THE TAXATION OF INDIVIDUAL RETIREMENT PLANS: INCREASING CHOICE FOR SENIORS

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Abstract

For many senior citizens, individual retirement plans, such as IRAs and 401(k)s, are a primary saving vehicle for retirement. Along with Social Security, individual retirement plans ("IRPs") represent a major source of money for retirement. However, even though IRPs are a valuable saving vehicle for many seniors, many IRPs have one major drawback: the forced distribution of assets and the associated taxation of those assets for senior citizens at age 70½ for traditional IRAs and the later of age 70½ or the year in which the account holder retires for 401(k)s. This requirement forces many seniors to take distributions when they do not need them Worse, in cases of a down market, the forced distributions may require seniors to sell assets at depressed prices to pay taxes, even if investment losses have been incurred.

This study addresses the minimum distribution requirement that effectively forces senior citizens to withdraw funds from IRPs or face a 50 percent excise tax, the reasoning behind the requirement, and the economic harm it can have on seniors, and some policy alternatives to this requirement that would help mitigate the bias against seniors and their retirement that this requirement creates.

This study proposes several options that would either repeal or modify the minimum age requirement for forced distributions beginning at age 70½. These options include: repeal, limited repeal, an increase in the minimum withdrawal age, a limited exclusion, a credit for excess withdrawals, allowing losses to be applied to other gains, and a grace period.

Any of the proposals would enhance efficiency by providing seniors with the choice of determining when it is in their best interest to make a withdrawal from their IRP, how much to withdraw and subsequently pay the appropriate tax. The individual is in the best position to know when is the right time to elect to make withdrawals, not the government. Further, forcing seniors to sell assets in market conditions that have reduced their retirement plan assets may undermine the retirement security of seniors and produce *less* tax revenue to the government.

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> We believe that there is a strong case for changing the minimum distribution requirements to reflect increases in life expectancy, the increase in labor force participation by women and older people, and the need for financing long-term care late in the life cycle.
>
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I. INTRODUCTION

Individual retirement plans ("IRPs") have many different variations. As defined here, IPRs include Individual Retirement Arrangements (IRAs), also commonly referred to as individual retirement *accounts*, and similar retirement plans such as 401(k)s. IRPs have become an important vehicle for many households to invest in the market and save for their retirement. Most of these plans allow for limited annual contributions to be made before taxes into a retirement account.[2] For example, traditional IRA contributions are tax deductible within certain limits. The contributions are allowed to grow deferred from taxation until withdrawal. IRPs can be invested in stocks, bonds, money-market funds, or a combination of all three.

Over the past decade, assets held in IRPs have increased approximately 250 percent, from $1.4 trillion in 1990, to an estimated $4.9 trillion in 2001.[3] IRAs have increased an estimated 277 percent, from $636 billion in 1990, to an estimated $2.4 trillion in 2001. Similarly, 401(k)-type retirement plans increased approximately 230 percent, from $756 billion in 1990, to $2.5 trillion in 2001.[4] For 2001, 39.7 percent, or 41.9 million U.S. households owned IRAs. An estimated 34.1 million households, or nearly one-third of all U.S. households, held traditional IRAs.[5]

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[1]Mark Warshawsky, "Distributions from Retirement Plans: Minimum Requirements, Current Options, and Future Directions," TIAA-CREF Institute, *Research Dialogues*, No. 57, September 1998, page 10.

[2] The exception being Roth IRAs, which are funded with post-tax dollars and the returns to which are then tax-free.

[3] Investment Company Institute, *Fundamentals*, June 2002, Figure 5, page 4. Includes IRAs and defined contribution plans, such as 401(k)s and the Federal Employees Retirement System (FERS) Thrift Savings Plan (TSP). Detail may not add due to rounding.

[4] *Ibid*. Detail may not add due to rounding.

[5] Investment Company Institute, *Fundamentals*, September 2002, Figure 1, page 1.

For many senior citizens, IRPs can be a primary saving vehicle for retirement. Further, along with Social Security, IRPs represent a major source of money for retirement. However, even though IRPs have been a valuable saving vehicle for many seniors, they do have one major drawback: the forced distribution of IRP assets and the associated taxation of those assets for senior citizens once they reach age 70½.[6]

Since most IRPs are funded with pre-tax dollars that are allowed to grow tax-deferred, eventual distributions from IRPs at retirement are taxed at the individual income tax rate. In order for the government to recapture the deferred taxes on the original contribution plus the related appreciation, the government generally requires seniors to begin withdrawing from their IRPs once they reach age 70½. This requirement often forces seniors to take distributions when they do not need them.

Worse, in cases of a down market, the forced distributions could require seniors to sell some of the assets in their IRPs at a loss and still have to pay taxes on the loss. Usually, the government does not tax transactions that generate losses. However, for those IRPs that are funded with pre-tax dollars a tax is due on distributions even if the distributions are at a loss. For many seniors, a forced distribution that might require assets to be sold at a loss could jeopardize their economic welfare in their remaining retirement years. This would be counter to the original intent of IRPs: to allow individuals to save and invest so that they have enough money to live a secure retirement. Further, forcing withdrawals according to an overly rigid schedule can limit the ability of seniors to smooth their consumption patterns over their retirement years and even deprive them of needed financial resources in case of future illness or other financial necessities.

The treatment of IRP withdrawals reflects an underlying problem with the U.S. income tax system. In many respects, the current tax system is counterproductive and biased against saving and investment. In general, the tax system imposes large losses on the economy that reduce the economic welfare of households. The current levels of taxation can impose relatively high output and welfare costs on the economy. While the range of economic losses imposed by the current level of taxation is rather broad, a conservative estimate is that these excess marginal burdens range from 25 to 40 cents of the last dollars raised in federal revenue; other estimates range much higher.[7]

The tax treatment of senior citizens invested in IRPs over age 70½ can be even more punitive. In short, effectively forcing seniors to take mandatory withdrawals from their IRPs once they reach age 70½ is not only biased against saving and investment but also biased against senior citizens in general and women in particular, at exactly the time

[6] Owners of IRA accounts must begin minimum withdrawals at age 70½. However, holders of 401(k) plans have the option of beginning their withdrawals at age 70½ or at retirement, whichever is later, so long as the account holder remains employed by the same employer that sponsored the 401(k) plan.

[7] For more information, see: United States Congress, Joint Economic Committee, *Tax Reduction and the Economy*. April 1999.

when they need all of their savings. This policy is not only unfair to seniors but is out of date with current work and retirement realities, as people continue working at older ages (some well past age 70) and life expectancies, especially for women, have increased and are continuing to increase. Further, in volatile market and financial conditions, seniors need flexibility in deciding how and when to withdraw their retirement assets. It is time that policy action be taken to alleviate this unfair tax treatment levied on seniors.

This study addresses the requirement that forces senior citizens to begin withdrawing from IRPs once they reach age 70½, the reasoning behind the requirement, the economic harm it can have on seniors and some policy alternatives to this requirement that would help mitigate the bias on seniors and their retirement that this requirement creates. Section II addresses some economic considerations and how the current tax treatment of forcing seniors to begin taking distributions from their IRPs once they reach age 70½ can unfairly and punitively affect performance, saving and investment and possibly jeopardize the future health of seniors' retirement funds. Section III of this paper provides a brief technical introduction to the mandatory withdrawal requirements and their implications. Section IV highlights some demographic statistics to illustrate the importance of IRPs as an investment vehicle for many millions of seniors. Section V addresses policy considerations to restore the fair tax treatment of senior citizens.

