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Taxation of Qualified Plan Distributions: History and Analysis

Christopher R. Hoyt
University of Missouri - Kansas City, School of Law

TAXATION OF QUALIFIED PLAN DISTRIBUTIONS: HISTORY AND ANALYSIS

*Christopher R. Hoyt**

I. INTRODUCTION

The laws governing the taxation of distributions from qualified plans[1] (pension,[2] profit-sharing,[3] and stock bonus plans[4]) and individual retirement accounts[5] ("IRAs") are a small but important aspect of the large, complex body of legislation governing retirement savings vehicles. Not until distribution does the government finally collect tax revenue from the contributions that were deducted years earlier by employers and IRA contributors and from the earnings that have accumulated tax-free.

The manner in which these distributions are taxed significantly affects congressional policy encouraging retirement savings. Existing tax law is generally consistent with the policy of granting tax-preferred status to retirement plans. As is true of virtually all pension legislation, however, the laws are unnecessarily complex and in some aspects are flawed.

Distributions are generally fully taxable when received, except that recipients of lump-sum distributions enjoy important tax con-

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* Assistant Professor, University of Missouri - Kansas City, School of Law.

[1] Qualified plans are described in I.R.C. § 401(a) as pension plans, profit-sharing plans, and stock bonus plans.

[2] There are two types of pension plans: "defined benefit" plans, which promise a regular retirement income to beneficiaries, and "defined contribution" plans, which promise that employers will make regular contributions to the plans but do not guarantee what income such investments will yield upon an employee's retirement. *See* Treas. Reg. § 1.401-1(b)(1)(i). Thus, beneficiaries bear the investment risk of defined contribution plans.

[3] Profit-sharing plans enable employees to share in the long-term profits of the employer. *See id.* § 1.401-1(b)(1)(ii). Although not specifically intended to provide retirement income, they obviously serve that purpose in many instances.

[4] Stock bonus plans are similar to profit-sharing plans, except that contributions do not necessarily depend upon the existence of profits, and benefits are distributed to employees or their beneficiaries in the form of employer stock. *See id.* § 1.401-1(b)(1)(iii).

[5] Individual retirement accounts are tax-sheltered retirement trusts or custodial accounts that may be established by any individual with earned income. *See* I.R.C. § 408. The maximum annual deductible contribution is the lesser of $2,000 or the individual's compensation for the year. *Id.* § 219(b). IRAs have received tremendous public acceptance since the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 311(a), 95 Stat. 172, 274-78, made them widely available. *See infra* notes 15-16 and accompanying text.

cessions in the form of the ten-year averaging tax and long-term capital gain treatment. The historical purpose for granting such special treatment was to provide relief from the "bunching" effect: because a lump-sum distribution represents many years of accumulated tax-sheltered income, a taxpayer receiving such a distribution could be pushed into an abnormally high marginal tax bracket if the entire distribution were taxed as ordinary income in the year of receipt.

When Congress first provided special treatment for lump-sum distributions, no alternate means of preventing the bunching effect existed. Today, however, alternatives do exist (*e.g.*, the rollover election and the general income averaging provisions). The rollover election permits recipients to transfer distributions tax-free into other qualified plans or into IRAs, thereby deferring tax until contributions and earnings are ultimately withdrawn.[6] No economic justification exists for offering recipients an additional tax option where existing alternatives such as the rollover election already solve the bunching problem. The continued existence of ten-year averaging and long-term capital gain treatment actually conflicts with important congressional policy by encouraging early distributions rather than periodic withdrawals during retirement.[7] Moreover, the capital gain provisions permit taxpayers to convert ordinary income into income taxed at lower rates, a result that violates fundamental principles of fairness.

Because alternatives exist, the only plausible justifications for granting special tax concessions for lump-sum distributions are congressional purposes (1) to assist individuals who wish to spend their money in a hurry or (2) to protect individuals who do not qualify for the rollover option, either because they inadvertently failed to roll over within the sixty-day rollover period or because they are not eligible for such treatment.[8] The first possible purpose conflicts with congressional intent to provide retirement income, and the second is better met by liberalizing the availability of rollover and other tax deferral opportunities. Repeal of the special

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[6] I.R.C. § 402(a)(5).

