>

## III. EMPLOYER-SPONSORED RETIREMENT PLANS AND INDIVIDUAL RETIREMENT ACCOUNTS

### A. In General

#### 1. Terminology

This Article will adopt, in slightly modified form, some of the useful terminology used by Natalie B. Choate in her highly regarded book, *Life and Death Planning for Retirement Benefits: The Essential Handbook for Estate Planners*.<sup>85</sup> Accordingly, terms should be interpreted throughout this Article as follows:

[A] "retirement plan" means a corporate or self-employed ("Keogh") pension, profit-sharing, or stock bonus plan that is "qualified" under § 401(a), a tax-sheltered annuity (or mutual fund) arrangement

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84. Angeline Lavin, David Moen & Thomas Davies, *Public Perceptions Regarding the Federal Estate Tax*, 12 REV. BUS. RES. ¶ 2.2 (2012). According to these scholars:

In 2002 a nationwide tax survey was jointly sponsored by National Public Radio, the Henry J. Kaiser Family Foundation, and Harvard University's Kennedy School of Government. The survey was conducted over the telephone and reached a sample of 1,339 respondents 18 years of age or older. The response rate was 49.5[%]. The survey found that 82% of respondents who expressed an opinion favored elimination of the estate tax. When Slemrod studied the data, he found that 49% of the survey respondents thought that "most families" have to pay the estate tax, when, in fact, very few are subject to the estate tax.

*Id.*

85. See generally NATALIE B. CHOATE, *LIFE AND DEATH PLANNING FOR RETIREMENT BENEFITS: THE ESSENTIAL HANDBOOK FOR ESTATE PLANNERS* (7th ed. 2010).

established under § 403(b), [a deferred compensation plan of a state or local government or tax-exempt organization], or an individual retirement account (IRA) created under § 408 or § 408A.<sup>86</sup>

A 401(k) plan is an elective deferral plan (also called a cash-or-deferred arrangement or CODA), meaning that the plan is at least partly funded by voluntary salary reduction (or bonus reduction) contributions. Under a CODA, the participant agrees, in advance, to have part of his compensation contributed to a retirement plan account for his benefit instead of being paid to him in cash. . . . A 401(k) plan . . . may be a Keogh plan.<sup>87</sup>

403(b) plans (also called “403(b) arrangements” or “TSAs,” which stands for tax-sheltered annuities) are available only to tax-exempt employers. Some 403(b) arrangements are funded exclusively by means of elective deferrals . . . . Others are funded partly or solely by employer contributions . . . .<sup>88</sup>

In short, the term “retirement plan” is broad and includes all types of employer-sponsored retirement plans, such as 401(k) plans, as well as plans that are not employer-sponsored retirement plans, such as IRAs. For convenience, this Article will focus on traditional employer-sponsored retirement plans on the one hand, and deductible IRAs (one key example of a retirement plan that is not a traditional employer-sponsored retirement plan) on the other hand. Collectively, this Article will refer to them as “traditional retirement plans.” This term expressly highlights the contrast between plans that provide a tax benefit up front (*i.e.*, traditional retirement plans) and plans that provide a tax benefit at the back end (*i.e.*, Roth-type retirement plans).<sup>89</sup> Roth-type 401(k) plans and Roth IRAs are discussed later as a possible solution to the problem.<sup>90</sup> These are collectively referred to as “Roth-type retirement plans.”

This Article will also occasionally refer to “defined contribution plans,” which are retirement plans in which savings are set aside without a promise of a fixed benefit amount in the future, and “defined benefit plans,” which are retirement plans that promise a fixed benefit in the future, such as a fixed percentage of a

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86. *Id.* at 534 (emphasis removed).

87. *Id.* at 535 (emphasis removed).

88. *Id.* (emphasis removed) (citation omitted).

89. *Ultimate Guide to Retirement*, CNN MONEY, [http://money.cnn.com/retirement/guide/IRA\\_Basics.moneymag/index2.htm](http://money.cnn.com/retirement/guide/IRA_Basics.moneymag/index2.htm) (last visited Apr. 2, 2015) [hereinafter *Ultimate Guide to Retirement*].

90. See *infra* Part V.A–B.

worker's average salary each year after retirement.<sup>91</sup> This Article focuses on defined contribution plans because it deals with removing a disparity that exists between assets owned inside a traditional retirement plan and assets owned outside a traditional retirement plan.<sup>92</sup>

## 2. Retirement Plan Overview

According to the U.S. Department of Labor, there are 638,390 defined contribution plans in the United States.<sup>93</sup> As of the second quarter of 2013, these plans had a total of 88,705 participants and \$4.5 trillion in assets.<sup>94</sup> Employer-sponsored retirement plans currently are available to nearly 80% of full-time workers, and over 80% of those workers participate in their company's plan.<sup>95</sup>

Why has Congress decided to give a tax break to people who utilize retirement plans? The tax break causes the federal government to lose revenue, regardless of whether the break comes from a present exclusion of certain income from gross income that is normally subject to taxes,<sup>96</sup> a deduction from income,<sup>97</sup> or a future exclusion of income.<sup>98</sup> The answer is simple: Congress offers these tax breaks to encourage individuals to use these plans to save for their own retirement.<sup>99</sup> To understand how this encouragement works, it is necessary to understand the tax breaks that Congress offers with each type of plan.

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91. *Retirement Plans, Benefits & Savings: Types of Retirement Plans*, U.S. DEP'T OF LABOR, <http://www.dol.gov/dol/topic/retirement/typesofplans.htm> (last visited Apr. 2, 2015). A defined benefit plan is effectively a lifetime annuity. *2012 ERISA Advisory Council Report: Examining Income Replacement During Retirement Years in a Defined Contribution Plan System*, U.S. DEP'T OF LABOR, <http://www.dol.gov/ebsa/publications/2012ACreport3.html> (last visited Apr. 2, 2015).

92. This same disparity does not exist with respect to defined benefit plans because the non-retirement plan version is an annuity that has been purchased outside a retirement plan, which does not qualify for the stepped-up basis at death. See *Qualified & Non-Qualified Annuities are Taxed Differently*, ANNUITY NEWS, <http://annuitynews.net/2010/08/01/qualified-and-nonqualified-annuities-are-taxed-differently/> (last visited Apr. 2, 2015).

93. *401(k) Fast Facts*, AM. BENEFITS COUNCIL 1 (Apr. 2014), [http://www.americanbenefitscouncil.org/documents2013/401k\\_stats.pdf](http://www.americanbenefitscouncil.org/documents2013/401k_stats.pdf).

94. *Id.*

95. *Id.*

96. See CHUCK MARR, NATHANIEL FRENTZ & CHYE-CHING HUANG, CTR. ON BUDGET & POL'Y PRIORITIES, RETIREMENT TAX INCENTIVES ARE RIPE FOR REFORM 1-3 (2013), available at <http://www.cbpp.org/files/12-13-13tax.pdf>. This occurs with a traditional employer-sponsored retirement plan. *Id.*

97. *Id.* (noting that this occurs with a deductible IRA).

98. *Id.* at 2, 6 (noting that this occurs with a Roth-type retirement plan).

99. See Emma Cecilia Eriksson, Note, *The Pension Protection Act of 2006: Is it Too Late to Save Traditional Pension Plans?*, 41 SUFFOLK U. L. REV. 133, 137 (2007) (noting that the increasing mobile work environment prompted Congress to adopt a more flexible retirement planning system). See also Sharon Reece, *Enron: The Final Straw & How to Build Pensions of Brick*, 41 DUQ. L. REV. 69, 69-70 (2002) (discussing the history of defined contribution plans).

*B. Basic Rules Applicable to Traditional Employer-Sponsored Retirement Plans*

As mentioned, employer-sponsored retirement plans,<sup>100</sup> such as 401(k) plans, get special tax treatment but also must fulfill some special requirements. If the plan is what is known as a “qualified retirement plan,” it must meet special rules of I.R.C. § 401(a).<sup>101</sup> Basic requirements that apply under § 401(a) include nondiscrimination,<sup>102</sup> vesting,<sup>103</sup> coverage,<sup>104</sup> disclosure,<sup>105</sup> and participation.<sup>106</sup>

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100. The plans may be either defined contribution plans or defined benefit plans. CHOATE, *supra* note 85, at 534. Defined contribution plans include money purchase, stock bonus, and profit-sharing plans, all of which require a separate account to be maintained for each employee. See BARRY KOZAK, EMPLOYEE BENEFIT PLANS 79–109 (2010). Defined benefit plans include annuity and pension plans that provide a fixed benefit typically based on the employee’s salary and years of service. Eriksson, *supra* note 99, at 140 (describing the accumulation and distribution of a defined benefit plan).

101. I.R.C. § 401(a) (2012). This section is aimed at ensuring that the funds promised to the employee will actually be available to the employee at retirement. The benefit to a company of using a qualified retirement plan, as opposed to non-qualified deferred compensation, is that the employer deducts the payment when it is put into the plan even though the employee does not include it in income until the funds are withdrawn at retirement. *401(k) Resource Guide - Plan Sponsors - Plan Qualification Requirements*, IRS, [http://www.irs.gov/Retirement-Plans/Plan-Sponsor/401\(k\)-Resource-Guide-Plan-Sponsors-Plan-Qualification-Requirements](http://www.irs.gov/Retirement-Plans/Plan-Sponsor/401(k)-Resource-Guide-Plan-Sponsors-Plan-Qualification-Requirements) (last updated Oct. 23, 2014). With non-qualified deferred compensation, the employer is not allowed a deduction until the employee includes the payment in income. *Albertson’s Inc. v. Comm’r*, 42 F.3d 537, 542 (9th Cir. 1994). This is known as the “matching principal,” and it exists because Congress has an affirmative policy of encouraging companies to utilize qualified retirement plans. *Id.* at 543. Although non-qualified deferred compensation is not subject to § 401(a), these plans are subject to I.R.C. § 409A(a)–(b), which provides detailed rules regarding constructive receipt and funding requirements in connection with nonqualified deferred compensation plans. Income from non-qualified deferred compensation arrangements is also IRD, and thus not eligible for the stepped-up basis at death. See SUSAN FLAX POSNER, ESTATE & GIFT TAX HANDBOOK ¶ 416 (2007). This proposal intentionally makes no change to this rule with respect to non-qualified deferred compensation because to do so would be inconsistent with the congressional policy of encouraging companies to use qualified retirement plans. In fact, this proposal enhances the congressional objective.

102. I.R.C. § 401(a)(4). Benefits cannot be weighted in favor of highly compensated employees. See *id.*; Treas. Reg. § 1.401-1(a)(3)(vi) (2014).

103. Benefits cannot be forfeited after some period of time. See *Frequently Asked Questions About Retirement Plans and ERISA*, U.S. DEP’T OF LABOR, [http://www.dol.gov/ebsa/faqs/faq\\_compliance\\_pension.html](http://www.dol.gov/ebsa/faqs/faq_compliance_pension.html) (last visited Apr. 3, 2015) [hereinafter *Retirement Plans and ERISA*].

104. I.R.C. § 410(b)(1). A specific portion of employees must be covered by the plan. *Id.*

105. Plan documents, including information about investments, must be made available to plan participants upon request. See *ABC Plan 401(k) Plan Fee Disclosure Form: For Services Provided by XYZ Company*, U.S. DEP’T OF LABOR 6–7, <http://www.dol.gov/ebsa/pdf/401kfe.pdf> (last visited Apr. 3, 2015).

106. If employees meet basic eligibility requirements, they must be permitted to participate in the retirement plan. I.R.C. § 410(a)(1)(A).

The total amount that may be put into a traditional employer-sponsored retirement plan each year is \$52,000.<sup>107</sup> In 2014, the taxpayer's employer can contribute to this amount or, if the plan is a cash or deferred arrangement (CODA) such as a 401(k) plan, the employee may contribute up to \$17,500 of the \$52,000 cap.<sup>108</sup> Assuming that the plan is not a Roth-type 401(k) plan,<sup>109</sup> amounts contributed to the plan are fully excluded from the employee's gross income.<sup>110</sup> Such amounts grow tax-free until they are distributed, at which time the contributions and all growth are taxable as ordinary income to the recipient.<sup>111</sup>

Under I.R.C. § 72(t), distributions from a traditional employer-sponsored retirement plan before the participant reaches age 59 ½ are subject to a 10% penalty tax on top of income taxes owed on account of the distribution, unless an exception applies.<sup>112</sup> Exceptions<sup>113</sup> include distributions (1) rolled over into a another traditional retirement plan,<sup>114</sup> (2) "made to a beneficiary (or the estate of the employee) on or after the death of the employee,"<sup>115</sup> (3) "attributable to the employee's" disability,<sup>116</sup> (4) that are "part of a series of substantially equal periodic payments . . . made for the life (or life expectancy) of the employee or the joint lives . . . of such employee and his designated beneficiary" after the employee separates from service,<sup>117</sup> (5) "made to an employee after separation from service after attainment of age [fifty-five],"<sup>118</sup> (6) that are dividends on employer securities held within an Employee Stock Ownership Plan (ESOP),<sup>119</sup>

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107. I.R.S. Notice 2013-73, 2013-49 I.R.B. 598. This is an inflation-adjusted amount for 2014, and amounts in excess of \$52,000 do not qualify for the tax benefits available to plan participants. *Id.* Nondiscrimination requirements can cause this amount to be lower, but as of 2014, it can be no higher than \$52,000. *Id.* See also I.R.C. § 401(a)(4); 26 C.F.R. 1.401-1(a)(3)(vi) (2014).