II. Economic Considerations

Individual retirement plans ("IRPs") have may different variations (e.g., traditional IRA, Roth IRA, 401(k), Keogh, etc.) but fall into two basic categories: those that have contributions funded with *pre-tax* dollars (deductible) and those funded with *after-tax* dollars (nondeductible).

The advantage of these retirement plans is simple: a participant may save during working years and continue to have such savings grow without taxes until the funds are withdrawn in retirement. Contributions to most of these plans are tax-deferred or tax-deductible and the tax becomes due once withdrawals are made. Other plans allow contributions to be made with after-tax dollars and the proceeds to be withdrawn tax-free during retirement.

The requirement to force seniors to begin taking distributions from IRPs only applies to traditional IRAs or 401(k) plans that are funded with deductible or tax-deferred contributions. This is because the government eventually wants to recapture these tax dollars on the contributions, plus related appreciation. Retirement accounts funded with deductible contributions are allowed to defer the original tax due. In order to ensure that the deferral does not last forever, the government requires seniors to begin withdrawing from these types of retirement accounts once they reach age 70½. However, even this treatment is not identical across deductible retirement accounts.

As mentioned, holders of traditional IRAs, as well as workers with pension plans from prior employers, must begin mandatory withdrawals beginning at age 70½. However, holders of 401(k) plans, also funded with deductible contributions, have the option of beginning their withdrawals at age 70½ or in the year in which they retire, whichever is later, so long as the account holder remains employed by the same employer that sponsored the 401(k) plan. Thus, a person with a 401(k) plan who decides to work until age 75 could continue to defer paying tax on their retirement account past age 70½, while a similar person with a traditional IRA would have to begin taking distributions once they reached 70½ even if they continued to work. In some cases, a person over age 70 with a traditional IRA could continue to work and still contribute to a 401(k) plan while simultaneously be required to withdraw funds from the traditional IRA.

The primary problem with requiring individuals to make mandatory withdrawals from their IRAs and 401(k)s is that it could force retirees to either sell capital assets or channel money from some other potentially productive source in order to pay the tax bill. This would not only be unfair, but it would also be inefficient, as resources would have to be allocated away from higher valued uses in order to pay a tax bill. Additionally, in times of down markets or markets with low valuations, seniors could be forced to sell assets at reduced prices or even at losses, just so the government can collect a tax bill. This could have the effect of forcing seniors to sell assets at reduced values during the years when they need savings the most. Lastly, in the event that some assets had to be sold at a loss, the loss would not be deductible either against capital gains or ordinary income since it was funded with pre-tax dollars.

If seniors are forced to sell assets at reduced values, the government could receive *less* tax revenue than if the same assets were sold for a higher value at a later date. Generally, a deferral of taxation is a benefit to both the investor and the government.[8] Whether a tax deferral actually results in a wash, a gain, or a loss to the Treasury, on a net present value basis, is dependent upon the tax rates in effect at the time of the deferral and at the time the tax payment is made, and the rate of return the deferral creates for the taxpayer. A rate of return greater than that of U.S. Treasury Bills would result in a net gain to the government, as well as the taxpayer, all else being equal. Hence, both seniors invested in IRPs and the U.S. Treasury could benefit from a tax change to the minimum withdrawal requirement.

[8] For a discussion and mathematical proof that shows how deferral of taxation would eventually increase tax revenue to the government, see Irving Fisher, "Paradoxes in Taxing Savings," *Econometrica*, vol. 10, issue 2, April 1942.

III. Technical Aspects of Mandatory Distributions

Individual retirement plans were created to encourage people to save during their working years in order to better fund their retirement. Penalties are imposed for early withdrawal and for failing to withdraw once an account owner reaches a minimum age or retirement.[9] The penalties can be extremely severe: those account holders who fail to make the mandated withdrawals suffer a massive penalty equal to 50 percent on the difference between the amount that should have been withdrawn and the actual amount withdrawn, if any.

Minimum distribution requirements, which establish the periods over which assets of the account must be distributed, were established to ensure that the benefits provided by the retirement account were used to fund retirement and not as an indefinite tax shelter. According to Mark Warshawsky, the former Director of Research at TIAA-CREF Institute and now the Deputy Assistant Secretary for Economic Policy, Microeconomic Analysis, at the U.S. Department of the Treasury, "Minimum distribution requirements were first put into place in 1962 to prevent Keogh plans from becoming vehicles for avoiding income and estate taxes. Since then, they have been imposed on all types of retirement plans. While their original intent may have been valid, the rules have become increasingly outmoded in today's labor market and social conditions, to say nothing of the strict regulatory regime controlling pensions."[10]

Different types of retirement plans have different specifics on when distributions can be made, penalties for early withdrawals, penalties for withdrawing too little during retirement, etc. Generally, account owners must either begin minimum distributions once they retire or reach a minimum age, currently 70½. However, as is the case with many government regulations that limit individual choice, many policies have unintended consequences that can cause much harm.

It is important to start out with a brief background of the regulations relating to minimum withdrawals from IRPs. Generally, there are two sets of requirements: *basic* and *incidental*.[11] Most attention and consideration are given to the *basic* requirements. Under this set of requirements, minimum withdrawal amounts must be made by the account owner beginning at a specified time (no earlier than age 59½ and no later than age 70½). Withdrawals must continue periodically (usually annually) based on percentage amounts specified by life expectancy tables provided for in regulation. The amounts withdrawn are to be included in the account owner's taxable income when filing annual tax returns. *Incidental* requirements set forth the limitations on the ability to defer

[9] Until recently, a penalty also applied if an account owner withdrew too much money in retirement years, but fortunately this has been repealed.

[10] Mark Warshawsky, "Optimal Design of Minimum Distribution Requirements for Retirement Plans," TIAA-CREF Institute, *Benefits Quarterly*, No. 4, 1998, pg. 9.

[11] *Ibid*., pg. 1.

taxation of assets held in IRPs to nonspousal beneficiaries. In addition, incidental requirements establish the mandatory withdrawal amounts and the life expectancy rates to be used when assets held in IRPs are passed on to nonspousal heirs.

Though the rules and calculations can be complex and confusing, required minimum withdrawal amounts are generally determined by dividing the account balance at the end of the year by the number of years listed in a life expectancy table. The life expectancy tables are determined by regulation. For example, using the new uniform lifetime table provided by the IRS, a 75 year old woman would divide her account balance by the number of distribution years listed for age 75, in this case assume 22.9 years.[12] For an account balance of $150,000 this would require a withdrawal of $6,550. Assuming a 27% tax bracket, this would amount to a tax bill of $1,769. The procedure would be repeated again each following year until the account balance is zero or the owner becomes deceased.