[7] This is one of the Treasury Department's arguments for repealing the special tax concessions for lump-sum distributions. *See* Treasury II, *infra* note 17, at 345.

[8] For example, recipients (other than spouses) who receive lump-sum distributions by reason of a plan participant's death are not eligible to roll the distributions over. I.R.C. § 402(a)(5), (7).

tax options in combination with liberalization of the deferral provisions would add significantly to the equity and simplicity of the Internal Revenue Code and at the same time would further the congressional objective of encouraging accumulation of retirement savings.

II. Policies Favoring Tax-Sheltered Retirement Savings

Qualified plans and IRAs are the safest and most lucrative of U.S. tax shelters. Employers may currently deduct contributions to the tax-exempt trusts that make up such plans.[9] Employees do not pay tax on the contributions or on the accumulated trust investment income until they receive distributions.[10] Usually such distributions occur during retirement when the taxpayer is in a lower marginal tax bracket. If a distribution is in the form of a lump sum, it may qualify for long-term capital gain treatment and the special ten-year averaging tax.[11] The combination of the deferral and the shifting of income to lower brackets can produce significant tax benefits for plan beneficiaries.

The annual revenue loss to the Department of Treasury that these plans cause is now the largest item in the Tax Expenditure Budget.[12] The resources invested in private and public pension plans had grown to an estimated $1.15 trillion as of the end of 1983, from only $400 billion in 1976.[13] The rate of growth has slowed, however, and it now appears less likely that private pension assets will by 1995 reach the $2.9 trillion level that the Department of Labor had predicted in 1980.[14]

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[9] *Id.* §§ 401(a), 501(a), 404.

[10] *Id.* § 402(a)(1).

[11] *See id.* § 402(a)(2), (e)(1).

[12] U.S. Dept. of Commerce, Statistical Abstracts of the United States 310 (1985). The estimated revenue losses in fiscal year 1984 were $50.535 billion from employer plans, $1.475 billion from self-employed plans, and $9.190 billion from IRAs. By comparison, the next largest tax expenditure was the business investment tax credit, totalling $26.750 billion.

[13] In 1983, $875 billion was held in private plans and the balance in public retirement plans. *Business Reduces Pension Funding to Cut Costs, Fend Off Takeovers*, Wall St. J., Oct. 11, 1984, at 35, col. 4 [hereinafter cited as *Pension Funding*]. Of the $875 billion, an estimated $220 billion was held in the plans of the nation's 100 largest corporations. *Pension Scoreboard: A Controversial Glow of Health*, Bus. Wk., Sept. 17, 1984, at 153 [hereinafter cited as *Pension Scoreboard*].

[14] Part of the reason may be that companies increasingly prefer profit-sharing or defined contribution plans over defined benefit plans because the companies want to shift the investment risk to the plan beneficiaries. *Pension Funding, supra* note 13, at 35, col. 6. In

The slow-down in the growth of pensions has been offset, however, by the tremendous public acceptance of IRAs since they became available to all working individuals in 1982. An estimated $27.8 billion was deducted on 1982 tax returns for contributions to IRAs.[15] By April of 1984 the accumulated assets in IRAs exceeded $100 billion dollars and are projected to reach between $350 billion and $500 billion by 1990, making such assets the largest component of retirement savings after pension funds.[16]

Despite the immense revenue drain that must be made up from other sources, Congress appears convinced that the public benefits of tax-sheltered retirement plans exceed their costs. Both the "Tax Reform Bill of 1985" and the Treasury's two tax reform proposals ("Treasury I" and "Treasury II") retain tax-preferred treatment for qualified plans and IRAs.[17] Congress extended tax benefits to qualified plans and IRAs in order to provide incentives for achieving two important policy goals: (1) assuring stable retirement income to retirees who might otherwise live in poverty and (2) main-

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addition, companies that have overfunded pension plans become attractive acquisition targets. Some corporations with over-funded pension plans have terminated their plans in order to use the excess assets for corporate purposes. More than 18,000 were terminated in 1983 alone. *Pension Scoreboard, supra* note 13, at 153. The pension plans of the nation's 200 largest corporations hold $73 billion of assets that are not needed to fund promised pension benefits. *The Huge Pension Overflow Could Make Waves in Washington,* Bus. Wk., August 12, 1985, at 71. The issue of whether such excess pension assets belong to employers or employees has caused considerable debate in Congress. The "Treasury II" proposal would assess a 10% excise tax on the amount of excess assets returned to employers. Treasury II, *infra* note 17, at 360-62. A similar 10% excise tax is proposed in House Tax Reform Bill, § 1132, *infra* note 17.