108. I.R.S. Notice 2013-73, 2013-49 I.R.B. 598. In 2014, individuals aged fifty or older may contribute an additional \$5,500 catch-up contribution to obtain the maximum amount after retirement. *Id.*

109. See *infra* Part V.B.

110. I.R.C. § 72(b)(1)–(2).

111. *Id.* § 72(b)(2).

112. *Id.* § 72(t)(2)(A).

113. Note that the exceptions for distributions from IRAs differ from the exceptions for distributions from employer-sponsored retirement plans. Compare *id.* § 72(t)(2) (listing to which distributions certain exceptions apply and how to apply them), with *id.* § 72(s)(2) (providing the exceptions for certain annuity contracts).

114. The 10% penalty only applies to amounts included in the employee's gross income. *Id.* § 72(t)(1). Rollover amounts are expressly excluded from gross income. *Id.* § 402(c)(1).

115. *Id.* § 72(t)(2)(A)(ii).

116. *Id.* § 72(t)(2)(A)(iii).

117. *Id.* § 72(t)(2)(A)(iv).

118. *Id.* § 72(t)(2)(A)(v).

119. *Id.* § 72(t)(2)(A)(vi). See *id.* § 404(k) (explaining ESOP and its relation to employer-sponsored retirement plans).

(7) made on account of an IRS levy against the account of the participant,<sup>120</sup> (8) made under a phased retirement program from federal retirement plans,<sup>121</sup> (9) to the extent the distribution does not exceed deductible medical expenses,<sup>122</sup> (10) to a nonparticipant under a Qualified Domestic Relations Order (QDRO),<sup>123</sup> (11) that are to unemployed individuals for health insurance premiums,<sup>124</sup> (12) that are for qualified higher education expenses,<sup>125</sup> (13) that are for certain first home purchases,<sup>126</sup> or (14) that are to individuals called for active duty.<sup>127</sup>

Taxpayers cannot enjoy eternal deferral of taxes on traditional employer-sponsored retirement plan assets. The Code compels distributions, called Minimum Required Distributions (MRDs), to begin at a certain point in time.<sup>128</sup> For most employees, these MRDs must begin no later than the first of April of either (1) the year following the participant's retirement or (2) the year after the participant turns age 70.5.<sup>129</sup>

Certain traditional employer-sponsored retirement plans must distribute benefits to married participants in the form of a qualified joint and survivor annuity unless the participant, with the spouse's consent, waives that form of benefit.<sup>130</sup> If the participant is not married, the plan can require a lump sum distribution to the participant or it can allow a payout of the plan assets over either the participant's life expectancy or a period that is shorter than the participant's life expectancy.<sup>131</sup> While the plan can require a payout of plan assets during a period of time that is shorter than what is required under the law,

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120. *Id.* § 72(t)(2)(A)(vii).

121. *Id.* § 72(t)(2)(A)(viii). *See id.* § 8412a (describing phased retirement plans).

122. *Id.* § 72(t)(2)(B).

123. *Id.* § 72(t)(2)(C).

124. *Id.* § 72(t)(2)(D).

125. *Id.* § 72(t)(2)(E).

126. *Id.* § 72(t)(2)(F).

127. *Id.* § 72(t)(2)(G).

128. *See, e.g., id.* § 401(a)(9); Treas. Reg. § 1.401(a)(9)-1, Q&A (1) (2014); Treas. Reg. § 1.403(b)-3(a)(6) (2014); Treas. Reg. 1.403(b)-6(e)(2)-(3) (2014); Treas. Reg. § 54.4974-1(b) (2014). Failure to take a minimum required distribution results in a 50% tax penalty on the amount that was supposed to be, but that was not, distributed. Treas. Reg. § 54.4974-2, Q&A (1).

129. I.R.C. § 401(a)(9)(C). *See also* Treas. Reg. § 1.401(a)(9)-2, Q&A (2).

130. I.R.C. §§ 401(a)(11), 417(a)(1). *See* Treas. Reg. § 1.401(a)-20, Q&A (1)-(2); Treas. Reg. § 1.417(e)-1(a)-(b) (2014). *See also* 29 U.S.C. § 1055(f) (2012) (noting the marriage requirements of certain plans under ERISA). To waive the benefit, the participant must have the spouse's consent. I.R.C. § 417(a)(2).

131. *See 401(k) Resource Guide – Plan Participants – General Distribution Rules*, IRS, <http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/401k-Resource-Guide-Plan-Participants-General-Distribution-Rules> (last updated Aug. 4, 2014).

it cannot allow a payout that is longer than the MRD period required under the law.<sup>132</sup>

Computing the MRD is relatively easy. For the plan participant, the prior year-end account balance is divided by the Applicable Distribution Period (ADP) or divisor.<sup>133</sup> The ADP, which is based on the participant's or beneficiary's age, is obtained from one of three IRS tables.<sup>134</sup> There are then two broad methods of calculating the MRD. The first method is what is commonly known as the recalculation method.<sup>135</sup> This is the method that applies for all lifetime MRDs and for post-death MRDs if the surviving spouse is the sole beneficiary.<sup>136</sup> Under this method, the MRD is calculated each year by using the prior year-end account balance and looking up the ADP in the tables.<sup>137</sup> In short, this method uses a recomputed life expectancy each year so that the money will never run out if only MRDs are taken. The second method is commonly known as the term-certain method.<sup>138</sup> Under this method, which applies to all post-death MRDs except if the surviving spouse is the sole beneficiary, the ADP is only obtained from the tables during the first distribution year; in each subsequent year, the ADP is then reduced by one.<sup>139</sup> Under this method, the money will run out if the beneficiary outlives his or her initially computed life expectancy.

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132. See *id.* This plan makes sense, given that the purpose of the MRD rules is to prevent unlimited tax deferral. *Retirement Topics – Required Minimum Distributions (RMDs)*, IRS, [http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Required-Minimum-Distributions-\(RMDs\)](http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Required-Minimum-Distributions-(RMDs)) (last updated Jan. 26, 2015) [hereinafter *Required Minimum Distributions*]

133. See also Treas. Reg. § 1.401(a)(9)-5, Q&A (1) (defining the procedure used for defined-contribution plans).

134. See *Required Minimum Distributions*, *supra* note 132. If it is a lifetime MRD, it is necessary to use either (1) the Uniform Lifetime Table or (2) the Joint and Last Survivor Table. Treas. Reg. § 1.401(a)(9)-9, Q&A (2)–(3). The Joint and Last Survivor Table is used if the participant's sole beneficiary is a spouse who is more than ten years younger than the participant; otherwise, the Uniform Lifetime Table is used. *Id.* See also *Required Minimum Distributions*, *supra* note 132. If it is a post-death MRD, then it is necessary to use the Single Life Table. Treas. Reg. § 1.401(a)(9)-9, Q&A (1). The life expectancy used in the Single Life Table might be the life expectancy of the surviving spouse, of a Designated Beneficiary (defined and discussed later in this Article), or of the deceased participant. See *Required Minimum Distributions*, *supra* note 132.

135. See, e.g., Jonathon A. Levy, *The IRS's New Proposed Rules for Required Minimum Distributions*, PROB. & PROP., Nov./Dec. 2001, at 16, 17; Michael F. Lynch & David J. Beausejour, *Distribution Options for IRAs Offer Tax-Saving Opportunities*, 58 TAX'N FOR ACCTS. 213, 215 (1997). See also Treas. Reg. § 1.401(a)(9)-5 (laying out the recalculation method).

136. Lynch & Beausejour, *supra* note 135, at 215.

137. See Treas. Reg. § 1.401(a)(9)-5. See also *Required Minimum Distributions*, *supra* note 132.

138. See Lynch & Beausejour, *supra* note 135, at 214.

139. *Id.* at 214–16.

One tricky aspect of the computation is that different results may occur if the participant died before, as opposed to after, his or her Required Beginning Date (generally age 70.5).<sup>140</sup> If the participant dies before the Required Beginning Date and if the participant has not named a “Designated Beneficiary,”<sup>141</sup> then all account assets must be distributed no later than December 31 of the year that contains the fifth anniversary of the participant’s date of death.<sup>142</sup> This has the effect of accelerating the taxes that are due on the distributions because payout is not occurring over a longer life expectancy, and the bulk of the distributions is likely to constitute IRD. Recall that the five-year rule is a maximum deferral allowed under law.<sup>143</sup> The plan can always require the payout to occur over a shorter period of time and the beneficiary can always select a shorter time period, including a lump-sum payment.<sup>144</sup>

How are distributions from a traditional employer-sponsored retirement plan taxed to the recipient? Under current law, the income tax effect of distributions is the same regardless of whether the distribution is to the participant or to a beneficiary.<sup>145</sup> This is because most distributions consist exclusively of property that is ordinary income to the participant and IRD after the participant’s death.<sup>146</sup> To the extent that the distributions would not produce ordinary income to the participant, such distributions would not produce IRD to a beneficiary after the participant’s death. The central point of this Article is a proposal to change the

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140. See Treas. Reg. § 1.401(a)(9)-3 (noting the different distribution schedule that must occur if the employee dies before the required beginning date). The “required beginning date” is the date by which an IRA owner or qualified plan participant must begin receiving required minimum distributions from the account. See Lynch & Beausejour, *supra* note 135, at 214. See also Treas. Reg. § 1.401(a)(9)-2, Q&A (2). The date generally occurs on April 1 following the calendar year the participant reaches age 70.5. Treas. Reg. § 1.401(a)(9)-2, Q&A (2); *Required Minimum Distributions*, *supra* note 132.

141. I.R.C. § 72(s)(4) (2012). A “Designated Beneficiary” is a person or, in certain limited situations, a trust for designated individuals. *Id.* Importantly, estates and charities are not Designated Beneficiaries. See Treas. Reg. § 1.401(a)(9)-4, Q&A (3).

142. I.R.C. § 401(a)(9)(B)(ii). See Treas. Reg. § 1.401(a)(9)-3, Q&A (1)–(2).

143. Treas. Reg. § 1.401(a)(9)-3, Q&A (1)–(2). Dep’t of the Treasury, *Publication 590: Individual Retirement Arrangements (IRAs)*, IRS 38–39 (Jan. 5, 2014), <http://www.irs.gov/pub/irs-prior/p590--2013.pdf> [hereinafter *Publication 590*].

144. See I.R.C. § 402(e)(4)(d) (defining lump sum distribution in terms of early payout in trust); Treas. Reg. 1.401(k)-1(c)–(d) (describing when early payout or lump sum payouts are appropriate).

145. A significant exception to this general statement occurs if the decedent’s estate has to actually pay federal estate taxes. Treas. Reg. § 1.691(c)-1, -2 (2014). This is because federal estate taxes paid on IRD are deductible against income taxes owed on that IRD. I.R.C. § 691(c). State death taxes are not. See Treas. Reg. § 1.691(c)-1(a)(2). As a result, if the estate has to pay a 40% federal estate tax and the beneficiary is in the 39.6% income tax bracket, the total tax owed will not be at a combined rate of 79.6%. Instead, it will only be 63.76% (40% plus 39.6% of 60%).

146. See I.R.C. § 401(a) (providing qualifications for distributions before and after the death of an individual); Treas. Reg. § 1.691(a)-1.

treatment between how a distribution is taxed during the participant's life and how it would be taxed after the participant's death.

As a general matter, all distributions from a traditional employer-sponsored retirement plan to the participant are taxable as ordinary income to the participant except to the extent that the distribution represents recovery of the participant's "investment in the contract."<sup>147</sup> "Investment in the contract" simply means after-tax money in the plan, or money that the participant has already paid taxes on.<sup>148</sup> This is commonly referred to as the participant's "basis" in the plan.<sup>149</sup> A participant's basis, or after-tax money, in the plan will not be subject to tax when it is distributed because that amount has already been taxed. Everything else, however, is taxed to the recipient as ordinary income.

Although most employees do not have any basis in a traditional employer-sponsored retirement plan, it certainly is possible. How might this occur? There are three possible ways. First, if the participant borrows from the plan but fails to satisfy the requirement of § 72(p),<sup>150</sup> then the loan is treated as a deemed distribution from the plan.<sup>151</sup> If the employee ultimately repays the loan, then that is treated as an after-tax contribution (*i.e.*, basis) to the plan.<sup>152</sup>

Second, if the plan was not a "qualified plan" at some point in the past, then contributions at that time would have been taxable income to the employee.<sup>153</sup> Those after-tax contributions would add to the employee's basis in the plan.<sup>154</sup> Finally, if the plan allowed employees to make after-tax contributions at any time in the plan's history, then such contributions would add to the employee's basis in the plan.<sup>155</sup>

When a distribution is made from a traditional employer-sponsored retirement plan with a "basis," the distribution is deemed to carry out proportionate amounts of after-tax and pre-tax money.<sup>156</sup> In essence, this means that every distribution from a traditional employer-sponsored retirement plan with after-

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147. I.R.C. § 72(b)(2).

148. *Id.* § 72(c)(1).

149. *Basis*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/basis.asp> (last visited Apr. 3, 2015).

150. I.R.C. § 72(p)(2)(A)–(D) lists certain limited situations in which a loan from a plan will not be treated as a distribution. For example, there is a maximum amount that may be borrowed from the plan (\$50,000 barring special circumstances), and there are specific repayment terms (substantially level payments, not less than quarterly, and generally repayable within five years). *Id.* § 72(p).