The legislative history behind retirement arrangements and minimum distributions requirements is long and detailed, to say the least.[13] For purposes of this study it is necessary only to briefly discuss the 1987 regulations and the new regulations issued January 11, 2001 and finalized April 16, 2002.[14]

Under the old regulations (pre-2001), IRP owners had to withdraw minimum amounts as specified by life expectancy tables at least every year after reaching age 70½. For owners of employer-sponsored retirement plans that were still employed by the employer that sponsored the plan the minimum distributions began after the latter of age 70½ or retirement.[15] Thus, individuals with 401(k) plans who continued to work after age 70½ were not required to make minimum distributions, so long as the account holder remains employed by the same employer that sponsored the 401(k) plan, while owners of traditional IRAs were once they reached age 70½ regardless of whether or not they continued to work.[16] Minimum withdrawals must begin for retirement plans from previous employers at age 70½, regardless of whether the account holder continues to work. Further, minimum distribution requirements from 403(b) plans can be postponed until age 75 for pre-1987 contributions and investment earnings.[17] This unequal

[12] U.S. Department of the Treasury, Internal Revenue Service, *Supplement to Publication 590*, June 2002.

[13] For more information on the regulatory history, see: Mark Warshawsky, "Further Reform of Minimum Distribution Requirements for Retirement Plans," *Tax Notes*, April 9, 2001.

[14] Though the regulations are considered "final" the Internal Revenue Service is still accepting comments and future adjustments may be made.

[15] Persons considered "5 percent owners" in a company retirement plan must begin withdrawals at age 70½.

[16] It should be noted that after the *Tax Reform Act of 1986* and before the 1997 tax reforms, even 401(k) owners had to make minimum withdrawals beginning at age 70½ even if they continued to work.

[17] James R. Storey and Paul J. Graney, "Retirement Plans With Individual Accounts: Federal Rules and Limits," Congressional Research Service, updated March 7, 2002, page 23.

treatment between traditional IRA owners and owners of employer-sponsored retirement plans continues in the new regulations.[18]

As discussed above, the minimum amount was determined every year by dividing the previous year-end account balance by a factor specified in a life expectancy table. A designated beneficiary's life expectancy could be included in the calculations. If the beneficiary was not the spouse of the account owner, the regulations limited the maximum age difference to 10 years. This was done to limit the amount of money and tax benefit that could be provided to nonspousal heirs.

One of two methods could be elected at the time of the first withdrawal for calculating the life expectancy factors. Under the *recalculation* method, which was not available if the beneficiary was not the spouse, the factors set forth in the life expectancy tables are used. The amount to be withdrawn is recalculated every year based on the asset value at the end of the previous period and the corresponding life-expectancy factor for the given age. Under the *period-certain* method, also called the one-year-less method, one year is subtracted from the original life expectancy factor every year that passes after the first distribution, based on mortality tables. This results in a faster drawdown of the account, as withdrawals increase rapidly until the initial age of life expectancy is reached and the balance reduced to zero.

The recalculation method generally allows for lower amounts to be withdrawn yearly, while the period-certain method will result in higher amounts and a faster depletion of the account. Regardless of the method chosen, a 50 percent excise penalty tax was applied on the difference between the mandatory minimum distribution amount required and the amount actually withdrawn, if any. The complexity of the regulations and confusion surrounding the different sets of regulations, along with the potential for severe penalties, necessitated the advice of a professional accountant for many retirees. This complexity adds an additional cost to complying with the regulations.

These regulations resulted in much confusion and criticism.[19] For example, life expectancies have increased and are expected to increase further. Hence, mandatory withdrawals should be lessened to allow for increased life expectancy. Second, many people continue to work well past age 70½, and therefore it was suggested the minimum age should be raised. Third, the life expectancy tables were based on, or more heavily weighted towards, men's mortality. Hence, women who tend to have longer life expectancies were forced to make larger withdrawals than should have been necessary.

[18] Since many employer-sponsored retirement plans take the place of pensions and the administrative burden that would be placed on plan administrators, the different treatment is allowed. However, since both employer-sponsored retirement plans and traditional IRA plans are funded with tax deferred dollars and are intended for "retirement" it can be argued that this treatment is not equitable and discriminates against traditional IRA owners.

[19] For a detailed analysis of these regulations and their difficulties, see: Mark Warshawsky, "Further Reform of Minimum Distribution Requirements for Retirement Plans," *Tax Notes*, April 9, 2001, page 299.

Fourth, the period-certain method was strongly criticized for its tendency to require high distributions that abruptly ended. Therefore, individuals could outlive their savings. The 50 percent penalty applied to withdrawals that were too low was considered overly punitive. Others claimed noncompliance with the minimum withdrawal requirements was extensive, as the IRS never provided specific guidance on what documentation was required.

In January 2001, the IRS released new guidelines covering minimum distribution rules from retirement accounts. The regulations were "finalized" in April 2002 but remain open for additional comments from the public. The new guidelines attempt to address many of the concerns and problems associated with the old regulations and are a step in the right direction. However, many of the procedures and requirements stay the same. The new regulations still require mandatory withdrawals for owners of IRP plans, but now allow for the use of better standardized life expectancy tables, which are longer than the previous tables and allow for smaller annual withdrawals.

Also, the new regulations addressed some compliance concerns. The IRS will now require the trustee or custodian of an individual's IRP to report both the year-end value of the IRP and the required distribution for the next year. This will presumably make it easier for the IRS to audit taxpayers to ensure correct withdrawals are being made.

Though many changes were made to the regulations to ease the complexity and financial burden on IRP owners, the main problems and inequities still remain. For example, the bias against saving remains intact and owners of IRAs and 401(k)s can still be forced to make withdrawals from accounts that are depressed in value, which could contribute to an erosion of the savings seniors need for future living expenses, medical needs or other expenses.

Additionally, even under the new rules, it is possible for seniors to get hit with two penalties in one year. If a senior fails to withdraw the required minimum distribution in the first year due and in a consecutive year, the April 1st deadline for making the first withdrawal may cause the senior to pay the 50 percent penalty for the two-year period in one year, along with both distributions. For example, if the senior were 70½ in 2002, the first mandatory withdrawal would be due April 1, 2003. By the end of 2003, two minimum withdrawals would be required to be paid, one for 2002 and one for 2003.

Further, if seniors finds it necessary to withdraw larger amounts than are required, for example to pay medical bills, the next year's withdrawal requirement would be based on the new reduced asset value, even though excess funds were withdrawn in the previous year. In other words, a credit is not provided for excess funds withdrawn in one year to be carried over to future withdrawal requirements.

It should also be noted that the new regulations still require that seniors use the most recent available account valuation for the given year. This is usually the last account statement of the calendar year. Withdrawals must be made in the following year. This could lead to an instance where a senior retirement account falls in value between the time of withdrawal and previous year-end account valuation, as would likely be the case for many seniors in 2002. Hence, a senior would be forced to take out *more* money than should be necessary. Of course, the opposite would be the case if the account value were to rise in value between the withdrawal period and the previous year-end account valuation.

To further illustrate this problem, and place it within the context of the current stock market fluctuations, consider the following example. A senior retiree has a beginning year balance of $125,000 in a traditional IRA. At the end of year one the market is up and the senior now as an account value of $150,000. Suppose the minimum distribution requirement forces a senior to withdraw 10 percent, or $15,000. A few months into the second year, and before the senior makes the required minimum withdrawal, the market declines heavily and reduces the value of the asset base by one-third. The senior is still forced to withdraw the $15,000, though on an account that is now valued at $100,000. The $15,000 minimum withdrawal turns into a 15 percent withdrawal instead of the 10 percent originally required.