[15] Joint Comm. on Tax'n, 98th Cong., 2d Sess., Analysis of Proposals Relating to Comprehensive Tax Reform 8 (Joint Comm. Print 1984) [hereinafter cited as 1984 Joint Comm. Report].

[16] *Growing Interest in IRAs Prompts Big Marketing Battle for Investors,* Wall St. J., April 13, 1984, at 35, col. 4.

[17] *See* U.S. Dept. of Treasury, 98th Cong., 2d Sess., Tax Reform for Fairness, Simplicity, and Economic Growth (2 vols.) (1984) [hereinafter cited as Treasury I]. Treasury I proposed comprehensive tax reform measures that significantly reduced or eliminated many tax expenditure items. In response to the ensuing public outcry and debate, the President issued a more moderate tax reform proposal on May 29, 1985. The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (1985) [hereinafter cited as Treasury II]. Although both proposals contain many technical changes, they would leave the fundamental structure of retirement plans unchanged. Using Treasury II as a point of reference, the House passed "The Tax Reform Bill of 1985," H.R. 3838, 99th Cong., 1st Sess. [hereinafter cited as House Tax Reform Bill], which is now being scrutinized by the Senate Finance Committee. Although the bill would make many changes to the laws governing qualified plans, it also would keep the fundamental structure intact.

taining a large savings base as a source of capital for American industry.[18]

Because of the enormous resources invested in qualified plans and the great potential for tax avoidance, Congress has enacted legislation over the years to ensure the financial stability of qualified plans and to extend coverage to broad classes of employees rather than to only a few key executives.[19] Congress' dual concern with protecting workers and limiting tax avoidance has produced one of the most complex sets of laws ever enacted. Congress has, for instance, vested a different agency with responsibility for each concern: the Department of Labor generally has jurisdiction over issues of financial security, such as the risk level of plan investments,[20] while the Treasury generally focuses on tax avoidance and tax equity issues, such as policies prohibiting discrimination in favor of highly compensated employees[21] or limiting tax deductions for contributions to accounts of highly compensated individuals.[22]

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[18] In Treasury I the Treasury stated:

> By encouraging taxpayers to save for retirement, the tax-preferred treatment of retirement plans serves two important public purposes. It helps retirees accumulate funds so they can live out their lives in dignity without becoming wards of society, and it produces savings that can be made available for capital formation. In the latter sense, tax-preferred retirement plans have much the same benefits as a consumed income tax but without its disadvantages . . . . The Treasury Department believes that the present tax incentives for such retirement plans should be retained but made more consistent.

1 Treasury I, *supra* note 17, at 116.

[19] The first major tax legislation affecting retirement plans was the Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798, which denied tax-exempt status to plans that discriminated in favor of a prohibited group. The Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, 76 Stat. 809(a), permitted sole proprietors and partners to establish qualified retirement plans (the so-called H.R. 10 or Keogh plans) but with severe limitations on the level of deductible contributions. The most comprehensive reform of qualified plans was the Employee Retirement Income Security Act of 1974 ("ERISA"), Pub. L. No. 93-406, 88 Stat. 829, which, among other things, assigned various law enforcement functions between the Labor and Treasury Departments. For a summary of the legislative history of this Act, see Chadwick & Foster, *Federal Regulation of Retirement Plans: The Quest for Parity*, 28 Vand. L. Rev. 641, 642-81 (1975).

[20] I.R.C. § 4975.

[21] *Id.* § 410.

[22] *Id.* § 415.