151. *Id.* § 72(p)(1)(A).

152. Treas. Reg. § 1.72(p)-1, Q&A (4), (11), (21) (2014).

153. I.R.C. § 72(f); Treas. Reg. § 1.402(a)-1(a)(iv) (2014).

154. I.R.C. § 72(f).

155. *Id.* § 72(e)(5)(A).

156. *Id.* §§ 72(e)(4)(A), 402(a), (b)(2).

tax money in the plan will carry out a pro rata share of the participant's after-tax and pre-tax money in the plan.<sup>157</sup>

If an employee has multiple employer-sponsored retirement plans, some with a basis and others without, then the plans are not aggregated.<sup>158</sup> This means all distributions from a plan without a basis will be taxable as ordinary income to the recipient while some fraction of a distribution from a plan with a basis will be taxable.<sup>159</sup> This differs from the rule for IRAs.<sup>160</sup> Furthermore, where an employer maintains a separate accounting of employee versus employer contributions in the same plan, each account is treated as a separate plan for purposes of determining if a "basis" applies to reduce the amount of taxable income.<sup>161</sup> This generally favors the employee because a basis is more likely to occur in the employee-contribution account. If, for example, that account has a high basis, a distribution from that account would mainly be tax-free.

### C. Basic Rules Applicable to Traditional IRAs

As mentioned, an IRA is a type of retirement plan that is not an employer-sponsored retirement plan.<sup>162</sup> In addition, because IRAs generally are not qualified retirement plans, they are not subject to the rules of § 401(a).<sup>163</sup> Further, ERISA generally does not apply to IRAs.<sup>164</sup> This means, for example, that ERISA's requirement that a spouse consent to the naming of a non-spousal beneficiary does not apply to IRAs.

The focus in this section is on traditional, deductible IRAs rather than on Roth IRAs, which are described below.<sup>165</sup> Accordingly, all references to Roth IRAs

157. *Id.* § 72(e)(5)(D), (e)(8).

158. *Id.* § 72(e)(12). Although it is beyond the scope of this Article, it is worth mentioning that the pro rata approach does not apply to pre-1987 balances. *See id.* § 72(e)(8)(D).

159. *See id.* § 402(g)(2)(C).

160. *See infra* Part III.C.

161. I.R.C. § 72(d)(2).

162. *See Publication 590, supra* note 143, at 7.

163. Confusingly, a retirement plan that is not a qualified retirement plan is not the same as a "non-qualified retirement plan." *Compare Qualified Retirement Plan*, INVESTOPEDIA, <http://www.investopedia.com/terms/q/qrp.asp> (last visited Apr. 6, 2015), with *Non-Qualified Plan*, INVESTOPEDIA, <http://www.investopedia.com/terms/n/non-qualified-plan.asp> (last visited Apr. 6, 2015). With a qualified retirement plan, the employer deducts the payment in the year that the employee receives the contribution to the plan. *See Qualified Retirement Plan, supra*. The term "non-qualified retirement plan" usually refers to a non-qualified deferred compensation arrangement that allows an employee to defer taxes but that does not allow the employer to deduct the payment until the employee includes the payment in income. *See Non-Qualified Plan, supra*. This works because the plan is drafted to defer the employee's constructive receipt of the income. *Id.*

164. *See Retirement Plans and ERISA, supra* note 103 (stating that ERISA "sets standards of protection for individuals in most voluntarily established, private-sector retirement plans"). This assumes that the IRA is not held within a qualified retirement plan. *Id.*

165. *See infra* Part V.A.

will specifically say “Roth IRAs,” and all references to “IRAs” or “traditional IRAs” are meant to include only deductible IRAs that are funded by individual contributions. While most of the tax rules governing IRAs are the same as rules governing traditional employer-sponsored retirement plans,<sup>166</sup> there are differences.

An IRA is a private retirement account for one person, most commonly structured as a custodial account.<sup>167</sup> A traditional IRA is funded by tax-deductible contributions from the account owner.<sup>168</sup> Simple Retirement Accounts (also called Savings Incentive Match Plan for Employees or SIMPLEs)<sup>169</sup> and Simplified Employee Pensions (SEPs)<sup>170</sup> are employer-funded IRAs that are more like traditional employer-sponsored retirement plans than IRAs because employer contributions are excluded from the employee’s income.<sup>171</sup>

In 2014, an individual under age fifty could contribute up to \$5,500 to a traditional IRA or a Roth IRA.<sup>172</sup> That amount increased to \$6,500 for individuals age fifty and older.<sup>173</sup> Whereas an employer-sponsored retirement plan has no income cap to be able to participate in the plan, IRAs have income caps if the account owner is covered by an employer-sponsored retirement plan at work.<sup>174</sup> A single person’s ability to deduct a contribution to a traditional IRA

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166. See I.R.C. § 408(a)(6) (providing that rules “similar to” the minimum distribution rules, applicable to qualified retirement plans, also apply to IRAs). The Treasury Regulations that apply to qualified retirement plans also apply to IRAs, with some variations. See Treas. Reg. § 1.408-8, Q&A (1)(a) (2014). Note that the words “the employee” should be read as “the IRA owner” when reading the Regulations in relation to IRAs. *Id.* at Q&A (1)(b). Similar rules apply to I.R.C. § 403(b) plans as well. I.R.C. § 403(b)(10).

167. See I.R.C. § 408(a) (defining “individual retirement account” and setting parameters for the custodian).

168. *Id.* § 219(a).

169. *Id.* § 408(p) (noting that the only permissible contributions must come from “a qualified salary reduction arrangement”). See also *Retirement Plans and ERISA*, *supra* note 103 (“A SIMPLE is a plan in which a small business with 100 or fewer employees can offer retirement benefits through employee salary reductions and matching contributions . . .”).

170. I.R.C. § 408(k) (defining SEPs as “individual retirement account[s] or individual retirement annuit[ies]” meeting particularized requirements, such as being twenty-one years old and working for the employer for at least three years).

171. See Dep’t of the Treasury, *Publication 560: Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*, IRS 2 (Jan. 7, 2015), <http://www.irs.gov/pub/irs-pdf/p560.pdf> (describing the ways in which these plans are subject to a combination of the qualified retirement plan and IRA rules).

172. Dep’t of the Treasury, *2014: Instructions for Form 8606*, IRS 1, 2 (Jan. 8, 2015), <http://www.irs.gov/pub/irs-pdf/i8606.pdf>. Form 8606 allows taxpayers to report distributions from traditional IRAs and Roth IRAs. *Id.*

173. *Id.*

174. See I.R.S. Notice 2013-73, 2013-49 I.R.B. 598. If a person is not covered by an employer-sponsored retirement plan at work, then he or she can utilize a traditional IRA or deductible IRA with no income limitations. IRS, DEP’T OF THE TREASURY, 4491: VITA/TCE TRAINING GUIDE

begins to phase out at an adjusted gross income of \$60,000 if the person is covered by a traditional employer-sponsored retirement plan at work.<sup>175</sup> It phases out completely at \$70,000.<sup>176</sup> For a married couple filing jointly, that phase-out range is \$96,000 to \$116,000.<sup>177</sup> For Roth IRAs, the phase-out ranges are much higher.<sup>178</sup> For single people, the range is \$114,000 to \$129,000, and the range is \$181,000 to \$191,000 for married people filing jointly.<sup>179</sup>

As a general matter, distributions from a traditional IRA before age 59 ½ are subject to a 10% penalty, on top of income taxes that may be owed.<sup>180</sup> There are exceptions to this general rule that basically mirror the early distribution exceptions that apply to employer-sponsored retirement plans, except that no termination of service is required to avoid the penalty with respect to IRAs.<sup>181</sup>

All distributions from traditional IRAs are generally taxable as ordinary income, at least to the extent that the account owner does not have a basis in the IRA.<sup>182</sup> There are several ways in which an account owner may obtain a basis in his or her IRA. First, as a general matter, an owner who contributes more than the deductible amount to an IRA in a particular year may make a “corrective distribution” of a portion of the contributed funds before the due date of the owner’s individual income tax return.<sup>183</sup> If the owner fails to make a timely corrective distribution, then the excess contribution is treated as an addition to the owner’s basis in the IRA.<sup>184</sup> Second, the owner may make non-deductible contributions to the IRA.<sup>185</sup> Third, the owner may rollover employer-sponsored retirement plan assets in which the owner has a basis into the IRA.<sup>186</sup> Finally,<sup>187</sup> as a general matter, a person serving in the military reserves who is called to

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206–07 (2014), available at <http://www.irs.gov/pub/irs-pdf/p4491.pdf> (describing the lack of income limit for individuals with an IRA, but without an employer-sponsored retirement plan). This means that even somebody as wealthy as Bill Gates can utilize a deductible IRA or Roth IRA if he has no retirement plan through his work.

175. *Publication 590*, *supra* note 143, at 2.

176. *Id.*

177. *Id.*

178. *Id.* at 2–3. As with traditional IRAs, these phase-out ranges only apply if the account owner is covered by a traditional employer-sponsored retirement plan at work. *Id.* at 3.

179. *Id.* at 3.

180. I.R.C. § 72(q)(1)–(2) (2012).

181. *See id.* § 72(t)(3).

182. *Id.* § 408(d)(1). Cash distributions are treated as distributions of that amount, while “property” distributions are treated as distributions of the fair market value of the property. *See* Treas. Reg. § 1.402(a)-1(a)(iii) (2014); I.R.S. Notice 89-25, 1989-1 C.B. 665, Q&A (10).

183. I.R.C. § 408(d)(5). *See 401(k) Plans Supplement*, U.S. DEP’T OF LABOR, <http://www.dol.gov/ebsa/publications/401kplans-supplement.html> (last visited Apr. 6, 2015).

184. I.R.C. § 408(d)(4)–(5).

185. *Id.* § 408(o)(1).

186. *Id.* §§ 401(a)(31), 402(c)(2).

187. “Finally” may be too strong a word. There are some miscellaneous additional ways in which basis may be obtained, at least indirectly. *See infra* note 188 and accompanying text.

active duty may, for a two-year period after the end of active duty, contribute up to the amount withdrawn from a traditional retirement plan while on duty into a traditional IRA or a Roth IRA without being subject to the 10% penalty of § 72(t).<sup>188</sup>

An owner must file IRS Form 8606 for any year that he or she takes a distribution from an IRA in which the owner has some basis, receives a distribution from a Roth IRA, converts a traditional IRA or part of one to a Roth IRA, or makes a nondeductible contribution to an IRA.<sup>189</sup> In filling out Form 8606, the owner is required to report his or her basis in the traditional IRA.<sup>190</sup>

If an owner with a basis in his or her IRA dies, the beneficiary who inherits the IRA inherits the owner's basis. Other than for a surviving spouse who elects to treat it as her own IRA, the inherited IRA is not aggregated with any other IRAs that the beneficiary may own.<sup>191</sup> In addition, if the beneficiary inherits IRAs from multiple decedents, the beneficiary must separately track bases for the IRAs from each decedent.<sup>192</sup> A surviving spouse may roll an inherited IRA over into the surviving spouse's own IRA, and the decedent's basis is merely added to the surviving spouse's basis in his or her own IRAs.<sup>193</sup>

If a person owns more than one IRA and has basis in any of them, they are all aggregated for purposes of determining what portion of any particular distribution represents return of basis.<sup>194</sup> In addition, all distributions that occur during the year are aggregated and treated as one single distribution.<sup>195</sup> To determine the portion of that year's distributions that is treated as return of basis, multiply the total combined value of all IRA distributions for the year by a fraction.<sup>196</sup> The numerator of the fraction is essentially the owner's aggregate basis in all IRAs.<sup>197</sup> This basis is made up of the sum of all nondeductible contributions that were made to the IRAs. The denominator is the sum of the

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188. I.R.C. § 72(t)(2)(G). This provision does not erase taxable income for the reservist; it only erases the penalty. *Id.* Because there is no tax deduction available for the contribution, it is generally considered advisable to make the contribution to a Roth IRA rather than a traditional IRA so that future earnings will be tax-free. *DFAS Phases in Roth TSP Contributions*, MILITARY.COM, <http://www.military.com/money/personal-finance/tsp-thrift-savings-plan/dfas-phases-in-roth-tsp-contributions.html> (last visited Apr. 6, 2015). If the contribution is made to a traditional IRA despite the advantages of a Roth IRA, the contribution will add to the owner's basis in the IRA. Also, an owner who acquires an IRA (or part of an IRA) from an ex-spouse in connection with a divorce also acquires the ex-spouse's basis in the IRA. I.R.C. § 408(d)(6).

189. *Publication 590*, *supra* note 143, at 6.

190. *2014: Instructions for Form 8606*, *supra* note 172, at 1, 6–7.

191. I.R.C. § 408(d)(3)(C).

192. *Publication 590*, *supra* note 143, at 22.

193. *See* I.R.C. § 408(d)(3)(C)(i), (D).

194. *See id.* §§ 72(e)(2)(B), (5)(A), (5)(D)(iii), (8)(B), 408(d)(2)(A)–(B).

195. *Id.* § 408(d)(2)(B).

196. *See* I.R.S. Notice 87-16, 1987-1 C.B. 451–52.