This withdrawal then further reduces the overall asset value of the retirement account going into the end of the second year. The market continues to decline throughout the second year and the minimum distribution requirement for the second year is based on an even smaller account value and the mortality factor in the life expectancy tables now force an even larger percentage to be withdrawn from the retirement account. In a short period of time, the value of the retirement account dwindles substantially. Further, the sale of assets in a down market, especially when such selling by retirees is aggregated over all retirement accounts that meet the minimum distribution requirement, might further depress market asset values. This illustration highlights the economic inefficiencies embedded in the minimum withdrawal requirement and why reform is necessary.

Forcing seniors to sell retirement assets just to pay a tax bill when they do not necessarily need the money at the time is bad tax policy and could do long-term harm to the security of senior citizens. Other options are available that would both alleviate this unfair burden and, if necessary, still recoup tax revenue for the government. These options are discussed in Section V.

IV. Demographic Highlights

Before examining in detail several policy proposals that address the unfair tax treatment of individual retirement plan owners, some demographic highlights are provided. According to data from the Federal Reserve Board's Survey of Consumer Finances (SCF), 48.8 percent of all families owned some type of tax-deferred retirement account in 1998. In 1995, 45.2 percent of all families owned such retirement accounts.[20]

Comprehensive data are not available from a single source that compares and contrasts demographic information on all the various forms of IRPs. Fortunately, some compelling data are available relating to IRAs and to a much lesser extent 401(k)s, the plans that are most predominately affected by the minimum distribution requirements. A review of the data relating to IRAs and 401(k)s shows that many millions of Americans could benefit from a change to the mandatory distribution requirements relating to IRPs.

An estimated 42 million American workers owned a 401(k) plan, with assets totaling $1.8 trillion, at the end of 2000.[21] Approximately 33 percent of all 401(k) participants also had someone in the household that owned an IRA.[22] If the sample is changed to include workers with an employer-sponsored retirement plan, 58 percent of these workers also owned an IRA.[23]

More detailed information is available on IRAs. For example, an estimated 41.9 million households (or 40 percent of all U.S. households) owned an IRA as of 2001. This is up from 30.6 million households owning IRAs in 1998 (30 percent of households), or a 37 percent increase in just three years. Chart 1 displays the number of households owning IRAs from 1998 – 2001, and corresponding percentages.

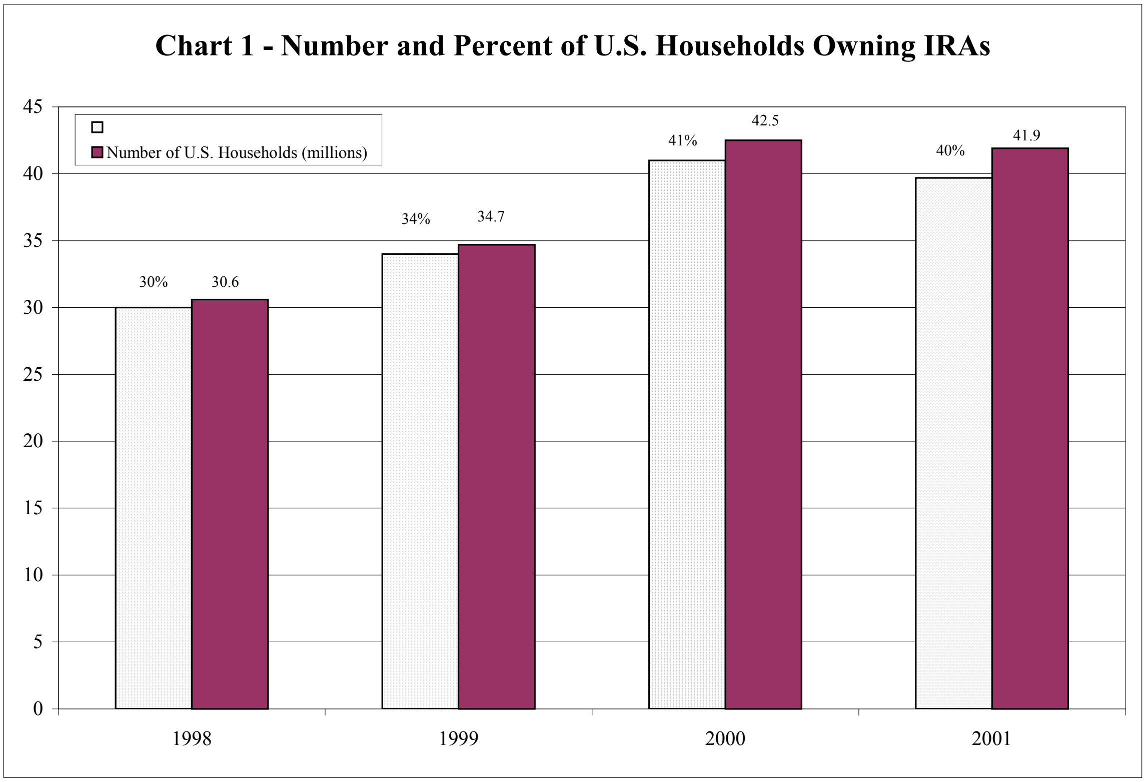
Additionally, as can be seen in Chart 2, the number of households that own traditional IRAs numbered 34.1 million in 2001 (32 percent of all U.S. households). The number of households with traditional IRAs has increased 34 percent since 1998 when 25.5 million households owned traditional IRAs.

[20] Arthur B. Kennickell, Martha Starr-McCluer and Brian J. Surette, "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," *Federal Reserve Bulletin*, January 2000, page 12. Tax-deferred retirement accounts include individual retirement accounts (IRAs), Keogh accounts, and certain employer-sponsored accounts.