III. Qualified Plan and IRA Distribution Requirements

A. *Eligible Distribution Events*

Because the principal purpose of qualified plans is to accumulate assets over a period of years in order to provide retirement income, Congress enacted legislation to prohibit certain early withdrawals. A participant's account balance in a qualified plan is not available for distribution until a specific "event" occurs. The event is usually the participant's retirement or attainment of a stated age, but can also be the participant's death or separation from service.[23] Profit-sharing plans, in contrast, generally have afforded participants greater flexibility in obtaining funds before retirement, since their purpose is not to provide retirement income but to permit employees to share in their employer's profits.[24] Distributions from these plans can be made in the event of financial hardship or illness.[25]

In addition to the requirement that a plan contain provisions restricting distributions before an eligible event, the Code imposes penalties upon recipients of premature distributions. If an IRA owner receives a distribution before attaining the age of 59½ or before becoming disabled, he or she must pay a penalty tax equal to ten percent of the distribution and must also include the entire distribution in income.[26] Similarly, if a five-percent owner of his employer[27] receives a distribution under such circumstances or receives an amount exceeding the benefits provided for under the plan formula, the amount will be subject to the ten-percent penalty tax and will be ineligible for income averaging.[28] Although such penalty taxes do not apply to distributions from tax-sheltered annuities,[29] annuities generally restrict distributions in accordance with the provisions applicable to profit-sharing plans.[30]

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[23] Treas. Reg. § 1.401-1(b)(1)(ii).

[24] *See id.*.

[25] *See* Rev. Rul. 71-224, 1971-1 C.B. 124.

[26] I.R.C. §§ 72(m)(5), 408(f).

[27] A 5% owner is defined in § 416(i)(1)(B)(i) as any person who owns (1) more than a 5% capital or profits interest in a non-corporate employer, such as a partnership, or (2) more than 5% of the outstanding stock or voting stock of a corporate employer. I.R.C. § 416(i)(1)(B)(i).

[28] *Id.* §§ 72(m)(5)(A)(ii), 402(e)(4)(I); Treas. Reg. § 1.72-17(e)(1)(i)(b); Prop. Treas. Reg. § 1.402(e)-2(e)(4).

[29] *See* I.R.C. § 403(b).

[30] Rev. Rul. 68-482, 1968-2 C.B. 186.

Depending on the terms of the plan, the participant may choose the timing of benefits.[31] Generally the choice is between receiving a lump-sum distribution of the entire account balance, an annuity, or installment payments over a fixed term.[32] Because of the complex rules governing annuity distributions, however, many plans refuse to make the annuity option available.

The plan may not restrict payment options in such a way as to discriminate in favor of highly compensated individuals. The Internal Revenue Service has ruled that plans that exercise paternalism by denying lump-sum distributions to those who might not have sufficient retirement income from other sources may be considered discriminatory.[33] This ruling appears to conflict with Treasury I, which states that a principal benefit of retirement savings plans is to provide retirement income to those who might otherwise become wards of the state.[34]

B. Required Distributions

1. Before Death

In addition to permitting plan participants to receive distributions, the Code requires distributions at certain times. The requirement has two objectives: first, to assure that employees receive payments during their retirement years, since certain employers or trustees might seek to retain the funds; and second, particularly in the case of certain five-percent owners and IRA owners, to assure that the deferred tax on the contributions and accumulated income will ultimately be paid.[35] The net effect of the

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[31] If, however, the account balance is $3,500 or less, the plan may make a lump-sum distribution without offering the recipient the option of periodic payments. *See* I.R.C. § 417(e).

[32] If the plan provides for the payment of benefits in any form of a life annuity, then it must provide qualified joint and survivor annuities for married participants (unless the recipient elects otherwise). *See* I.R.C. § 401(a)(11); Treas. Reg. § 1.401-11.

[33] Rev. Rul. 85-59, 1985-1 C.B. 135. The Internal Revenue Service ruled that plans that restrict lump-sum distributions to participants earning $50,000 or more per year are per se discriminatory. The Service also ruled that three other plans were not per se discriminatory, but that the Service would examine the pattern of distributions to determine whether the plans discriminated in operation. In these plans, trustees were permitted to exercise discretion in making lump-sum distributions, to require recipients to have a minimum net worth before making lump-sum distributions, or to require a statement from a lawyer or accountant justifying the lump-sum distribution. *See id.*

[34] *See supra* note 18.

[35] The Tax Reform Act of 1984, Pub. L. No. 98-369, § 521(a)(1), 98 Stat. 494, 867, gener-

distribution rules is generally to require the taxpayer to elect a method of distribution (*e.g.*, in installments or as a lump sum) by age of 70½.