197. *Id.* at 452.

combined year-end account balances plus the combined distributions for the year plus “outstanding rollovers.”<sup>198</sup> Outstanding rollovers are simply amounts that have been withdrawn from one IRA prior to year-end that will be rolled over into another IRA within sixty days after the withdrawal but after year-end.<sup>199</sup>

Although community property laws have no impact on distributions from most employer-sponsored retirement plans, an IRA may be community property because IRAs are not subject to federal rules giving surviving spouses specific rights to the assets.<sup>200</sup> Despite this, distributions from an IRA to one spouse do not create community income; instead, the distributions produce income only to the person who receives them.<sup>201</sup>

#### IV. ANALYZING THE CURRENT SYSTEM

##### A. *In General*

It is helpful to analyze the current system of no basis step-up for traditional retirement plan assets versus a basis step-up for other assets under standard tax policy principles of equity, administrative efficiency, and neutrality.<sup>202</sup>

##### 1. *Equity*

The concept of “horizontal equity” requires that similarly situated taxpayers bear similar tax burdens.<sup>203</sup> The concept of “vertical equity” requires that

198. *Id.*

199. *Id.*

200. Most employer-sponsored retirement plans are subject to the Retirement Equity Act of 1984 (REA). See I.R.C. §§ 401(a)(11), 417; 29 U.S.C. § 1055 (2012); Treas. Reg. §§ 1.401(a)-20, 1.417(e)-1 (2014). REA, which preempts state law to the contrary, effectively nullifies community property laws. See I.R.C. § 408(g); *Bunney v. Comm’r*, 114 T.C. 259, 261 (2000). Specifically, the REA provides that distributions from a plan to a married employee must be distributed as a “qualified joint and survivor annuity” (QJSA) unless waived by the employee with the consent of the spouse. I.R.C. § 401(a)(11); 29 U.S.C. § 1055; Treas. Reg. §§ 1.401(a)-20, 1.417(e)-1. Furthermore, if a married employee dies before retiring, the plan must pay the surviving spouse a “qualified pre-retirement survivor annuity” (QPSA) unless the surviving spouse has waived the right to the QPSA. I.R.C. § 417(c).

201. See *Morris v. Comm’r*, 83 T.C.M. (RIA) 1104, at \*6–7 (2002); *Bunney*, 114 T.C. at 262–63.

202. See JOSEPH A. PECHMAN, *FEDERAL TAX POLICY* 5 (5th ed. 1987); Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 568 (1965). The terminology used and the groupings of items in each category sometimes vary, but the basic principle is consistent. For a more recent interpretation, see Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 1 (2006). Professor Avi-Yonah identified efficiency, equity, and administrability as the three traditional grounds for evaluating tax policy. *Id.*

203. See John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539, 545 (1993) [hereinafter Donaldson, *Future of Transfer Taxation*]; see also Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509, 546–47.

taxpayers who are not similarly situated bear tax burdens relative to their respective abilities to pay.<sup>204</sup> The failure of the stepped-up basis at death to apply to at least a portion of traditional retirement plan assets compromises horizontal and vertical equity. Under the current system, unrealized capital gains generally are not subject to the income tax at the recipient's death.<sup>205</sup> This general rule does not apply to unrealized gain on assets owned within a traditional retirement plan.<sup>206</sup> Thus, the estates of two similarly situated taxpayers, one with assets in a traditional retirement plan and the other with assets outside a traditional retirement plan, are treated very differently for income tax purposes. This is a gross violation of the principal of horizontal equity.

In addition, über-wealthy people are automatically likely to hold the great bulk of their assets outside a traditional retirement plan because there are absolute limits on the amount that may be contributed to traditional retirement plans each year.<sup>207</sup> These people unquestionably have the greatest ability to pay. People who hold a large percentage of their wealth in retirement plans, on the other hand, are likely to be members of the middle and upper-middle class.<sup>208</sup>

Despite this great difference in ability to pay and despite our society's efforts to encourage people to utilize traditional retirement plans to save, we penalize those who do utilize traditional retirement plans in two key ways as compared to assets invested outside of retirement plans. First, assets invested outside a traditional retirement plan generally are eligible for capital gains treatment on sale, limiting the federal income tax rate applicable to the gain to a maximum rate of 23.8%.<sup>209</sup> Second, traditional retirement plan assets are not eligible for

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204. See Donaldson, *Future of Transfer Taxation*, *supra* note 203, at 545; see also Schmalbeck, *supra* note 203, at 561–63.

205. Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 *FORDHAM L. REV.* 395, 456 (1987). Although the federal estate tax may apply to subject this unrealized appreciation to some level of tax, the current estate tax exemption amount is so large (\$5,430,000 in 2015) that very few taxpayers ever pay this tax. *Estate Tax*, IRS, <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Estate-Tax> (last updated Jan. 9, 2015).

206. Zelenak, *supra* note 32, at 364.

207. *INV. CO. INST.*, 2014 *INVESTMENT COMPANY FACT BOOK* 80, 125 (54th ed. 2014), available at [http://www.icifactbook.org/pdf/2014\\_factbook.pdf](http://www.icifactbook.org/pdf/2014_factbook.pdf). See also Justin King & Elliot Schreur, *The Slow Strategy that Might Rebuild Middle-Class Wealth*, *ATLANTIC* (Jan. 11, 2015, 9:00AM), <http://www.theatlantic.com/business/archive/2015/01/a-slow-strategy-that-might-rebuild-middle-class-wealth/384384>. In general, the limits are \$52,000 for employer-sponsored retirement plans and \$5,500 for IRAs in 2014. See *supra* notes 172–73 and accompanying text.

208. King & Schreur, *supra* note 207. Cf. *INV. CO. INST.*, *supra* note 207, at 126.

209. See IRS, *DEP'T OF THE TREASURY, TAX GUIDE 2014: FOR INDIVIDUALS 117–18* (2015) [hereinafter *TAX GUIDE 2014*], available at <http://www.irs.gov/pub/irs-pdf/p17.pdf>. The maximum capital gains rate is currently 20%, *id.*, but there is a 3.8% surtax on net investment income of individuals whose modified adjusted gross income exceeds \$250,000 for married couples filing joint returns (\$200,000 for singles), I.R.C. § 1411(a)(1) (2012). This is called the Unearned Income Medicare Contribution Tax. *Id.* Net investment income includes capital gains as well as “interest, dividends, annuities, royalties, and rents.” *Id.* § 1411(c)(1)(A). Although distributions

the stepped-up basis at death and, furthermore, are taxable at ordinary income rates of up to 39.6%.<sup>210</sup> Assets held outside a traditional retirement plan, on the other hand, are not taxable at all to the person who inherits the assets<sup>211</sup> and are inherited with a basis equal to market value on the decedent's date of death.<sup>212</sup>

## 2. Efficiency

Traditionally, efficiency concerns are judged in the following two principal ways: (1) indirect costs (*i.e.*, costs to taxpayers for attempting to comply with the law) and (2) direct costs (*i.e.*, costs to the government for administering the tax law).<sup>213</sup> The current system is efficient if the account owner of an employer-sponsored retirement plan or IRA has no basis or "investment in the contract" and if the IRS Form 1099 issuer knows on which return the income belongs. In that case, all of the income paid from a retirement plan to the account owner is taxed as ordinary income.<sup>214</sup> If the owner dies, compliance is easy for the owner's named beneficiaries: all payments are taxed as ordinary income because it is IRD. Enforcement is also relatively easy for the government for the same reason.

The matter is more complicated if the owner has a basis in the traditional employer-sponsored retirement plan or IRA. In that case, as discussed above, a portion of the distribution may be non-taxable return of capital.<sup>215</sup> If the distribution is made to a beneficiary after the decedent's death, anything other than the owner's basis is taxable to the beneficiary as ordinary income because it is IRD.<sup>216</sup> This certainly adds complexity because the beneficiary then needs to track the decedent's basis to find out which portion of the distribution

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from employer-sponsored retirement plans and IRAs, including Roth IRAs, are not subject to this surtax, the distributions are factored in to determine if the \$250,000/\$200,000 threshold income levels have been reached. *Id.* § 401(b). This means that a distribution, even from a Roth IRA, could effectively be subject to the surtax. For example, suppose a married couple makes \$225,000 a year including \$100,000 of interest, dividends, royalties, and rents. The couple is not subject to the 3.8% surtax. If the couple takes a \$50,000 distribution from an IRA, they have a modified adjusted gross income of \$275,000. This means that the full \$100,000 will now be subject to the 3.8% surtax (*i.e.*, a tax of \$3,800). This is effectively a phantom income tax rate of 7.6% on the \$50,000 distribution from the IRA.

210. See TAX GUIDE 2014, *supra* note 209, at 117–18. See also *supra* note 147 and accompanying text.

211. I.R.C. § 102(a).

212. *Id.* § 1014(a).

213. See Donaldson, *Future of Transfer Taxation*, *supra* note 203, at 548–49. See also Schmalbeck, *supra* note 203, at 529–30; Yorio, *supra* note 205, at 409–10.

214. See Yorio, *supra* note 205, at 431 ("By virtue of the repeal of the capital gains deduction, long-term capital gains will be taxed at the same rate as ordinary income." (footnote omitted)).

215. See *supra* notes 182–90 and accompanying text (describing how a taxpayer obtains a basis in the retirement plan and how this amount must be reported for tax purposes).

216. This assertion assumes that the beneficiary does not roll the distribution over into the beneficiary's own IRA. See I.R.C. § 408(d)(3)(C).

represents return of capital. This complexity similarly applies to the government's efforts to ensure the proper payment of taxes.

### 3. Neutrality

The concept of tax neutrality suggests that the Code, to the extent possible, should not cause people to change behavior solely for tax reasons unless there is a public policy reason for doing so.<sup>217</sup> Our current system fails at this. As mentioned, the reason for special tax rules applicable to employer-sponsored retirement plans and IRAs is to encourage people to use those plans to save for retirement because those plans will ensure that individuals' money is protected for retirement, and they will maximize growth of their assets.<sup>218</sup> Unfortunately, this does not always happen. For example, suppose a hypothetical single taxpayer, Theodore, earns a constant amount of *taxable* income of \$35,000 per year.<sup>219</sup> Assuming he has no children and no deductions other than the standard deduction and personal exemption, he would reach this amount of taxable income if his gross income were \$45,150 per year.<sup>220</sup> This amount was chosen to roughly approximate the average wage of an American worker.<sup>221</sup>

Theodore deposits \$5,000 at the end of each year, from ages thirty to fifty (*i.e.*, for twenty years), into a deductible IRA, where it is invested in publicly traded stock. At age fifty, the stock will have a total value of \$228,810, assuming an

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217. See Donaldson, *Future of Transfer Taxation*, *supra* note 203, at 550–51.

218. See *supra* note 101 and accompanying text.

219. To simplify, one must assume that there is no inflation and the brackets do not change over time. Any hypothetical example requires a myriad of assumptions, many of which are unrealistic. Nevertheless, it is impossible to produce a truly accurate mathematical model with respect to this type of planning. In part, that is due to the extraordinary number of variables involved. As an example, the following is a sampling of the types of variables that would alter the conclusions of any mathematical model: (1) the hypothetical taxpayer's tax bracket at the time of each contribution, (2) the taxpayer's tax bracket during each year after retirement, (3) the taxpayer's age at death, (4) inflation, (5) return on investment, (6) assets owned by the taxpayer outside a retirement plan, (7) fees charged by the plan administrator, (8) the tax brackets of the beneficiaries who inherit plan assets at the taxpayer's death, (9) the taxpayer's marital status, (10) the marital status of the beneficiaries, (11) the possibility that the ordinary income tax rates will change over time, (12) the possibility that the preferential rate on capital gains will change over time, (13) the possibility of changes to § 1014 basis adjustment at death, and (14) state and local taxes that might apply to income from investments. Furthermore, most of these variables are impossible to predict with any degree of accuracy. Therefore, a hypothetical example is necessary to illustrate at a basic level how the § 1014 basis adjustment affects the outcome when we make some rather simplistic assumptions and utilize relatively constant rates of return and rates of taxation.

220. Taxable income of \$35,000, plus the 2014 standard deduction of \$6,200 for single people, plus the \$3,950 personal exemption amount for 2014. Rev. Proc. 2013-35, 2013-47 I.R.B. 541–42.

221. The average American wage, before taxes, is \$48,463 per year. See Alanna Petroff, *Who Pays the Most Income Taxes?*, CNN MONEY (May 2, 2014, 5:47 AM), <http://money.cnn.com/2014/05/02/pf/taxes/income-taxes-wages/index.html>. This hypothetical uses a slightly lower amount of \$45,000, in part because most taxpayers are going to have more deductions than our hypothetical average taxpayer, such as a mortgage interest deduction or personal exemptions for children.

average growth rate of 8% per year compounded annually.<sup>222</sup> At that point, Theodore stops contributing to the plan and allows the stock to grow in value at an average of 8% per year until he retires twenty years later, at age seventy. Upon retirement, the total account value is \$1,066,474.