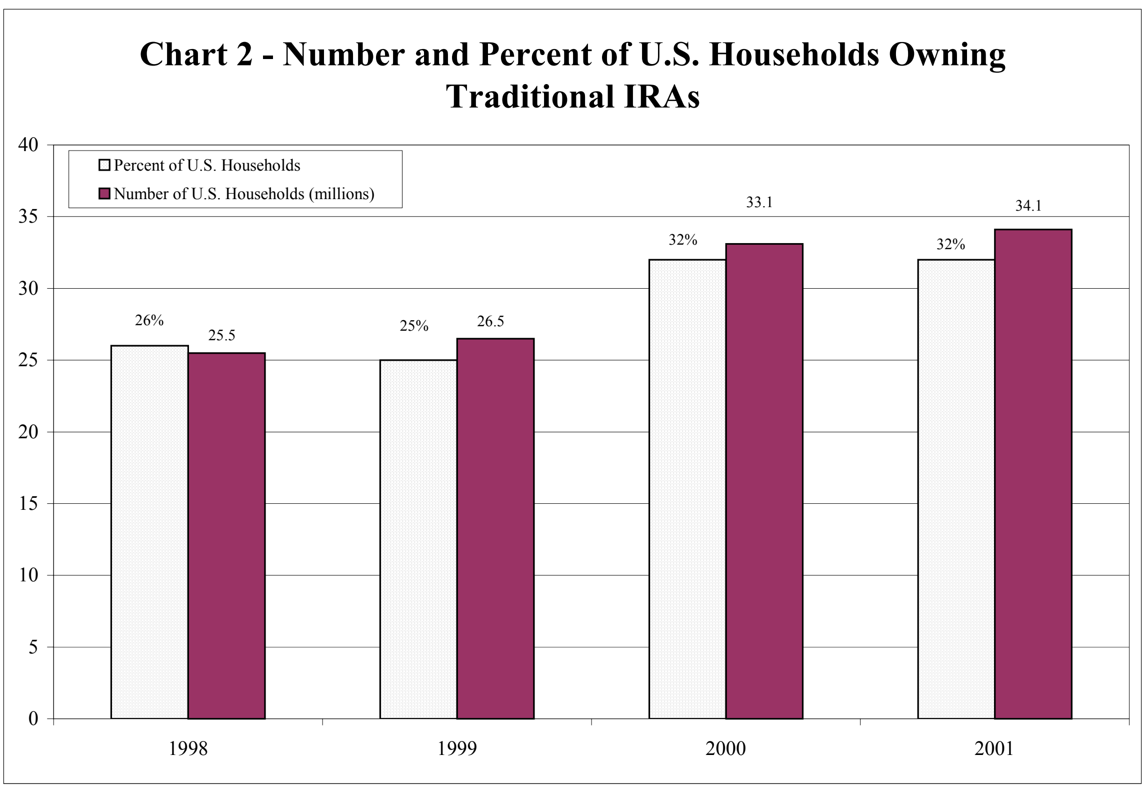
[21] Investment Company Institute, *Perspective*, November 2001, page 1.

[22] Investment Company Institute, *401(k) Plan Participants: Characteristics, Contributions, and Account Activity*, Spring 2000, Figure 2, page 4.

[23] Investment Company Institute and Securities Industry Association, "Equity Ownership in America," Fall 1999, Figure 45, page 50.

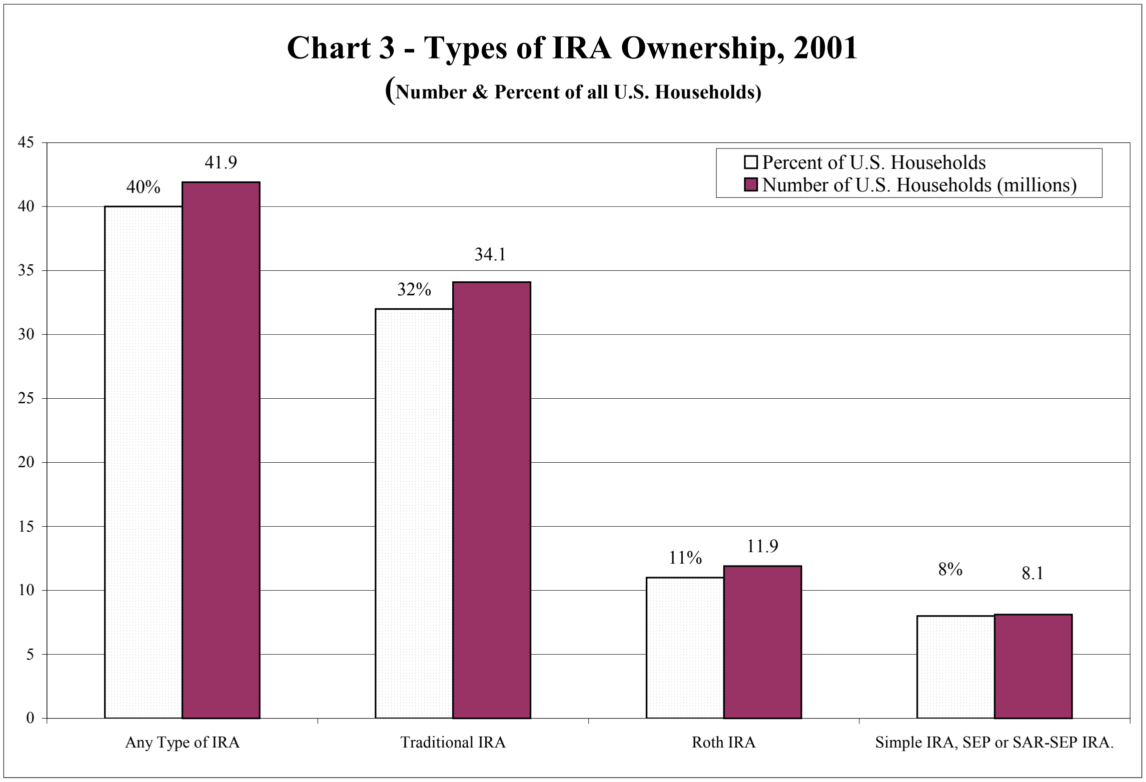


Source: ICI, "*Fundamentals*," selected years, multiple responses included.



Source: ICI, "*Fundamentals*," selected years, multiple responses included.

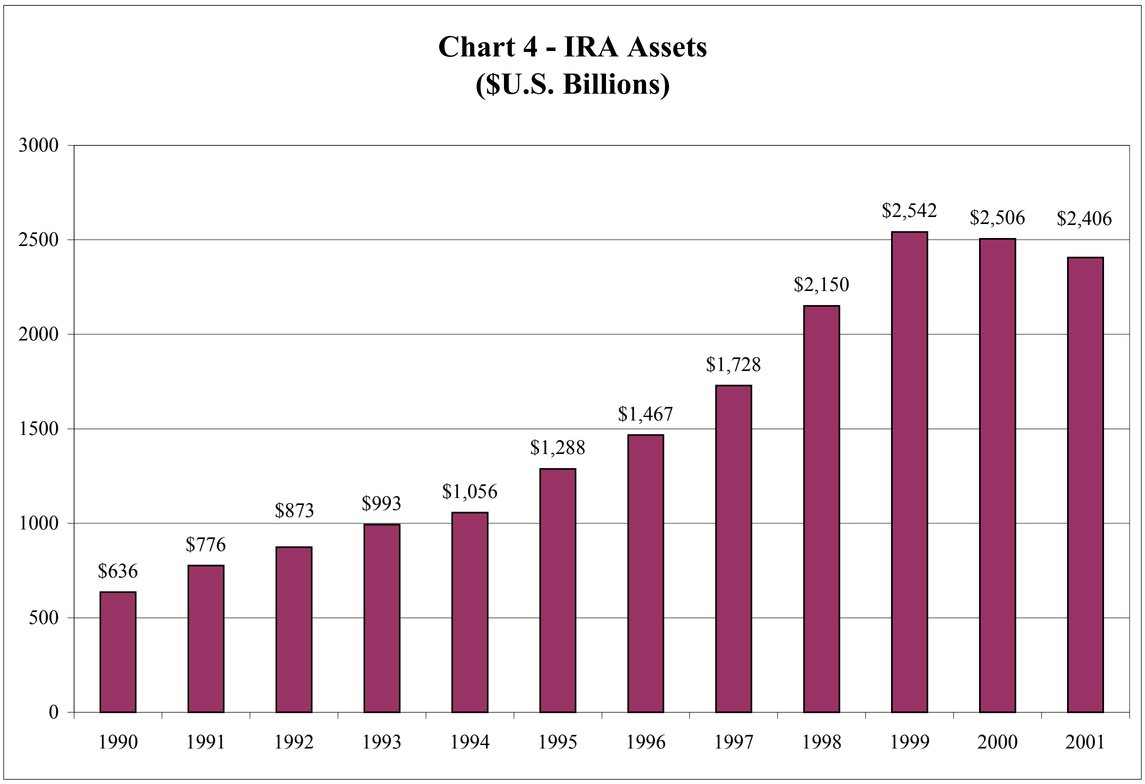
Traditional IRAs are the most common type of IRA for U.S. households. As shown in Chart 3, 32 percent of U.S. households owned a traditional IRA as of 2001, 11 percent a Roth IRA and 8 percent other forms of IRAs.[24]



Source: ICI, "*Fundamentals*," Vol. 11, No. 3, September 2002, Figure 1, multiple responses included.