The first objective is addressed by section 401(a)(14) of the Code, which requires distributions to begin no later than the sixtieth day after the close of the plan year in which the latest of one of the following events occurs:

> (1) the participant reaches age sixty-five, or the normal retirement age specified under the plan, if earlier;
> (2) the participant reaches the tenth anniversary of his initial participation in the plan; or
> (3) the participant leaves the employer's service for any reason.[36]

A plan may permit participants to elect to have payments begin at a later date, however, subject to the required distribution rules discussed below.[37] Such an election should not trigger constructive receipt, particularly in light of the repeal of the "made available" rule.[38]

The second objective is addressed by recent tax legislation.[39] Qualified plans must now provide for distribution of an employee's entire interest or commencement of periodic distribution no later than April 1 of the calendar year following the calendar year in which the employee reaches age 70½ or retires, whichever is

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ally imposed on "5% owners" the restrictions which previously had been imposed on key employees and self-employed individuals. *See* I.R.C. § 416(i)(1)(B)(i); *supra* note 27.

Arguably a third objective of required distributions is to ensure that the plans in fact provide retirement income rather than accumulate funds for some other purpose, such as passing wealth to heirs. This is one reason cited by the Department of Treasury in support of expanding the required distribution rules to cover all tax-favored retirement savings plans:

> The tax-favored status of retirement plans is intended to enable individuals to replace, after retirement, compensation that terminates with retirement. Minimum distribution rules support this rationale by limiting the extent to which tax-deferral on retirement savings can be extended beyond the individual's retirement. Given the purpose of minimum distribution rules, they should apply to all retirement plans receiving tax-favored treatment.

Treasury II, *supra* note 17, at 345.

[36] I.R.C. § 401(a)(14).

[37] *See* Treas. Reg. § 1.401(a)-14(b).

[38] *See infra* note 61-62 and accompanying text.

[39] The required distribution rules were enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, § 242(a), 96 Stat. 324, 521, and were significantly amended by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 521(a)(1), 98 Stat. 494, 866.

later.[40] If the employee is a five-percent owner (regardless of whether or not the plan is top-heavy) or if the proceeds are in an IRA, distributions must begin by April 1 of the year after the five-percent owner or IRA owner reaches age 70½, whether or not he has retired.[41] Note that the April 1 date differs from the date provided in section 401(a)(14), which may lead to confusion.

If the distribution does not occur as a lump sum, the distributee may elect to have the entire interest paid out over (1) the life of the employee, (2) the combined lives of the employee and a "designated beneficiary," (3) a time period not exceeding the life expectancy of the employee, or (4) a time period not exceeding the total joint life expectancy of the employee and the designated beneficiary.[42]

A designated beneficiary can be any individual designated by the employee, including a minor child.[43] Distributions may even be made for the benefit of another individual.[44] These options effectively give unmarried and married taxpayers the same flexibility to defer qualified plan distributions. Before amendment by the Tax Reform Act of 1984 (the "1984 Act"), only married taxpayers could extend the payout period beyond the employee's life, by tying the period to the life expectancy of a spouse.[45]

If a beneficiary is designated, more than fifty percent of the actuarially determined present value of the anticipated payments must be distributable during the life expectancy of the employee. This is the so-called "incidental death benefits test." If a spouse is the designated beneficiary, the test does not apply; instead, the joint and survivor annuity tables are used.[46] Despite the distribu-

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[40] I.R.C. § 401(a)(9)(A), (C).

[41] *Id.* IRAs are subject to a 50% excise tax on any required distributions that are not made.

[42] *Id.* § 401(a)(9)(A)(ii).

[43] *Id.* § 401(a)(9)(E). Section 401(a)(9)(F) provides that any amount paid to a child shall be treated as if paid to the surviving spouse, if the amount will become payable to the surviving spouse upon the child is reaching majority or upon certain other specified events. This prevents the shifting of income from high-bracket parents to low-bracket children. It also allows the surviving spouse eventually to receive income. In the absence of this provision, an employee could select one designated beneficiary (either the child or the spouse) but not both. *See id.* § 401(a)(9)(A)(ii).