For simplicity, suppose that after retirement Theodore has no other taxable income when he retires other than amounts necessary to eliminate the personal exemption and the standard deduction.<sup>223</sup> If he were to take everything out of the plan as a lump sum distribution (*i.e.*, a \$1,066,474 distribution), he would owe federal income taxes on the distribution in the amount of \$379,370.<sup>224</sup> After taxes, Theodore would have net proceeds of \$687,104.<sup>225</sup>

In reality, Theodore probably would not take a lump sum distribution upon retiring. Instead, he would take minimum required distributions to spread out the income and defer taxes. The income tax effect of those minimum required distributions would depend on his other income, including Social Security, interest income, and investment income from assets held outside retirement plans. His life expectancy also would be recomputed each year, which potentially has the effect of spreading distributions out over a longer period of time. For simplicity, however, it is convenient to assume a payment over his life expectancy from the time of retirement. According to IRS mortality tables, his life expectancy at age seventy is seventeen years.<sup>226</sup> Ignoring growth in the assets after retirement, that works out to pre-tax annual payments of \$62,734.<sup>227</sup> The federal income tax on those annual payments, using 2014 rates, is

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222. All computations were performed on the estate-planning tool NumberCruncher2014.01. *See Software*, LEIMBERG.COM, <http://www.leimberg.com/products/software/numbercruncher.html> (last visited Apr. 7, 2015).

223. In reality, Theodore is likely to have at least some Social Security income. *See Social Security Basic Facts*, SOCIAL SECURITY, <http://www.ssa.gov/news/press/basicfacts.html> (last updated Apr. 2, 2014) (highlighting that the majority of elderly adults in the United States receive some form of social security income).

224. This is based on rates that apply in the year 2014:  $[(\$1,066,474 - 406,750) \times .396] + \$118,118.75 = \$379,370$ . Rev. Proc. 2013-35, 2013-47 I.R.B. 539. This is just a rate of 39.6% on income in excess of \$406,750 plus the total tax, at lower rates, on \$406,750 of income. *See id.*

225. The result of \$1,066,474 distribution minus \$379,370 in taxes.

226. *See* Treas. Reg. § 1.401(a)(9)-9, Q&A (1) (2014).

227. This figure is the result of \$1,066,474 divided by 17.

\$11,540.<sup>228</sup> That means his after-tax payments are \$51,194<sup>229</sup> per year. Over seventeen years, that works out to total net payments of \$870,298.<sup>230</sup>

Now, assume instead that Theodore took the same \$5,000 a year and invested it, after taxes, in stock outside a retirement plan. Assuming federal taxes of 15%,<sup>231</sup> Theodore would have a net amount of only \$4,250<sup>232</sup> per year to invest in stock after paying taxes on the \$5,000. At the end of twenty years, Theodore would have stock valued at \$194,488, and his income tax basis in the stock would be \$85,000.<sup>233</sup> He then allows the stock to grow in value at an average of 8% per year, until he retires twenty years later at age seventy. At that point, the total account value is \$906,500. If he were to sell the stock, he would owe federal income taxes on the capital gains in the amount of \$195,517, assuming he sells all the stock in one year and is subject to the 3.8% net investment income tax.<sup>234</sup> After paying those taxes, he would have net proceeds of \$710,983. This is \$23,879 more than the net proceeds of \$687,104 if he had invested through a retirement plan and taken a lump sum distribution at retirement.

It is tempting to assume that a traditional retirement plan will always be better for Theodore because he can take minimum required distributions, rather than a lump sum, to radically lower his taxes. That is not necessarily true. As mentioned, although his net proceeds would only be \$687,104 if he takes a lump sum distribution at age seventy, he increases his net proceeds to approximately \$870,298 if he instead takes just the minimum required distributions from the retirement plan over his life expectancy.<sup>235</sup> This is better than his net proceeds

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228. Rev. Proc. 2013-35, 2013-47 I.R.B. 539 (stating the tax is \$5,081.25 plus 25% on any amount over \$36,900 but not over \$89,350). This somewhat unrealistically assumes that \$62,734 is Theodore's only taxable income. In reality, he is likely to have other income sources that would push him into an even higher income tax bracket. Nevertheless, it is useful to assume that \$62,734 is his only taxable income because it demonstrates a minimum amount of taxes that he is likely to pay as a result of the distributions, especially if his other income soaks up the standard deduction and personal exemption.

229. The result of \$62,734 minus \$11,540.

230. The result of \$51,194 multiplied by 17.

231. Rev. Proc. 2013-35, 2013-47 I.R.B. 539. As a single person with taxable income of \$35,000, Theodore is in the 15% income tax bracket. *Id.*

232. Federal taxes are equal to 15% of \$5,000, which is \$750. The yearly payment of \$5,000 minus \$750 equals \$4,250.

233. The result of \$4,250 multiplied by 20.

234. The gain on sale is \$821,500 (\$906,500 sales price minus \$85,000 basis). The basis of \$85,000 is the purchase price of the stock (\$4,250 x 20). The capital gains tax is computed at the maximum rate of 20% plus the 3.8% net investment income tax. *See* I.R.C. § 1411(a) (2012). The gain on sale of \$821,500 x 23.8% equals \$195,517. The net proceeds after paying the tax are \$710,983 (\$906,500 sales price minus \$195,517 in taxes). If he spreads the gain out over a few years so that he avoids the 3.8% net investment income tax, his tax is only \$164,300 (*i.e.*, a 20% capital gains tax rate), leaving net proceeds after paying the tax of \$742,200 (\$906,500 sales price minus \$164,300 in taxes).

235. *See supra* note 230 and accompanying text.

of \$710,983 if he were to just own stock outside of a retirement plan and sell it as a lump sum at age seventy. This approach, however, fails to compare apples to apples.

If Theodore were to own his stock outside of a retirement plan, he could just as well defer the sale of the stock over time. In fact, he does not need to sell the stock at all, given that no minimum distribution rules apply to stock owned outside of a retirement plan.<sup>236</sup> To be fair, however, we should assume that he sells one-seventeenth of his stock holdings each year over his seventeen-year life expectancy. Assuming no change in the stock value once he reaches age seventy, to match our assumptions with respect to the retirement plan assets, he would sell \$53,324<sup>237</sup> worth of stock each year for seventeen years. His total income tax basis in the stock is \$85,000,<sup>238</sup> which means that his basis in the shares of stock that he sells each year would be \$5,000.<sup>239</sup> This means that his taxable gain on sale each year would be \$48,324.<sup>240</sup> Assuming that he has no taxable income apart from that gain, he would pay a tax on the capital gains at a rate of 0% on the first \$36,900 of income and only 15% on the amount in excess of \$36,900.<sup>241</sup> Said differently, he will pay a 15% capital gains tax on only \$11,424 of capital gains income.<sup>242</sup> That is a tax of \$1,714, leaving him with net proceeds of \$51,610.<sup>243</sup> Over seventeen years, that works out to a total net return of \$877,370.<sup>244</sup> This is \$7,072 more than the total net payments of \$870,298 that he would receive if he were to invest in stock through a retirement plan and only take minimum required distributions upon retirement, but we are not done yet.

If Theodore invests outside of a retirement plan, he is not required to sell anything during his life. This means that he can time his sales to minimize taxes. In 2014, taxpayers in the 10% and 15% brackets do not pay any capital gains taxes.<sup>245</sup> For single taxpayers, the 15% bracket extends to taxable income of \$36,900, and for married taxpayers filing jointly, it extends to taxable income of

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236. See I.R.C. § 408(d)(1) (2012).

237. The result of \$906,500 at age seventy divided by a seventeen-year life expectancy.

238. The result of \$4,250 contributions multiplied by 20 years.

239. The result of \$85,000 divided by 17.

240. The result of \$53,324 minus \$5,000.

241. I.R.C. § 1(h)(1). The capital gains rate is 15% for a taxpayer in the 25%, 28%, 33%, or 35% income tax bracket. *Id.* The capital gains rate is 20% for taxpayer in the 39.6% income tax bracket and 0% for a taxpayer in the 10% or 15% income tax bracket. *Id.* § 1(h)(1)(B), (D). For 2014, the 15% income tax bracket for single individuals applies to taxable income of up to \$36,900, and the 39.6% bracket for single individuals applies to taxpayers with taxable income over \$406,750. Rev. Proc. 2013-35, 2013-47 I.R.B. 539.

242. This is derived by subtracting \$36,900 from \$48,324.

243. The result of a \$53,324 sale price minus \$1,714 tax.

244. This sum is the product of a \$51,610 net return per year multiplied by 17.

245. I.R.C. § 1(i).

\$73,800.<sup>246</sup> Recall that we assumed that Theodore would sell \$53,324 worth of stock each year for seventeen years, resulting in a taxable gain of \$48,324. If he were married, this gain would be completely tax-free,<sup>247</sup> giving him net proceeds of about \$906,500, because all of his capital gains income would fall within the 15% married bracket.<sup>248</sup> Even if we continue to assume that he is single, he could choose to sell slightly less stock each year to keep his taxable income no greater than \$36,900, which would keep him in the 15% bracket. This means that he could sell \$41,900 of stock each year, assuming he has no other taxable income, and he would pay no tax on the gain.<sup>249</sup> If he were to live long enough to sell all of his stock, he would have net proceeds of \$906,500. This, of course, exceeds the net proceeds of \$870,298 that he would receive if he were to invest in stock through a retirement plan and only take minimum required distributions upon retirement. In short, he is over \$36,000 better off because he invested outside a retirement plan. A thoughtful person cannot help but ask why our tax laws are designed to encourage people like Theodore to invest through a retirement plan.

While our current low capital gains rate combined with the ability to time stock sales allows someone in Theodore's income tax bracket to fare better than a taxpayer at a higher income level, it does not necessarily work out so well for taxpayers in higher income tax brackets who have to pay capital gains taxes at higher rates. At least, that is the case if the taxpayer sells the stock before dying.

The real difference between investing inside and outside a traditional retirement plan, and the point of this Article, can be seen if Theodore holds onto stock invested outside of a retirement plan until death. In this case, his beneficiary, Ben, would inherit the stock with a basis equal to its value on the date of Theodore's death. Suppose Theodore dies at age seventy, when the stock is worth \$906,500. If Ben were to sell the stock for \$906,500, he would have no taxable gain whatsoever and would keep the net proceeds. This is true even if Ben was in the top income tax bracket of 39.6%. As we will see, this is a marked difference from the net proceeds realized had Theodore instead invested in the stock through a retirement plan.

If the stock were invested through a traditional retirement plan, there are two possible outcomes depending on how the inheritance is paid to the beneficiary Ben. One possible outcome occurs if Ben is not directly named under the plan, and instead inherits through Theodore's estate (or through a trust that is not a "see-through" trust).<sup>250</sup> In that case, the plan would lack a designated

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246. Rev. Proc. 2013-35, 2013-47 I.R.B. 538.

247. *Id.*

248. The result of a \$53,324 sale price per year multiplied by 17.

249. Subtracting \$5,000 from a \$41,900 sales price equals \$36,900.

250. See Lifson, *supra* note 56, at 832. A "see-through trust" is a trust that complies with the four "minimum distribution trust rules" of Treas. Reg. § 1.401(a)(9)-4, Q&A (5)(b) (2014): (1) the trust must be valid under state law; (2) the trust must either be irrevocable or, by its terms, become

beneficiary, requiring all proceeds (\$1,066,474) to be paid out as a lump sum within five years of Theodore's death.<sup>251</sup> Assuming that Ben, like Theodore, has taxable income of \$35,000 per year before receiving his inheritance, then Ben would have a significant income tax liability.<sup>252</sup> In this case, Ben's tax liability would be \$393,229.<sup>253</sup> This would leave Ben with net proceeds of only \$673,245 from the retirement plan assets.<sup>254</sup> In short, Ben would have inherited an additional \$233,255 had Theodore instead invested outside a traditional retirement plan.<sup>255</sup>

The second possible outcome is that Ben would qualify as a designated beneficiary. This would be the case if the plan were to name Ben, individually, as the sole beneficiary of Theodore's retirement plan. In that case, Ben could

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irrevocable upon the death of the account owner; (3) the beneficiaries must be "identifiable"; and (4) certain required documents must be presented to the plan administrator. To then qualify for the extended payout time (rather than the five-year payout period), all beneficiaries of the trust must be individuals. *Id.* at Q&A (5)(c). If these requirements are met, the trust is a see-through trust, and distributions from the retirement plan can be paid out over the life expectancy of the oldest beneficiary of the trust. *See* Lifson, *supra* note 56, at 832.

251. Carolyn T. Geer, *Smart Ways to Bequeath Your IRA*, WALL ST. J. (Apr. 26, 2014, 8:08 PM), <http://www.wsj.com/articles/SB10001424052702304734304579517792953571168>. Note that this is fairly common because improper drafting or administration causes the trust to be disqualified as a trust that is not a see-through trust. *Id.* It's a tricky situation because trusts are widely viewed as the best way to provide for minor beneficiaries who lack the capacity to receive outright distributions. Another option developed fairly recently is the "trusteed IRA" or the "individual retirement trust." *Id.* The basic idea is that no separate trust needs to be drafted. *Id.* Rather, as one attorney explains, "the IRA provider serves as trustee, distributing the IRA assets to [the] beneficiaries as [the account owner] stipulate[s]." *Id.* This arrangement comes at the expense of higher fees from the IRA provider. *See id.*

252. This hypothetical assumes that Ben takes the distribution as a lump sum. A surviving spouse can always roll inherited benefits into his or her own IRA or into his or her own qualified retirement plan. I.R.C. § 402(c)(9), (e)(1)(B) (2012). Alternatively, he or she can roll the inherited benefits into an "inherited" IRA; that is, it can be rolled into an IRA in the name of the deceased spouse and naming the surviving spouse as the beneficiary. *See id.* § 402(c)(11); I.R.S. Notice 2009-68, 2009-39 I.R.B. 423. A non-spouse "Designated Beneficiary," on the other hand, like Ben, can only do a direct rollover to an inherited IRA or a Roth IRA. A rollover to a Roth IRA is subject to income taxes. *See* I.R.S. Notice 2009-68, 2009-39 I.R.B. 424. All plans since 2010 are required to offer Designated Beneficiaries the option of doing a direct rollover. *See* I.R.C. § 402(f)(2)(A). This only applies to direct rollovers, which means that if funds are distributed directly to the beneficiary rather than being rolled directly into the inherited IRA, then the distribution is fully taxable, and a direct rollover becomes impossible. *See id.* § 402(c)(11)(A). Furthermore, the possibility of doing a direct rollover only exists for a Designated Beneficiary, which is defined as an individual or group of individuals named under the plan. *Id.* Under this definition, an estate or a non-see-through trust is not a Designated Beneficiary. Thus, if a widower dies without naming a successor beneficiary, and if the plan provides that the payment is to be made to his estate, which is very common, the benefits cannot be rolled over into an inherited IRA.