[24] Other includes: SIMPLE IRA for employers with no more than 100 employees, Simplified Employee Pension (SEP) IRA and SAR-SEP IRA, which is a SEP-IRA with a salary reduction feature.

According to the Investment Company Institute (ICI), as of 2001, assets held in IRAs were approximately $2.4 trillion.[25] As shown in Chart 4, this in an increase of 278 percent from 1990 when assets held in IRAs were $636 billion.



Source: ICI, "*Fundamentals*," Vol. 11, No. 2, June 2002, Figure 5, multiple responses included, estimated for 2000 & 2001.

[25] Investment Company Institute, *Fundamentals: Investment Company Institute Research In Brief*, Vol. 11, No. 2. Washington, DC: June 2002.

Assets held in IRAs span a variety of financial structures. As shown in Table 2, mutual funds represented the most common choice of investment vehicle for IRAs. In 2001, mutual funds held 49 percent of total IRA assets. This figure includes both traditional and Roth IRAs. Second were brokerage accounts, which accounted for 32 percent of total IRA assets in 2001.

Table 2 - IRA Assets and Share of Total IRA Assets by Institution, 1990-2001*

	Mutual Funds		Bank and Thrift Deposits [1]		Life Insurance Companies [2]		Securities Held in Brokerage Accounts [3]		Total Assets
	Assets	Share (%)[4]	Assets	Share (%)[4]	Assets	Share (%)[4]	Assets	Share (%)[4]	
1990	140	22	266	42	40	6	190	30	636
1991	188	24	282	36	45	6	260	34	776
1992	238	27	275	31	50	6	311	36	873
1993	323	32	263	26	61	6	346	35	993
1994	350	33	255	24	69	7	382	36	1056
1995	476	37	261	20	81	6	471	37	1288
1996	598	41	258	18	92	6	518	35	1467
1997	777	45	254	15	135	8	562	33	1728
1998	975	45	249	12	156	7	770	36	2150
1999	1264	50	244	10	201	8	833	33	2542
2000	1237	49	252	10	202	8	816[e]	33	2506[e]
2001	1173	49	255	11	200[e]	8	779[e]	32	2406[e]

*Notes: Assets in $US billions

e = estimated

[1] Bank and thrift deposits include Keogh deposits

[2] Annuities held by IRAs, excluding variable annuity mutual fund IRA assets

[3] Excludes mutual fund assets held through brokerage accounts, which are included in mutual funds

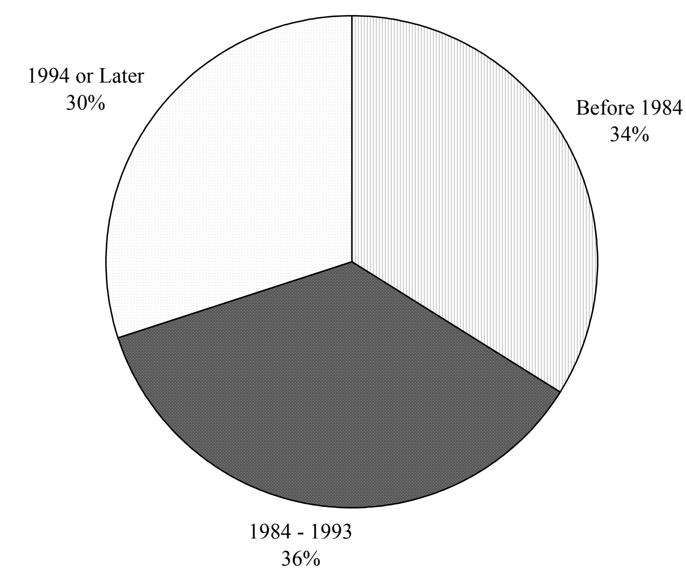
[4] Percent of total IRA assets

Source: Investment Company Institute, "*Fundamentals*," Vol. 11, No. 2, June 2002, Figure 6, page 5.

It is interesting to note the changing preferences of IRA owners. While the percentage of assets held in brokerage accounts has held relatively constant from 30 percent in 1990 to 32 percent in 2001, mutual funds have grown to be the investment vehicle of choice. In 1990, mutual funds accounted for only 22 percent of total IRA assets. In 2001, mutual funds accounted for 49 percent of total IRA assets, more than double the 1990 level. The amount of IRA assets under mutual fund management reached a high of $1.3 trillion in 1999 and a 50 percent share of total IRA assets. This increase in assets under management came at the expense of bank and thrift deposits, which accounted for 42 percent of total IRA assets in 1990 and fell to only 11 percent in 2001.

Chart 5 shows most traditional IRAs were opened before 1993. A total of 70 percent of all traditional IRAs were opened before 1993, with 36 percent opened between 1984 and 1993 and 34 percent opened before 1984. Thirty percent of all traditional IRAs were first opened in 1994 or later.[26]

Chart 5 - Year First Traditional IRA was Opened



Source: ICI, "*Fundamentals*," Vol. 11, No. 3, September 2002, Figure 3.

Though very little data are actually available on the retirement account withdrawal patterns of senior retirees, the Investment Company Institute has recently begun to survey retirement account holders to gain some insight into this area. As shown in Table 3, 17 percent of traditional IRA holders made some type of withdrawal from their IRA in 2001, or 5.8 million households out of the total 34.1 million U.S. households that owned a traditional IRA in 2001.

Of these 17 percent (5.8 million households), more than half, or 53 percent, made their withdrawal in order to comply with the mandatory distribution requirement that begins at age 70½. This number is up from 2000, when 39 percent of those that made a withdrawal from a traditional IRA did so to comply with the minimum distribution requirement.[27] Hence, the requirement that forces seniors to withdraw funds from their traditional IRAs currently affects approximately 3 million U.S. households, or between roughly 3 million and 6 million seniors depending on household marriage status.

[26] Investment Company Institute, *Fundamentals: Investment Company Institute Research In Brief*, Vol. 11, No. 3. Washington, DC: September 2002.

[27] Investment Company Institute, *Fundamentals: Investment Company Institute Research In Brief*, Vol. 10, No. 3. Washington, DC: September 2001, Figure 3, multiple responses included.