[44] Soller & Stone, *Complex Distribution Rules in the New Law May Affect Plans' Qualifications*, 61 J. Tax'n 258, 259 (1984).

[45] *See* I.R.C. § 401(a)(9)(A) (1983); I.R.C. § 401(a)(9)(B) (1981).

[46] *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 1137-38 (1984), *reprinted in* 1984 U.S.

tion requirement imposed by the incidental death benefits test, the ability to designate a child as beneficiary gives estate planners more flexibility to increase the estate that will pass to heirs.

Another tax-deferral advantage added by the 1984 Act results from the potential extension of the required distribution period by annual recalculations of life expectancy.[47] Under present law IRA owners and qualified plan participants have significantly greater opportunities for deferral than before.

Under prior law, for example, a single woman who reached age 70½ was obligated to withdraw 1/15th of the account balance each year because she had a life expectancy of fifteen years under the Service's tables.[48] Under present law, however, she may recompute her life expectancy annually and, because people who are older are expected to live longer, she can effectively extend the distribution period. For example, the life expectancy tables provide that a woman at age eighty is expected to live to age 89½ and a woman at age eighty-five is expected to live to age 92½. Similar annual recomputations can be made if distributions occur over the combined lives of the employee and spouse. If someone other than a spouse is the designated beneficiary, the recalculation may be made only with respect to the life of the employee, not the life of the designated beneficiary.[49] Consequently, during the lifetime of the employee a designated beneficiary other than a spouse will receive payments at least as fast as the employee would have.

2. *After Death*

All qualified plans must provide for mandatory distribution of an employee's interest upon his death.[50] Generally the entire remaining interest must be distributed within five years after the

Code Cong. & Ad. News 1445, 1825-26.

[47] I.R.C. § 401(a)(9)(D).

[48] Treas. Reg. §§ 1.72-9, 1.401-11(e)(4), 1.408-2(b)(6). The Treasury is likely to issue revised unisex mortality tables to conform with the Supreme Court's decision in Arizona Governing Comm. for Tax Deferred Annuity & Deferred Compensation Plans v. Norris, 463 U.S. 1073 (1983). The Court held that an employer-sponsored retirement program (provided directly or through an insurance company) that paid smaller monthly benefits to women than to men constituted unlawful sex discrimination. After the decision, the Treasury issued unisex tables to measure the present value of deferred charitable gifts. *See* Treas. Reg. § 1.642(c)-6, as amended by T.D. 7955, 1984-1 C.B. 40.

[49] I.R.C. § 401 (a)(9)(D).

[50] I.R.C. § 401(a)(9)(B).

death of the employee or surviving spouse.[51]

An important exception exists for distributions to a designated beneficiary that begin within one year after the employee's death; such payments may be made over the life expectancy of the beneficiary.[52] If payments to the employee have already begun at the time of death, the five-year rule can be avoided if distributions to the designated beneficiary continue at least as rapidly as distributions during the employee's life.[53] Payments to a surviving spouse, however, need not begin until the date on which the employee would have reached age 70½.[54]

Because of the flexibility provided by present law, advance planning can significantly reduce the risk of bunching excessive amounts of income into any one taxable year of a designated beneficiary. A designated beneficiary may also be able to choose between fully taxable periodic distributions or a lump-sum distribution that qualifies for the ten-year averaging tax. The latter option affords the beneficiary an additional opportunity to maximize his or her cash flow from the inherited account.

C. *Pending Legislation*

Of all the "flat tax" bills that Congress has considered recently, only the House Tax Reform Bill and Treasury II would materially change the rules governing distributions from tax-favored retirement savings plans.[55] Treasury II would have applied uniform distribution requirements to most tax-favored retirement savings plans, including qualified plans, IRAs, and tax-sheltered annuities. Distributions that did not represent a return of an individual's nondeductible contributions would have remained fully taxable. In addition, premature distributions from any plan (*i.e.*, before the

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[51] *Id.* § 401(a)(9)(B)(ii).

[52] *Id.* § 401(a)(9)(B)(iii).

[53] *Id.* § 401(a)(9)(B)(i).

[54] *Id.* § 401(a)(9)(B)(iv).