253. Using 2014 rates, the computation is as follows:  $[(\$1,066,474 + \$35,000 - 406,750) \times .396] + \$118,118.75 = \$393,229$ .

254. The result of \$1,066,474 minus \$393,229.

255. The result of \$906,500 minus \$673,245.

arrange to have the plan assets rolled directly into an inherited IRA.<sup>256</sup> This would allow Ben to spread income taxes out over many years as he defers the receipt of that income over his life expectancy. In this case, the tax effect depends on Ben's age and income tax bracket. If, for example, he is thirty years old and earns taxable income of \$35,000 per year before the rollover, we would first note that his life expectancy is just over fifty-three years.<sup>257</sup> We would then take the total account value of \$1,066,474 and divide it by fifty-three years to see how much he must receive from the plan each year, at a minimum.<sup>258</sup> That works out to \$20,122 per year. That will push his total income level up from \$35,000 to \$55,122 per year, which is a move from the 15% income tax bracket to the 25% income tax bracket.<sup>259</sup> In short, this means that \$18,222 of the \$20,122 that he receives will be subject to federal taxes at a rate of 25%, and the other \$1,900 will be taxed at 15%.<sup>260</sup> This tax reduces his net proceeds from the \$20,122 gross retirement plan payments each year to \$15,281.<sup>261</sup> Over his fifty-three year life expectancy, he will have total net proceeds from the retirement plan of \$809,893.<sup>262</sup> This is \$136,648<sup>263</sup> more than the \$673,245 that he would have received had he taken a lump sum distribution, but it is \$96,607 less than the \$906,500 that he would have received had he received his inheritance outside a retirement plan.

What does this hypothetical tell us? Perhaps it is better to start with what it does not tell us. It does not tell us that taxpayers are always better off investing outside a traditional retirement plan. As we have seen, they can be better off if they only take minimum required distributions during their lives, but they can also be worse off when we consider that there is no duty to sell assets owned outside a retirement plan during life. The result depends on their tax bracket and how much they choose to sell during life.

The hypothetical also does not tell us that a taxpayer's family is always better off investing outside a traditional retirement plan. The result depends on the

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256. See *supra* note 252.

257. Treas. Reg. § 1.401(a)(9)-9, Q&A (1) (2014).

258. In reality, this assessment only determines how much he will receive in the first year. In subsequent years, it is necessary to subtract one from his initial life expectancy and then apply that new life expectancy to the account balance on December 31. This determines how much must be distributed the following year.

259. The top amount of income in the 15% bracket is \$36,900. Rev. Proc. 2013-35, 2013-47 I.R.B. 539. Everything up to that amount is taxed at 15%. *Id.* The excess in this case is taxed at 25%. *Id.* That excess is \$18,222.

260. The result of \$36,900 minus \$35,000 is \$1,900, which is taxed at 15% for a total tax of \$285 (15% of \$1,900). The result of \$55,122 minus \$36,900 is \$18,222, which is taxed at 25% for a total tax of \$4,556 (25% of \$18,222). The total tax on the \$20,122 payment, therefore, is \$4,841 (\$285 plus \$4,556).

261. The result of \$20,122 minus \$4,841 in tax.

262. The result of \$15,281 multiplied by 53.

263. The result of \$809,893 minus \$673,245.

beneficiary's age and income level. That being said, the numbers demonstrate that the stepped-up basis at death can make it significantly more favorable from a tax perspective to invest outside a traditional retirement plan.

This system does not make sense. Congress is giving up significant tax revenue by allowing traditional retirement plans to exist.<sup>264</sup> If Congress' goal is to incentivize people like Theodore to invest for retirement through a traditional retirement plan, Congress is misguided. If the incentive works, Theodore may be worse off from a tax perspective for having used the traditional retirement plan. While the innumerable variables and uncertainties involved make it impossible to state a blanket rule, it is safe to say that Theodore *can* be better off from a tax perspective if he invests outside a traditional retirement plan during his life rather than investing inside a traditional retirement plan and taking minimum required distributions when he retires. Moreover, as a direct result of the stepped-up basis at death and its limited applicability, Theodore's family is very *likely* to be better off from a tax perspective if Theodore invests outside a traditional retirement plan, rather than through one, during his life.

## V. ALTERNATE APPROACHES TO AN EQUITABLE SOLUTION

### A. Roth IRAs

In 1998, Congress began to allow people to use a new type of IRA: the Roth IRA.<sup>265</sup> The basic idea is simple enough: contributions to Roth IRAs are not deductible, but distributions are tax-free.<sup>266</sup> Roth IRAs follow the same rules as traditional IRAs except to the extent that the Code specifically identifies a difference.<sup>267</sup> There are three principal differences: contributions to Roth IRAs are not deductible like they are with traditional IRAs,<sup>268</sup> distributions from Roth IRAs are not taxable like they are from traditional IRAs,<sup>269</sup> and the minimum

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264. *Ret. Sec. & Defined Benefit Pension Plans: Hearing Before the Subcomm. on Oversight of the H. Comm on Ways and Means*, 107th Cong. 63 (2002) (statement of Karen D. Friedman, Director of Policy Strategies, Pension Rights Center). According to Karen D. Friedman, the tax break for retirement plans constitutes "the largest of all of the nation's federal tax subsidies." *Id.*

265. I.R.C. § 408A (2012).

266. *Id.* § 408(c)(1), (d)(2)(B). With a Roth IRA, investors are effectively betting that future tax rates will be significantly higher than current tax rates. See David Ning, *5 Reasons to Save for Retirement in a Roth 401(k)*, U.S. NEWS & WORLD REP. (Apr. 23, 2014, 10:26 AM), <http://money.usnews.com/money/blogs/on-retirement/2014/04/22/5-reasons-to-save-for-retirement-in-a-roth-401-k>. For the up-front payment of taxes to make financial sense, tax rates have to increase so much over time that the payment of taxes now will leave the taxpayer better off than paying the taxes in the future, even when the time value of money is factored into the computation. *Id.*

267. I.R.C. § 408A(a).

268. *Id.* § 408A(c)(1).

269. *Id.* § 408A(d)(1).

distribution rules generally do not apply to Roth IRAs during the account owner's lifetime.<sup>270</sup>

Let us return to our hypothetical worker, Theodore. What would happen if Theodore were to invest the same \$5,000 per year in a Roth IRA, rather than in a traditional IRA or outside a retirement plan? To compare apples to apples, it makes sense to assume that he has \$5,000 to invest before taxes. After taxes, that leaves him with \$4,250 to invest. As we have seen, that will grow to \$194,488 twenty years later, when Theodore is fifty years old. Twenty years later, when he is ready to retire at age seventy, it will be worth \$906,500. If Theodore takes the money out of the plan during life, it comes out tax-free, giving him net proceeds of \$906,500. If, on the other hand, he dies at age seventy, Ben will inherit the account with a value of \$906,500 and have no income whatsoever. This is the same result as if he had invested outside a retirement plan.

There is no question: the Roth IRA is superior to the traditional IRA in the context of transfers at death because a Roth IRA does not create IRD for the beneficiary. The real issue is how the Roth IRA fares against investing outside a retirement plan. In this case, the Roth IRA may or may not fare better from a tax perspective; while the account owner is alive the distributions are tax-free, and the lifetime sales are subject to the capital gains tax.<sup>271</sup> At death, however, the benefit fades away because both types of investments are generally equal from a tax perspective (*i.e.*, all gain is tax-free).<sup>272</sup>

The real issue is that investing through a Roth IRA brings with it complexity and limitations that do not exist if assets are invested outside of a retirement plan. For example, the maximum amount that could be contributed to a Roth IRA in 2014 was \$5,500.<sup>273</sup> The assets then need to be kept in the Roth IRA to obtain its tax benefits.<sup>274</sup> Specifically, a distribution is only not in the recipient's income if the assets have been kept in the Roth IRA at least five years.<sup>275</sup> Furthermore, a recipient does not have to include the distribution in his or her

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270. *Id.* § 408A(c)(5). Roth IRAs are only subject to the minimum distribution rules after the death of the participant. *Id.* As a result, Roth IRAs do not have a "required beginning date." *See id.*

271. *Id.* § 1(h)(1). This is due to the fact that the capital gains rate is 0% for people in the 10% and 15% income tax brackets (up to \$36,900 of taxable income for singles and \$73,800 of taxable income for married couples). *Id.* § 1(h)(1)(B). For people who stay within these brackets, including many retired people in the U.S., there is absolutely no tax benefit to a Roth IRA.

272. *Id.* §§ 1(h)(1), 408A(c)(5).

273. *Retirement Topics - IRA Contribution Limits*, IRS, <http://www.irs.gov/Retirement-Plans/Plan-Participant-Employee/Retirement-Topics-IRA-Contribution-Limits> (last updated Jan. 22, 2015). This is the maximum combined amount that may be contributed to all IRAs each year. *Id.* The amount is increased by \$1,000 for individuals who are at least fifty years old. I.R.C. § 219(b)(5).

274. I.R.C. § 408A(d)(3)(B). *See* Treas. Reg. § 1.408A-6, Q&A (1) (2014).

275. I.R.C. § 408A(d)(2)(B); Treas. Reg. § 1.408A-6.

income if the distribution is made once the beneficiary turns age 59 ½, is made after the death or disability of the account owner, or is a qualified first-time homebuyer expense.<sup>276</sup> If these requirements are not satisfied, distributions are potentially subject to income taxes and are subject to the 10% penalty on early withdrawals.<sup>277</sup>

There are also limitations on who can contribute to a Roth IRA. In 2014, the amount that may be contributed to a Roth IRA phased out for single taxpayers with a modified adjusted gross income (modified AGI) between \$114,000 and \$129,000.<sup>278</sup> For married taxpayers filing jointly, the modified AGI range is \$181,000 to \$191,000.<sup>279</sup> For married taxpayers filing separately, the modified AGI range is \$0 to \$10,000.<sup>280</sup> Modified AGI does not include any income that may be reported from converting a traditional IRA into a Roth IRA.<sup>281</sup>

The real issue with Roth IRAs is that there are no real tax benefits compared to investing outside of a retirement plan for single taxpayers with taxable income of up to \$37,450 and married taxpayers with taxable income of up to \$74,900.<sup>282</sup> This is the case because people at that income level do not pay any capital gains taxes.<sup>283</sup> For people above those income levels but below the cap that allows you to contribute to a Roth IRA (\$129,000 for single taxpayers and \$191,000 for married taxpayers), Roth IRAs provide tax benefits compared to assets invested outside a retirement plan if that taxpayer cashes out on investments during life.<sup>284</sup> The tax benefit, however, is generally limited to the difference between a tax-free Roth IRA distribution and a 15% tax on capital gains.

As a general matter, there is very little benefit to having assets in a Roth IRA at death versus owning capital assets outside a retirement plan if the Roth IRA assets pay out to the beneficiary right away at the account owner's death, as required anytime anybody other than a designated beneficiary is named as the beneficiary.<sup>285</sup> The real potential benefit of a Roth IRA occurs if assets can be kept in the Roth IRA for as long as possible after the account owner's death.<sup>286</sup>

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276. I.R.C. § 408A(d)(2)(A).

277. Treas. Reg. § 1.408A-6 Q&A (4)-(5).

278. See *supra* notes 178-79 and accompanying text.

279. *Publication 590*, *supra* note 143, at 3.

280. *Id.*

281. *Modified Adjusted Gross Income - MAGI*, INVESTOPEDIA, <http://www.investopedia.com/terms/m/magi.asp> (last visited Apr. 7, 2015).

282. Rande Spiegelman, *Taxes: What's New for 2015?*, CHARLES SCHWAB (Jan. 14, 2015), <http://www.schwab.com/public/schwab/nn/articles/Taxes-Whats-New>.

283. *Id.*

284. See *Publication 590*, *supra* note 143, at 3; *Ultimate Guide to Retirement*, *supra* note 89.

285. See *supra* notes 140-41 and accompanying text.

286. Although the minimum distribution rules do not apply to Roth IRAs during the life of the account owner, they do apply after the death of the account owner. *Roth IRA Required Minimum Distribution (RMD)*, ROTHIRA.COM, <http://www.rothira.com/roth-ira-required-minimum-distribution-rmd> (last visited Apr. 7, 2015). This prevents money from being kept in a Roth IRA forever.

Although the payout from a Roth IRA is tax-free to the beneficiary, that really is no different from the stepped-up basis at death that applies to assets held outside the IRA when the distribution from the Roth is made at death.