Table 3 - Traditional IRA Distributions in 2001	
	2001
Made a withdrawal from a traditional IRA	17%
Reason for withdrawal:	
- To take a required minimum distribution at age 70 1/2 or older	53%
- To buy a home	7%
- To purchase investments outside of an IRA	5%
- To pay for health care	4%
- To make a large purchase	7%
- Other reasons	20%
Source: ICI, "Fundamentals," Vol. 11, No. 3, September 2002, Figure 8, multiple responses included.	

A different study, using older data from the 1995 Survey of Consumer Finances (SCF) and expanded to include more types of retirement plans (and therefore also more households), estimated that the number of households affected in 1995 to be approximately 3.2 million households,[28] or also between 3 million and 6 million seniors depending on household marriage status. Therefore, according to the ICI data, many more seniors are affected by the minimum distribution requirements than in 1995. Additionally, if the SCF and ICI data are any indication of a developing trend, even more seniors will be affected by the minimum distribution requirements in the near future.

In the legislative process, the costs of policy proposals are often considered over a 10-year period. If the number of households cited in the above paragraph are expanded to include the number of households that would be affected over a 10-year period the number increases to 8.6 million households,[29] or between 9 million and 17 million seniors depending on household marriage status. Regardless, the number of affected seniors will only grow as the baby boom generation reaches retirement age. A repeal or modification to the mandatory distribution requirement could significantly benefit seniors especially when they need help the most, in their retirement years.

[28] Jeffrey R. Brown, Olivia S. Mitchell, James M. Poterba, and Mark J. Warshawsky, "Taxing Retirement Income: Nonqualified Annuities and Distribution from Qualified Accounts," *National Tax Journal*, Vol. 52, No. 3, September 1999, page 590.

[29] *Ibid*.

V. POLICY ALTERNATIVES

For many senior citizens, IRPs can be a primary saving vehicle for retirement. Further, along with Social Security, IRPs represent a major source of money for retirement. However, even though IRPs have been an important saving vehicle for many seniors, as this study has illustrated, they do have one major drawback: the forced distribution of IRP assets and the associated taxation of those assets for senior citizens once they reach age 70½. A range of policy prescriptions could be considered that would help to alleviate the potential economic harm the mandatory minimum withdrawal requirement can impose on senior citizens.

Repeal

The first proposal is to completely repeal the requirement that owners of IRPs begin withdrawals at age 70½. A bill (H.R. 1386) introduced to the U.S. House of Representatives by Rep. Jim Saxton (R-NJ) proposes this option. Rep. Saxton introduced similar bills (H.R. 252) in the 106th Congress and (H.R. 3079) in the 105th Congress. The bill would amend the Internal Revenue Code of 1986 to remove the requirement of a mandatory beginning date for distributions from individual retirement plans. This option would give senior citizens the full choice of deciding when to take withdrawals from their IRP.

Under this option, a tax liability would only be incurred when the account owner decided it was time for a withdrawal to be made. Since individuals are the only ones who really know their own financial needs and constraints, this option would be the most economically efficient option. Additionally, this option would be consistent with the economic philosophy that income should be taxed only when used for consumption, not for saving and investing.

Repeal with Recapture upon Transfer to Nonspouse (Death Distribution Mandate)

A second proposal, which would address the economic problems associated with the mandatory distribution requirement but would result in lower revenue costs to the government, is to allow the IRP owner the option of deferring withdrawals to a later time but changing the way the IRP is taxed once it is passed on in an estate. If the account owner opted for continued deferral, it would be required that whatever assets remain in the IRP once the owner is deceased would be taxed immediately in full when the assets are passed on to a nonspousal heir at the end of the year, instead of allowing for a withdrawal plan based on the life expectancy of the heir.

A continued deferral would still be allowed for the spouse of a decedent, just as other assets are allowed to pass tax-free in an estate to a decedent's spouse. But, in order to ensure that the government reclaims the tax due on the original tax-deferred contributions, and that a repeal of the mandatory distribution requirement would not lead to a type of unfair tax shelter, a tax liability would be generated once the remaining assets of the IRP were passed on to a nonspousal heir. Note that under this option, if IRP owners elected not to take the deferral, then the normal mandatory distribution rules would apply and at death the IRP would fall under current treatment of estate tax laws.

Increase Minimum Age

A third option is to increase the minimum age at which mandatory withdrawals must begin. Representatives Rob Portman (R-OH) and Ben Cardin (D-MD) have introduced comprehensive pension reform bills over the last few Congresses that proposed, among other things, to increase the minimum age to 75.

This proposal has considerable merit. First, increasing the minimum age requirement to 75 addresses the changing demographic reality that many seniors continue to work well past age 70. Second, this policy option has a lower revenue cost than a full or partial repeal. However, critics claim it could still force seniors to withdrawal funds during future down markets, or during other market conditions when IRP assets are depressed. But, it cannot be proven that the definite benefits associated with the inside build-up of assets due to an additional five years of deferral would be less than the potential downside of having to withdraw funds in future down markets. The five years of deferral would be a known benefit, whereas the prospect of future down markets is largely speculative.

Limited Exclusion

A fourth proposal would allow for a limited exclusion from the minimum withdrawal requirements up to a specified amount. This option has also been considered by Reps. Portman and Cardin. For example, if the exclusion limit was set at $500,000 then only those owners holding accounts with asset values over $500,000 would have to comply with the minimum withdrawal requirements and only applied to the marginal difference between the account value and $500,000. If a retiree was age 71 and had an account value of $600,000 then the first $500,000 would be excluded and the retiree would only be forced to apply the minimum withdrawal requirements to the difference, or $100,000. Once the asset value of the account fell below $500,000 the minimum withdrawal requirements would no longer apply. Therefore, for many senior retirees, a limited exclusion with a reasonable limit could effectively remove a large number of seniors from having to sell retirement assets just to pay a tax bill.

Allow Withdrawals Above the Minimum Required to be Credited to Future Minimum Withdrawal Requirements

As stated earlier, seniors might find it necessary in any given year to withdraw larger amounts from their IRPs than required by law, for example to pay medical bills. Under the current minimum distribution requirements, the following year's withdrawal requirement would be based on the new reduced asset value, even though excess funds were withdrawn in the previous year. In other words, a credit is not provided for excess funds withdrawn in one year to be carried over to future withdrawal requirements.

A fifth proposal would be to allow for such excess withdrawals to be credited to future minimum withdrawals. Credits should be allowed to carry-forward in perpetuity until such time that the credits are consumed.

Allow Losses to Apply to Capital Gains or Ordinary Income

A sixth proposal would treat any IRP losses similar to capital losses. Therefore, any assets that were sold for a loss could be offset against capital gains or against ordinary income, up to specified limits. Currently $3,000 of capital loss can be applied to ordinary income and any remaining loss balance carried forward to future years. However, this proposal probably would not provide much relief to many seniors whose IRP assets might be seriously depressed in value, but still not incur a nominal loss. Further, mandatory withdrawals would still be required.

Grace Period

Finally, a seventh proposal would allow for a specified "grace period" under which seniors at or over age 70½ could elect to defer the mandatory withdrawals for a specified number of years. The grace period would allow seniors to avoid having to sell IRP assets at depressed values and allow them to wait until asset values are higher before either beginning or resuming mandatory withdrawals.