[55] The most widely discussed proposals considered by Congress, in addition to the House Tax Reform Bill and Treasury II, are "The Fair Tax Bill of 1985," H.R. 800/S. 409, 99th Cong., 1st Sess. (1985), commonly referred to as the "Bradley-Gephardt" proposal, and "The Fair and Simple Tax Bill of 1985," H.R. 2222, 99th Cong., 1st Sess. (1985), commonly referred to as the "Kemp-Kasten" proposal. Over fifteen flat tax bills were introduced in the 98th Congress. *See* 1 Treasury I, *supra* note 17, Exhibits 8A, B; 1984 Joint Comm. Report, *supra* note 15, Appendix.

recipient reached age 59½, was separated from service, was disabled, or died) would have been subject to a nondeductible twenty-percent excise tax. Only a ten-percent excise tax would have applied if the proceeds were used to purchase a first principal residence, to replace unemployment benefits, or to pay for a dependent's college expenses.

Under Treasury II all tax-favored plans, including tax-sheltered annuities, would have been subject to the required minimum distribution rules that now apply to IRAs. Failure to comply with these rules would result in a fifty-percent excise tax to the extent of delinquent distributions. The House Tax Reform Bill adopts most of the Treasury II proposals described above, except that it would impose a fifteen-percent excise tax on premature distributions and would exempt systematic payments to early retirees from the tax.[56]

IV. Taxation of Lump-Sum Distributions

A. General Rule: Annuity Treatment

Distributions from qualified plans are generally taxed under the annuity provisions of section 72 of the Code.[57] Distributions attributable to employer contributions, the participant's tax-deductible contributions,[58] or the trust's investment income are taxed as ordinary income.[59] If the plan participant has made nondeductible contributions (*i.e.*, has made an "investment in the contract"), then distributions attributable to those amounts represent a tax-free return of capital.[60]

The option to choose between receiving the distribution in a

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[56] Treasury II, *supra* note 17, at 346-49; House Tax Reform Bill, *supra* note 17, §§ 1121-1123; *see also* H.R. Rep. No. 426, 99th Cong., 1st Sess. 724-31.

[57] I.R.C. § 402(a)(1).

[58] Where a plan permits voluntary employee contributions, employees may make tax-deductible contributions of up to the lesser of $2,000 or 100% of compensation, instead of contributing to an IRA. *Id.* § 219(a), (b), (e). Qualified plan distributions of accumulated deductible employee contributions, like distributions from IRAs, are fully taxable as ordinary income and do not qualify for ten-year averaging or long-term capital gain treatment. *See id.* § 402(e)(4)(A). Qualified plan distributions may be rolled over, however. *Id.* § 402(a)(5)(A), (D)(i). Contributions attributable to § 401(k) cash or deferred arrangements are not treated as employee contributions, and thus qualify for the ten-year averaging tax. *Id.* § 402(a)(8).

[59] *Id.* § 72(a).

[60] *Id.* § 72(b).

lump sum or in installments should not trigger constructive receipt of the entire account balance.[61] In 1981 Congress deleted the words "made available" from section 402(a)(1) so that qualified plan benefits now are taxable only in the year of actual distribution.[62] Although this change provided employees with considerable flexibility at retirement, the ability to obtain funds before retirement remains restricted by the qualified plan distribution requirements noted above. In addition, the doctrine of constructive receipt continues to apply to section 403(b) tax-sheltered annuities (Treasury II and the House Tax Reform Bill would change this risk, however).[63]

The Code includes alternate formulas for determining what portion of an annuity payment represents a tax-free return of capital. The general rule is that a recipient may exclude from income a percentage of the payment equal to the ratio of the investment in the contract to the expected return under the annuity contract (the "exclusion ratio").[64] If the sum of the annuity payments over the first thirty-six months will exceed the employee's investment

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[61] The rules of constructive receipt are found in the regulations, which provide:

> General rule. Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Treas. Reg. § 1.451-2(a).

[62] Until December 31, 1981, § 402(a)(1) provided in part:

> (a) Taxability of Beneficiary of Exempt Trust. — (1) General Rule. Except as provided in paragraphs (2) and (4), the amount actually distributed or made available to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities).

I.R.C. § 402(a)(1)(1981).