The primary advantage of a Roth IRA over holding assets outside an IRA occurs if the beneficiary leaves assets in the Roth IRA as long as possible. Of course, the beneficiary can effectively do the same thing with assets held outside an IRA by refraining from selling the assets. In fact, the beneficiary can achieve another step-up in basis if he or she holds on to those assets until death. If the beneficiary decided to “cash out” by selling an asset during life, the Roth IRA would be more desirable. This is because the post-death appreciation in the Roth IRA, until the time of distribution, will not be taxed.<sup>287</sup>

Of course, Roth IRAs come at a cost. Putting investments in Roth IRAs ties them up in ways that do not exist for assets held outside of a retirement plan. As mentioned, these investments must be kept in the Roth IRA for at least five years to avoid the 10% penalty and the tax on income earned.<sup>288</sup> Business owners may be affected by limitations on their ability to borrow against retirement plan assets.<sup>289</sup> Furthermore, a Roth IRA held until death will force a designated beneficiary to consider the applicability of the minimum distribution rules, rules that do not apply to assets held outside a retirement plan.<sup>290</sup> If Congress is attempting to encourage people to save through retirement plans, it should ensure that the benefits of utilizing the plan outweigh the inconvenience of doing so. While a Roth IRA’s benefits may be significant enough during the account owner’s lifetime to entice the taxpayer to utilize a Roth IRA instead of investing outside a retirement plan, most of those benefits melt away at the account owner’s death.<sup>291</sup>

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287. *Id.*

288. Dep’t of the Treasury, *Publication 575: Pension and Annuity Income*, IRS 31–32 (Jan. 7, 2015), <http://www.irs.gov/pub/irs-pdf/p575.pdf>.

289. Richard J. Kovach, *Toward Equalization of the Personal Retirement Savings Prerogatives of Small Business Owners and Their Employees*, 31 *LOY. U. CHI. L.J.* 369, 387–88 (2000). As Professor Richard Kovach describes:

[A] business owner who chooses to invest surplus profits in a qualified retirement plan faces numerous complex rules that restrict the ability of plan participants to borrow from their accrued benefits. Most importantly, an entrepreneur who builds up a substantial accrued benefit in a qualified plan, perhaps exceeding \$1,000,000, can borrow no more than \$50,000 at a time against that benefit without incurring prohibitory tax consequences. A substantial diversion of profits into a qualified retirement plan thus restricts access to capital that might temporarily benefit an enterprise.

*Id.* at 387 (footnotes omitted).

290. *See Roth IRA Required Minimum Distribution*, *supra* note 286.

291. Although this Article focuses on the income tax aspects of transfers at death, it bears mentioning that there are potential estate tax consequences to investing through a retirement plan that can be avoided by investing outside a retirement plan. *See* Andrea Coombes, *Beware Leaving a Roth for Heirs*, *WALL ST. J.* (Sept. 7, 2014, 4:01 PM), <http://www.wsj.com/articles/should-i-leave-a-roth-to-my-heirs-1410120116>. For example, the total value of the plan on a decedent’s

It is difficult to know how these factors contribute to decisions to save through a Roth IRA, a deductible IRA, or outside a retirement plan. According to the most recent data from the Employee Benefits Research Institute, the average deductible IRA account balance in 2011 was \$110,918, and the median balance was \$31,944.<sup>292</sup> The average Roth account balance was \$25,228, and the median balance was \$11,344.<sup>293</sup> This, however, does not tell the whole story. In 2011, a higher aggregate amount was contributed to all Roth IRAs (\$3.7 billion) compared to the total amount contributed to all deductible IRAs (\$2.3 billion).<sup>294</sup> Nevertheless, on an individual basis, more was contributed during the year to deductible IRAs on average (\$3,879) when compared to Roth IRAs (\$3,633).<sup>295</sup> A fair reading of this data would seem to suggest that deductible IRAs remain more popular than Roth IRAs for the average person; however, for a smaller number of wealthier people, the Roth IRA is the investment vehicle of choice, particularly for large rollovers from traditional retirement plans.<sup>296</sup>

### B. Roth 401(k) Plans

A new option for elective deferrals through an employer-sponsored retirement plan came into existence in 2006: the Designated Roth Account (DRAC).<sup>297</sup> From 2006 through 2010, DRACs were allowed as separate accounts within two possible types of Cash-or-Deferred Arrangements (CODAs): 401(k) plans and

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date of death will be included in his or her gross estate. *See Estate Tax, supra* note 205. This can have significant planning consequences if the account owner has an estate anywhere close to the lifetime exemption amount, which was \$5.34 million in 2014. *Id.* In this case, assets held in a Roth IRA or Roth 401(k) are generally better than assets held in a deductible IRA or traditional employer-sponsored retirement plan because the estate tax is assessed on the full value of the non-Roth accounts, including assets that will ultimately be used to pay income taxes, although estate taxes allocable to those accounts are deductible for income tax purposes. *See id.* However, there is no real opportunity to make lifetime gifts of retirement plan assets while those assets are held inside the plan. In contrast, assets held outside a retirement plan could be given away during life to shift appreciation to the donee and minimize the adverse estate and gift tax effect. The downside of doing this, of course, is that the benefit of the stepped-up basis at death is lost if assets are transferred during life. Thus, this strategy is only truly beneficial if the lifetime transfer of appreciating assets is fairly certain to reduce estate taxes that will be owed at death.

292. *See* CRAIG COPELAND, EMP. BENEFIT RESEARCH INST., INDIVIDUAL RETIREMENT ACCOUNT BALANCES, CONTRIBUTIONS, AND ROLLOVERS, 2011: THE EBRI IRA DATABASE 5-7 (2013), available at [http://www.ebri.org/pdf/briefspdf/EBRI\\_IB\\_05-13.No386.IRAs.pdf](http://www.ebri.org/pdf/briefspdf/EBRI_IB_05-13.No386.IRAs.pdf).

293. *Id.*

294. *Id.*

295. *Id.*

296. *See* INV. CO. INST., THE U.S. RETIREMENT MARKET, THIRD QUARTER 2014 tbl.8 (2014) available at [http://www.ici.org/research/stats/retirement/ret\\_14\\_q3\\_data.pdf](http://www.ici.org/research/stats/retirement/ret_14_q3_data.pdf). Traditional IRAs hold vastly more wealth overall than Roth IRAs. As of 2013, \$6.019 trillion in assets were held in traditional IRAs while only \$505 billion were held in Roth IRAs. *Id.*

297. I.R.C. § 402A(a)(1) (2012). *See Roth 401(k) & 401(B) Contributions: Making Sense of It All*, RBC WEALTH MGMT. (Oct. 2014), <http://www.rbcwm-usa.com/resources/file-687833.pdf>.

403(b) plans.<sup>298</sup> In 2011, the list expanded to include governmental 457(b) plans.<sup>299</sup> These DRACs are commonly called “Section 401(k) plans” or “Section 403(b) plans.”<sup>300</sup> Although the rules for all three are basically the same, this Article will focus on Roth 401(k) plans, which are the most common.<sup>301</sup> Although employers may offer these plans, they are not required to do so.<sup>302</sup> Said differently, it is perfectly acceptable for an employer to offer a traditional 401(k) plan but not a Roth 401(k) plan.

The basic idea of a Roth 401(k) plan is very similar to that of a Roth IRA. The employee may elect to defer a portion of wages into the plan.<sup>303</sup> The diverted wages are not excluded from income (like a 401(k)) or deductible from income (like an IRA), but they will grow tax-free within the plan.<sup>304</sup> Amounts taken out of the plan in the future generally are not subject to income taxes.<sup>305</sup> Unlike Roth IRAs, however, there is no income cap above which an employee may not make contributions.<sup>306</sup> Very high-income people who work at companies that have such a plan will be likely to use them.<sup>307</sup>

The maximum amount that an employee may divert into a Roth 401(k) in a given year is the same as the maximum amount that may be contributed to a traditional 401(k) plan.<sup>308</sup> More specifically, the total combined amount that an employee may contribute to traditional 401(k) plans and Roth 401(k) plans in any given year is capped at a specific dollar amount. For 2014, that amount is \$17,500.<sup>309</sup> This is significantly greater than the \$5,500 that may be contributed to a Roth IRA in 2014.<sup>310</sup>

A major difference between a Roth 401(k) and a Roth IRA is that Roth 401(k) plans are subject to the minimum distribution rules during the participant’s

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298. G. VICTOR HALLMAN & JERRY S. ROSENBLOOM, *PRIVATE WEALTH MANAGEMENT* 344 (8th ed. 2009).

299. I.R.C. § 402A(e)(1). See *Pension Analyst*, PRUDENTIAL (Oct. 2010), <http://www.prudential.com/media/managed/InPlanRothConversion-PruPA-1010.pdf>.

300. See, e.g., Mary Kay Foss, *Estate Planning: Roth IRA Changes*, GROCO CPAS & ADVISORS, [http://www.groco.com/readingroom/ira\\_rothchanges.aspx](http://www.groco.com/readingroom/ira_rothchanges.aspx) (last visited Apr. 7, 2015).

301. *Ultimate Guide to Retirement*, *supra* note 89.

302. See HALLMAN & ROSENBLOOM, *supra* note 298, at 344.

303. *Id.*

304. *Id.*

305. See *id.*

306. I.R.C. § 402A(c)(2) (2012). See *Roth Comparison Chart*, IRS, <http://www.irs.gov/Retirement-Plans/Roth-Comparison-Chart> (last updated Oct. 23, 2014).

307. See HALLMAN & ROSENBLOOM, *supra* note 298, at 344. This, of course, is subject to standard nondiscrimination rules and tests.

308. I.R.C. § 402(g)(1)(B). See *Roth Comparison Chart*, *supra* note 306.

309. I.R.S. News Release IR-2013-86 (Oct. 21, 2013). On top of the \$17,500, an additional \$5,000 “catch up” contribution is allowed each year for participants who are age fifty or older by the end of the year. *Id.* See I.R.C. §§ 402(g)(1)(C), 414(v)(1).

310. I.R.S. News Release IR-2013-86 (Oct. 21, 2013).

lifetime, whereas Roth IRAs are not.<sup>311</sup> Both are subject to the minimum distribution rules after the participant's death.<sup>312</sup> For purposes of this proposal, the main effect of subjecting Roth 401(k) accounts to the minimum distribution rules is that the long-term tax benefits of the Roth 401(k) are lower than those of a Roth IRA because the Roth 401(k) participant does not have the option of deferring distributions until after death.<sup>313</sup>

### C. Smooth Retirement Accounts

Professor Thomas J. Brennan has raised an interesting proposal characterized by what he calls "Smooth Retirement Accounts," which lie somewhere between the back-loaded taxation of traditional retirement accounts and the front-loaded taxation of Roth-type accounts.<sup>314</sup> His proposal attempts to address this Article's concern with taxpayers' choices to invest for retirement when the decision requires understanding complicated and varying information regarding future tax rates as well as the individual taxpayer's changing tax situation based on earnings in a given year.<sup>315</sup>

The heart of Professor Brennan's proposal is relatively simple. He argues that retirement saving tax payments should not require full payment at either the time of contribution or distribution.<sup>316</sup> Instead, tax payments should be spread out over time.<sup>317</sup> In addition, in order to avoid distorting investment decisions, he argues that taxes should be levied without reference to investment performance in the account.<sup>318</sup>

This Article does not attempt to analyze the merits of Professor Brennan's proposal. However, his proposal illustrates how our current system forces taxpayers to make highly complex decisions with radically different outcomes that are based on variables impossible to predict. Professor Brennan is attempting to remove these variables from the decision-making process. His proposed solution offers a radical change to our current system. This Article, on the other hand, takes a bite-sized approach by focusing on just one variable: the different tax treatment of assets inherited from a traditional retirement plan versus the tax treatment of assets inherited from outside a retirement plan or from a Roth-type retirement plan.

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311. Compare I.R.C. § 408A(c)(5), with Treas. Reg. § 1.401(k)-1(f)(3) (2014).

312. I.R.C. § 401(a)(9). See Treas. Reg. § 1.408A-6 (2014).

313. See *supra* note 311 and accompanying text.

314. Thomas J. Brennan, Professor of Law, Northwestern University School of Law and Professor of Finance (Courtesy), Address at the New York University School of Law Colloquium on Tax Policy and Public Finance: Smooth Retirement Accounts (Feb. 11, 2014), available at [http://www.law.nyu.edu/sites/default/files/upload\\_documents/Thomas%20Brennan.pdf](http://www.law.nyu.edu/sites/default/files/upload_documents/Thomas%20Brennan.pdf).

315. *Id.* at 1–2.

316. *Id.* at 2.

317. *Id.*

318. *Id.*

## VI. PROPOSED AMENDMENTS

The author's proposal would require that the U.S. Secretary of the Treasury amend Treasury Regulations § 1.691(b), which defines "income in respect of a decedent."<sup>319</sup> In addition, although arguably unnecessary, it would be prudent for Congress to amend I.R.C. § 691, which deals with IRD. If Congress made these changes, it would not need to amend § 1014(c) (dealing with the stepped-up basis at death). Congress would need to amend § 72(c) to permit the basis step-up to count as an "investment in the contract."<sup>320</sup> The following sections address each of these changes in turn.