This option should have the lowest revenue implications since most of the tax that would be deferred would be recaptured in a short period of time and much of it could be recaptured within the five- or ten-year budget window used by the Congress for scoring purposes. However, like the option to raise the minimum age at which mandatory withdrawals would be required, unless the regulation that relates the minimum amount of distribution to life expectancy is changed or an additional number of years is added to the life expectancy table equal to the number of years allowed for the grace period, seniors would be forced to take out larger distribution amounts. Again, if at such time market conditions were depressed, the problem of selling assets at reduced valuations would only be compounded.

Regardless of whether or not any of these options eventually become law, at the very least one policy change should immediately be implemented: equalizing the treatment between traditional IRA owners and owners of 401(k)-type plans. The law should be changed to allow owners of traditional IRAs the choice as to whether they want to begin to take the mandatory distributions at the latter of either age 70½ or retirement. This option is currently available to owners of 401(k)-type plans, which are funded with tax-deferred dollars, and should be available to owners of traditional IRA plans.

A combination of these proposals might also be appealing from both a policy perspective and a revenue perspective. The minimum age at which mandatory withdrawals begin could be increased to age 75 along with a grace period that would allow seniors then at or over age 75 to defer mandatory withdrawals for a short period of time (maybe three years). The regulations relating to the life expectancy tables could also be revised to allow for an extension equal to five years (the difference between 75 and 70) plus any additional years for which a grace period were elected.

Whatever policy option is ultimately decided upon, it is important to recognize that all of these options would enhance the ability of seniors invested in IRPs to maximize their return and allow them the right to exercise more control as to when withdrawals are made. The individual should make the choice, not the government.

Differences over Revenue Costs

The Joint Committee on Taxation (JCT) staff provides revenue estimates on the impact of tax legislation. A thorough discussion of the rules, procedures, methodologies and guesses that go into revenue estimation is well beyond the scope of this paper. However, it is important to note that the JCT's revenue estimations are not always accurate and are often based on myriad and hidden assumptions. Hence, different economists can come up with completely different revenue estimations for the same piece of tax legislation.

For example, a comprehensive pension reform bill introduced in the U.S. House of Representatives by Representatives Rob Portman (R-OH) and Benjamin Cardin (D-MO) in 1998 and 1999 contained several provisions to modify the mandatory minimum withdrawal requirements. Earlier versions of the bill increased the minimum age at which withdrawals were required to 75, and removed the requirement entirely for those with account assets under $300,000. Later versions of the bill lowered the amount to $100,000. In an article that was published in *Tax Notes*, Warshawsky notes that, the reform "efforts ran into problems with the revenue estimators, as the Joint Committee of Taxation economists estimated the loss in tax revenues from these types of changes to run up to $40 billion over the relevant time period."[30] Warshawsky further notes, "a careful empirical analysis showed that the JCT estimate was double an alternative, fully documented, calculation."[31]

[30] Mark Warshawsky, "Further Reform of Minimum Distribution Requirements for Retirement Plans," *Tax Notes*, April 9, 2001, page 300.

[31] *Ibid*.

This alternative analysis was provided in a *National Tax Journal* article that estimated:

- Full repeal of the minimum distribution requirements would result in an estimated 10-year revenue loss of only \$21 billion, or approximately \$2.1 billion per year;
- Partial repeal allowing for the first \$300,000 of account assets to be excluded from the minimum distribution requirements would result in an estimated 10-year revenue loss of \$13 billion and benefit over 8 million U.S. households; and
- Partial repeal allowing for the first \$100,000 of account assets to be excluded from the minimum distribution requirements would result in an estimated 10-year revenue loss of \$8 billion and benefit over 6 million U.S. households.[32]

As far as can be determined, differences between the methodologies used by the JCT staff and Brown, et al. have never been reconciled. Unfortunately, the JCT staff has been unwilling to fully disclose its revenue estimation assumptions to the public.

It is just as important to discuss the implications and differences of competing policy proposals as it is to discuss the differences in revenue estimations. Along with whatever policy proposal is ultimately advanced to repeal or modify the minimum withdrawal requirements, careful and detailed examination should be given to the accuracy or inaccuracies of revenue estimates provided by the staff of the Joint Committee on Taxation.

VI. CONCLUSION

Tax policies are often evaluated based on three criteria: efficiency, equity and simplicity. An efficient tax policy is one that raises a given amount of revenue while causing the least economic distortion. Equity often implies that similarly situated taxpayers should pay similar taxes. Tax simplicity suggests that tax policy be simple to understand and comply with, or reduce the complexity of an existing tax policy.

This study proposes several options that would repeal or modify the mandatory minimum withdrawal requirement that affect millions of seniors and their IRPs. Under current law, seniors could be forced to sell IRP assets at depressed values just to pay a tax bill during the time of their lives when they need their savings the most. Any of the proposals discussed in this study would help alleviate this unfair tax treatment by increasing the efficiency, equity and simplicity of the tax system.

[32] Jeffrey R. Brown, Olivia S. Mitchell, James M. Poterba, and Mark J. Warshawsky, "Taxing Retirement Income: Nonqualified Annuities and Distribution from Qualified Accounts," *National Tax Journal*, Vol. 52, No. 3, September 1999, page 590.

These proposals would enhance efficiency by providing senior retirees with the choice of when it is in their best interest to make a withdrawal from their IRP and subsequently pay the appropriate tax. The individual is in the best position to know when is the right time to withdraw retirement funds, not the government. Further, forcing seniors to sell assets in market conditions that have reduced their retirement plan assets only results in *less* money to seniors and *less* tax revenue to the government.

Additionally, equity could be enhanced by equalizing the treatment between traditional IRA owners and owners of 401(k)-type plans. Recall that 401(k) plans are also funded with tax-deductible or tax-deferred contributions, like traditional IRA plans. However, unlike traditional IRA plans, 401(k) owners are allowed to choose whether to begin their mandatory withdrawals beginning either in the year in which they retire or age 70½, whichever is greater.

An outright repeal of the requirement dictating minimum withdrawals from IRP plans would vastly improve the current tax treatment of IRP plans and result in less complexity. Even under the new regulations, the calculation of the asset base and amount of minimum withdrawal necessary may be difficult to calculate for many seniors. Additionally, if they fail to make the required withdrawal, punitive penalties of 50 percent are applied. If the tax due on the required minimum withdrawal does not contribute to the erosion of a senior's available retirement fund, the 50 percent tax the government summarily applies definitely would.

Though some of the policy options above, short of full repeal, may seem complex, they are no more complex than the current requirements but do expand individual choice and efficiency by allowing the individual greater choice over their saving and consumption. Given the certain economic harm that the minimum IRA and 401(k) withdrawal requirements will impose on many seniors this year, policymakers have a range of options available to address this problem. Passing legislation now would help many millions of seniors this year.

In the long run, repealing or modifying the rules requiring forced withdrawals of IRP plans beginning at age 70½ will improve economic efficiency by increasing the returns seniors receive on their IRP investments and not forcing them to sell assets at depressed values. Additionally, in the long run, any increase in returns would likely result in an increase in tax revenue to the government. Hence, both owners of IRP plans and the U.S. Treasury would benefit from this tax change.

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