THE TAXATION OF INDIVIDUAL RETIREMENT ACCOUNTS

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A. BACKGROUND.

In 1993 there was approximately $919 billion in Individual Retirement Accounts in the United States. It has been estimated that there is currently about $56 billion in IRAs in the state of Texas. Sixty percent of IRAs are invested in mutual funds and brokerage accounts.

As distributions from an IRA are received, the recipient must pay income tax on the taxable amount received. The longer the distribution is delayed, the longer the tax is deferred and the greater the tax free accumulation. The key point in most distribution planning is tax deferral. In most cases this will mean that more income taxes will be paid overall, but the use of the deferred tax to reinvest will more than offset the additional tax.

Many commentators believe that the end goal of distribution planning should not be to minimize taxes but to recommend strategies that will maximize after tax accumulations to the IRA owner and spouse or their beneficiaries. However, there are serious tax implications for IRA owners and their beneficiaries. Examples of taxes other than the income tax on distributions that effect IRAs are:

1. EXCESS DISTRIBUTIONS (The "Too Much Tax"): There is a maximum amount that may be distributed each year from a participant's qualified plan or IRA. Distributions in excess of this amount incur a 15 percent penalty tax. This excise tax is imposed whenever the aggregate taxable amount distributed from all IRAs and qualified plans, during any particular year, exceeds the greater of $112,500 indexed for inflation and $150,000. The 1995 amount is $150,000. There is a special grandfather rule which, if elected, could shield greater amounts from the excess distributions tax.

Distribution planning can be done before age 70 1/2 to reduce the IRA balance so that the minimum distributions made after age 70 1/2 will not exceed the threshold amounts for excess distribution purposes.

Exclusions from the excess distributions tax are:

a) rollover distributions excluded from gross income;

b) return of basis distributions; or

c) distributions after the IRA owner's death.

2. EXCESS ACCUMULATIONS (The "Too Late Tax"): After the death of the IRA owner, an additional estate tax is imposed equal to 15% of the excess retirement accumulation. The decedent's estate is subject to this tax to the extent that all of his or her retirement benefits, including IRAs, exceed the amount that would have been necessary to pay the decedent an annuity for the remainder of the decedent's life in an annual amount equal to the greater of $112,500 indexed for inflation or $150,000. This tax is in addition to the regular estate tax and is reported on the federal estate tax return.

Community property is disregarded in computing this tax so that the full value is included and not just the decedent's one half interest. Neither the unified credit, the charitable deduction or the marital deduction are allowed. This additional estate tax is deductible when computing the regular estate tax.

If the surviving spouse is the sole beneficiary of all of the decedent's retirement benefits the surviving spouse may make an election to be treated as the owner of the decedent's retirement benefits for purposes of determining excess distributions to the spouse during the surviving spouse's life and excess accumulations upon the death of the surviving spouse.

The threshold for incurring the Excess Accumulation Tax upon death is very low when compared to the threshold distribution for the excess distribution tax. Examples: If the age at death of the decedent is 65 and the applicable federal rate is 9.4%, the threshold amount above which the excise tax must be paid is $1,110,000; at age 70, with the same AFR, the threshold amount is $995,000.00. At age 70, if the AFR is 6.4%, the threshold amount is $1,185,000.

3. MINIMUM DISTRIBUTIONS (The "Too Little Tax"): Unless certain exceptions apply, distributions from an IRA must begin by April 1 after the year in which the owner reaches age 70 1/2. This is known as the required beginning date (RBD). These distributions are subject to the minimum distribution rules of sections 408 and 401 of the Internal Revenue Code. If the minimum distributions are not made in any given year, there is an excise tax equal to 50 percent of the amount that should have been distributed but was not. The life expectancy of the IRA owner and spouse can be recalculated annually.

If the IRA owner decides not to recalculate life expectancy each year, the IRA owner must withdraw an amount which is either:

a) the value of the IRA at the age of 70 1/2 divided by the life expectancy of the IRA owner; or

b) the value of the IRA at age 70 1/2 divided by the joint and last survivor life expectancy of the IRA owner and their spouse; or

c) the value of the IRA at age 70 1/2 divided by the joint and last survivor life expectancy of the IRA owner and their designated beneficiary.

If the IRA owner decides to recalculate life expectancy each year, the IRA owner must withdraw an amount which is either:

a) the value of the IRA at the age of 70 1/2 divided by the life expectancy of the IRA owner, as recalculated each year; or

b) the value of the IRA at age 70 1/2 divided by the joint and last survivor life expectancy of the IRA owner and their spouse, as recalculated each year.

You can only recalculate using the joint life expectancy of the IRA owner and their spouse.

4. EARLY DISTRIBUTIONS TAX (The "Too Early Tax"): A 10 per cent excise tax is imposed on all distributions from an IRA before the owner reaches age 59 1/2. Exceptions are:

a) Amounts received on account of death or disability of the IRA owner.

b) Distributions in substantially equal periodic payments made for the life or life expectancy of the IRA owner or the joint life expectancies of the IRA owner and his beneficiary.

c) the transfer of an IRA to a spouse (or former spouse) incident to divorce.

5. FEDERAL ESTATE TAX: The value of an IRA is included in the gross estate of the IRA owner. If the IRA owner is married, the IRA owner's community property interest is included in the gross estate. The federal estate tax, for estates in excess of $600,000, ranges from 37% for estates of $6000,000 to 55% for estates in excess of $3 million. There is also a Generation Skipping Tax for transfers to persons more than one generation below that of the transferor, for example to grandchildren.

PHASES OF THE IRA:

There are several phases in the life cycle of an IRA. These phases are the accumulation phase before an IRA owner reaches age 59 1/2, the free years between ages 59 1/2 and 70 1/2 and the distribution phase after the IRA owner reaches age 70 1/2.

During the free years between ages 59 1/2 and 70 1/2 the IRA owner can accumulate or take distributions without any penalty other than the excess distributions/accumulations penalty. Of course, distributions during this period are subject to income tax. These years should also be planning years for projecting the value of the IRA after the required beginning date of 70 1/2 to reduce the likely hood of minimum distribution or excess accumulation problems.

During the distribution phase, the major concern involves complying with the minimum distribution rules. Decisions as to whether or not to recalculate life expectancy each year, the possible use of disclaimers and the desire to fully fund the credit shelter trust are just some of the concerns during this period.

In summary, there is a "too early tax" (the Early Distributions Tax), a "too late tax" (the Excess Accumulations Tax), a "too much tax" (the Excess Distribution Tax) and a "too little tax" (the minimum distribution tax).

Sources: Planning an Estate, by Harold Weinstock, McGraw-Hill (1995); Estate Planning and Taxation Coordinator, Research Institute of America (1995); "The Life Cycle of an IRA", by G. Philip Morehead, Real Estate, Probate and Trust Law Reporter, Volume 33, No. 4, (July 1995); "Tax and Estate Planning for Qualified Retirement Benefits", Paul G. Griesemer, AALU Annual Convention (1995); "IRA Distribution Planning Provides Significant Tax Deferral Opportunities", by William D. Cunningham, Journal of Taxation of Employee Benefits, (March/April 1994); "Maximizing Qualified Retirement Accumulations Through Optimum Distribution Planning", by William D. Cunningham, AWSCPA - ASWA 54th Annual Meeting, Houston, Texas (1994).

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