As mentioned, § 691 does not define "income in respect of a decedent," but the Treasury Regulations define it to include "amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for a taxable year ending" on or before his date of death.<sup>321</sup> The term specifically includes accrued income of a decedent and contingent claims that the decedent had at the time of death.<sup>322</sup> To implement this proposal, the following language would need to be added to the end of § 1.691(a)-(b) of the Treasury Regulations:

Notwithstanding the foregoing, the term "income in respect of a decedent" shall not include any amounts contained in a retirement plan under Internal Revenue Code sections 401(a), 403(b), 408, or 457(b), except for the value of contributions made by the decedent or the decedent's employer that were either excluded from the decedent's income or deducted by the decedent. In the event that the total value of the contributions shall exceed the value of the account on the decedent's date of death, then 100% of the account shall be deemed to be income in respect of a decedent.<sup>323</sup>

Effectively, this language redefines IRD with respect to traditional retirement plans to only treat as IRD the value of the plan up to the sum of (1) amounts contributed to the plan by the employer that were excluded from the employee's (participant's) income; (2) amounts contributed to the plan by the employee (participant) in a CODA arrangement, such as a 401(k) plan; and (3) in the case of a deductible IRA, amounts contributed to the plan by the account owner that were deducted. This language does not affect the treatment of Roth-type retirement plans. Said differently, previously untaxed income would be IRD;

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319. The Code provides that "the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of [the Internal Revenue Code], including all rules and regulations as may be necessary by reason of any alteration of law in relations to internal revenue." I.R.C. § 7805(a) (2012).

320. I.R.C. § 72(c)(1).

321. Treas. Reg. § 1.691(a)-1(b) (2014).

322. *Id.* § 1.691(a)-1(b)(1)-(3).

323. The total value of the contributions would exceed the value of the account if, for example, stock held in the account went down in value after purchase.

however, once the contribution is inside the retirement plan, it may be invested in, say, stock, and all growth of the stock or dividends produced by the stock will not be treated as IRD. This approach would not affect the treatment of distributions from the plan during the participant or account owner's lifetime. It would only alter the tax treatment at death to put traditional retirement plans on equal footing with assets invested outside of retirement plans.

It is not entirely clear that the Secretary of the Treasury has the authority to unilaterally change the definition of IRD. After the seminal 1984 decision of *Chevron U.S.A. Inc. v. Natural Resources Defense Council*,<sup>324</sup> courts began to make a distinction between regulations issued with an express grant of statutory power and regulations that merely interpreted statutes<sup>325</sup> without an express grant of authority.<sup>326</sup> Regulations with an express grant of statutory authority were afforded what became known as “*Chevron* deference”; that is, they were essentially given the same weight as congressional legislation.<sup>327</sup> In the 2011 case of *Mayo Foundation for Medical Education and Research v. United States*,<sup>328</sup> the Supreme Court effectively did away with the traditional distinction between interpretive regulations and regulations issued with an express grant of statutory authority.<sup>329</sup> Effectively, Treasury Regulations now receive *Chevron* deference.

Despite the strong deference granted to Treasury Regulations, it would seem prudent from a political perspective only to make a change of the magnitude proposed in this Article with congressional action. Because the proposed action effectively is a tax cut that occurs at the time of death, it would seem fairly easy to get congressional approval of the change. To do this, Congress would need to amend § 691. As mentioned, the Code does not define “income in respect of a decedent,” and the burden of supplying the definition has fallen on the courts and on the Department of the Treasury.<sup>330</sup> This Article does not propose an alteration to this historic burden. Rather, this Article proposes that Congress create a new § 691(a)(6), which would contain the exact language proposed above.<sup>331</sup>

Section 691(a)(3) currently notes that an item of IRD is to have “the character which it would have had in the hands of the decedent if the decedent had lived

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324. 467 U.S. 837 (1984).

325. Referred to as “interpretative regulations.” *Id.* at 851–52 (quoting H.R. REP. NO. 95-294, at 211 (1977), reprinted in 1997 U.S.C.C.A.N. 1077, 1290).

326. See Kristin E. Hickman, *The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1545–46 (2006).

327. *United States v. Mead Corp.*, 533 U.S. 218, 226–27 (2000).

328. 131 S. Ct. 704 (2011).

329. *Id.* at 713–14.

330. See *supra* Part II.B.

331. See *supra* note 323 and accompanying text.

and received such amount.”<sup>332</sup> Because the proposed new language would apply both to the Treasury Regulations and the Code, there should be no need to alter this language of § 691(a)(3). Although it is arguable that the tax treatment of retirement plan assets should be the same whether the assets are paid out during the participant or account owner’s lifetime or after death, § 691(a)(3) is specifically limited to IRD. By redefining IRD to exclude post-contribution gains from the definition of IRD, § 691(c) would not affect the character of that gain.

As mentioned, Congress would not need to amend § 1014(c) to achieve the objective of this Article. This is because § 1014(c) provides as follows: “[t]his section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.”<sup>333</sup> Thus, the stepped-up basis at death is the default rule, and IRD is the exception. By redefining IRD to effectively exclude post-contribution gains in retirement plans, those gains will be eligible for the basis adjustment to market value on date of death.

It is helpful at this point to lay out a couple of examples to illustrate how this proposal would work in practice. First, assume that the decedent had transferred a total of \$100,000 into a deductible IRA during his lifetime. Also assume that the account, which contains only publicly-traded stock, is valued at \$150,000 on the date of the decedent’s death. The decedent’s heir, assuming a lump sum distribution, would inherit the property with a basis of \$50,000. Said differently, the first \$100,000 in the account is defined as IRD, which is not eligible for the basis step-up. This will produce \$100,000 of ordinary income for the heir. Effectively, the step-up only applies to the additional \$50,000 of value in the account. When the dust settles, the heir will pay taxes on \$100,000 of ordinary income, and he will take the property with a total basis of \$150,000.

Second, assume that the decedent had transferred a total of \$100,000 into a deductible IRA during his lifetime; but, now assume that the account, which contains only publicly traded stock, is only valued at \$50,000 on the date of the decedent’s death. In this case, the entire account would be deemed to consist of IRD. Thus, the decedent’s heir, assuming a lump-sum distribution of the entire \$50,000 worth of stock, will have ordinary income of \$50,000. He will then have a basis of \$50,000 in the stock.

In order for this proposal to work, one additional change will need to be made to the Code. This change is directed at the situation in which the decedent’s heir does not take the entire account balance as a lump-sum distribution but, instead, receives annuitized payments or substantially equal payments over the heir’s life expectancy. As mentioned, all distributions from a traditional employer-sponsored retirement plan to the participant are taxable as ordinary income to the participant, except to the extent that the distribution represents recovery of

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332. I.R.C. § 691(a)(3) (2012).

333. *Id.* § 1014(c).

the participant's "investment in the contract."<sup>334</sup> As previously mentioned, this is commonly referred to as the participant's "basis" in the plan, and amounts attributable to that basis are not generally taxable to the participant or to the participant's beneficiary. With respect to this proposal, it is necessary to expand this idea and establish that the beneficiary's basis in the account should be increased by the new basis step-up that applies to the plan. To do this, a new § 72(c)(5) should be enacted, which would read as follows:

(5) *Adjustment in investment where property is acquired from a decedent.* In the case where property is acquired from a decedent, the recipient's investment in the contract shall be the sum of the decedent's investment in the contract and any basis adjustment allowed with respect to the property under section 1014.

The goal of this new section would be to put the heir in the decedent's shoes with respect to the account and to increase the heir's basis in the account by any basis step-up allowed with respect to the account as a result of the decedent's death.

#### A. *The Benefits of the Proposal*

The proposal set forth in this Article attempts to remove a penalty that can affect people who decide to save for retirement through a traditional retirement plan: the loss of the stepped-up basis at death.

##### 1. *Equity*

As mentioned, the concept of "horizontal equity" requires that similarly situated taxpayers bear similar tax burdens,<sup>335</sup> and the concept of "vertical equity" requires that taxpayers who are not similarly situated bear tax burdens relative to their respective abilities to pay.<sup>336</sup> This proposal greatly increases both horizontal and vertical equity by having the basis step-up apply to assets whether or not they are held in a traditional retirement plan. Thus, the estates of two similarly situated taxpayers (one with assets in a traditional retirement plan and the other with assets outside a traditional retirement plan) are treated almost the same for income tax purposes, which respects horizontal equity. The only difference in treatment is with respect to assets that were contributed to the plan by the decedent or the decedent's employer. Because these assets received favorable tax treatment at the time of contribution, thereby reducing the decedent's tax liability at that time, they do not again receive favorable treatment when the decedent dies. That being said, investing through a traditional retirement plan is still preferable under this proposal because of the time value of money. For example, a \$100,000 deduction at the time of contribution would

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334. *Id.* § 72(b)(2).

335. *See supra* note 203 and accompanying text (defining horizontal equity).

336. *See supra* note 204 and accompanying text (defining vertical equity).

only result in a lost tax benefit of \$100,000 at death, even if the decedent dies thirty years after the contribution date. This makes investing through a traditional retirement plan somewhat more desirable than investing outside a traditional retirement plan, which is consistent with the congressional goal of encouraging people to utilize retirement plans.<sup>337</sup>

In addition, this proposal respects vertical equity. As mentioned, exceptionally wealthy people are likely to hold the bulk of their assets outside a traditional retirement plan because there are absolute limits on the amount that may be contributed to retirement plans each year.<sup>338</sup> These people unquestionably have the greatest ability to pay. This proposal greatly reduces the current inequitable situation by ensuring that both ways of investing will qualify for the basis step-up. However, for various reasons, it is not a perfect solution. First, as previously noted, the proposal does not compensate for the time value of the earlier deduction to a traditional retirement plan and the later loss of a tax benefit based on that absolute dollar amount. This provides a slight benefit to traditional retirement plans over investing outside of a plan. If very wealthy people are less likely to utilize traditional retirement plans than less wealthy people, then this is actually consistent with the principle of vertical equity, but it is rough justice. Second, this proposal does not address the significant difference between ordinary rates and capital gains rates. As mentioned, IRD produces ordinary income, which is taxable at rates of up to 39.6%, while investments in most assets outside of retirement plans produce capital gains, which are taxable at rates of up to 20%.<sup>339</sup> This proposal does not address this disparity, but it is something that could be considered in a more comprehensive proposal. As it now stands, the current rate differential benefits people who invest outside of retirement plans, which severely compromises vertical equity.

## 2. Efficiency

While this proposal improves the equity situation, it weakens administrative efficiency when one considers the added complexity of the proposal. This proposal also accounts for efficiency concerns regarding both indirect costs (*i.e.*, costs to taxpayers for attempting to comply with the law) and direct costs (*i.e.*, costs to the government for administering the tax law). The proposal increases both of these costs because it ensures that any inheritance of a traditional retirement plan will come with an “investment in the contract.” Thus, a portion of any distribution will be a nontaxable return of capital from the basis step-up, and another portion will be taxable because it comes from contributions of the decedent or the decedent’s employer. This certainly adds a degree of complexity

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337. See *supra* note 99 and accompanying text.

338. See *supra* notes 12, 207 and accompanying text.

339. See *supra* notes 209–10 and accompanying text.

because the beneficiary will need to identify which portion of a distribution is taxable and which portion is not.<sup>340</sup> This complexity similarly applies to the government's efforts to ensure the proper payment of taxes.

### 3. *Neutrality*

The concept of tax neutrality suggests that the Code, to the extent possible, should not cause people to alter behavior solely for tax reasons unless there is a public policy reason for doing so.<sup>341</sup> Our current system fails at this because it encourages people to save for retirement through traditional retirement plans, but then treats those plans very unfavorably if the taxpayer dies before the plan assets are distributed. This Article's proposal eliminates this problem by removing one unfavorable aspect of investing through a traditional retirement plan. While the proposal does not go so far as to make a traditional retirement plan significantly better than investing outside such a plan,<sup>342</sup> it at least removes this key barrier.

#### *B. The Problem with the Proposal*

The single biggest problem with this Article's proposal is that it will certainly create a degree of revenue loss for the federal government. It is impossible to accurately forecast the amount of revenue loss because too many variables are involved. For example, revenue loss will certainly depend on future tax rates. Even utilizing current rates, it is difficult to identify the effect because the tax on distributions is not imposed until the beneficiary takes a distribution from the plan. A beneficiary who will receive a basis step-up might decide to accelerate distributions if he or she owes very little taxes. These behavior modifications are speculative at best. Nevertheless, it is safe to say that excluding from taxation the gain that is currently taxed will, overall, result in a revenue loss for the federal government.

## VII. CONCLUSION

The main benefit of this Article's proposal is that it reduces a gross inequity that now exists between investing through a traditional retirement plan and investing outside such a plan. That inequity is the stepped-up basis at death, which does not apply to assets held inside a traditional retirement plan. Extending the step-up to traditional retirement plans does not remove all inequities, but it is a large step in the right direction. Additionally, the proposal is consistent with congressional intent to entice people to utilize retirement plans to save for retirement.

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340. This rarely happens under the current system.

341. See Donaldson, *Future of Transfer Taxation*, *supra* note 203, at 550–51.

342. Traditional retirement plans could be made better, for example, by abolishing the basis step-up outside traditional retirement plans while creating a basis step-up only for investments inside traditional retirement plans.

Current law incentivizes the use of traditional retirement plans when those plans may not actually produce the best long-term tax situation for the taxpayer. These improvements come with a cost: extending the basis step-up to traditional retirement plans will cause the federal government some revenue loss. However, this loss is a relatively small price to pay to reduce current inequities and to ensure that tax policy encourages behavior that is actually beneficial to the taxpayer.