The words "or made available" were deleted by the Economic Recovery Tax Act of 1981 ("ERTA"), Pub. L. No. 97-34, § 314(c), 95 Stat. 172, 286, in order to relieve the income tax burden of constructive receipt which many plan participants were facing.

[63] *See* Rev. Rul. 67-388, 1967-2 C.B. 153; Treasury II, *supra* note 17, at 346; House Tax Reform Bill, *supra* note 17, § 1122(d).

[64] I.R.C. § 72(a). An exception applies, however, where substantially all contributions to the qualified plan were nondeductible employee contributions. In that case, all of the distributions will be taxable until all income has been distributed. *Id.* § 72(e)(7); *see* Joint Comm. on Tax'n, Gen'l Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 817-18 (Joint Comm. Print 1984).

in the contract, however, the recipient must apply the cost recovery method, by which each payment is treated as a tax-free return of capital until the full investment in the contract has been recovered (the "three-year cost recovery rule").[65] All subsequent payments are fully taxable as ordinary income.[66]

In addition to their importance with respect to periodic qualified plan distributions, the annuity provisions are significant in planning the tax treatment of lump-sum distributions. If a plan participant elects ten-year averaging for a lump-sum distribution and uses the after-tax proceeds to purchase an annuity, payments from the annuity will be subject to the exclusion ratio. By comparison, all distributions from an IRA are fully taxable as ordinary income and do not qualify for ten-year averaging.[67] As a result, the smaller annuity payments might provide greater after-tax cash flow than the larger IRA payments, since a portion of the annuity payments will be tax-free.

B. History of Special Treatment For Lump-Sum Distributions

Until 1942 all distributions from retirement plans were taxed under the annuity rules.[68] With income tax rates as high as eighty-two percent,[69] however, bunching became a serious problem. Probably to provide relief from bunching, the Revenue Act of 1942[70] made the taxable portion of a lump-sum distribution eligible for long-term capital gain treatment. Special treatment for lump-sum

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[65] I.R.C. § 72(d). Treasury II and the House Tax Reform Bill would eliminate the three-year cost recovery rule. *See* Treasury II, *supra* note 17, at 138; House Tax Reform Bill, *supra* note 17, § 1122(c).

[66] *See* I.R.C. § 72(d).

[67] I.R.C. § 408(d)(1); Treas. Reg. § 1.408-4(a).

[68] *See* I.R.C. § 165(b) (1939).

[69] The 82% marginal tax rate was enacted as part of the Revenue Act of 1942, Pub. L. No. 77-753, § 103, 56 Stat. 798, 802-03 (amending I.R.C. § 12(b)). The highest marginal rate has continued its decline from the 91% rate in effect under the Internal Revenue Code of 1954 as enacted. The top rate fell to 77% in 1964, 70% in 1965, and 50% in 1982. Revenue Act of 1964, Pub. L. No. 88-272, § 111(a), 78 Stat. 19, 19-23 (amending I.R.C. § 1); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101(a), 95 Stat. 172, 176-82 (amending I.R.C. § 1).

[70] Pub. L. No. 77-753, 56 Stat. 862. Although the legislative history contains no clear explanation of congressional intent, at least one commentator has suggested that Congress was responding to the problem of bunching. *See* S. Rep. No. 1631, 77th Cong., 2d Sess. 138, *reprinted in* 1942-2 C.B. 607; *see also* Note, *The Taxation of Lump Sum Distributions From Employee Benefit Plans Under § 402(a)(2)*, 35 Tax Law. 1187 (1982).

distributions was especially important at that time because neither the general income-averaging statutes[71] nor the rollover statutes had yet been enacted.[72]

In 1954 Congress extended long-term capital gain treatment to lump-sum distributions received by beneficiaries upon the death of a plan participant. This change demonstrated congressional concern for the adverse tax impact that bunched income could have on recipients other than plan participants.[73]

Over the years Congress has extended additional benefits, primarily tax deferrals, to taxpayers inheriting distributions. These rules permit (1) surviving spouses to roll lump-sum distributions over,[74] (2) designated beneficiaries to receive distributions over extended periods,[75] and (3) other beneficiaries to defer distributions for up to five years after the plan participant's death.[76]

The long-term capital gain treatment provided in 1942 prompted criticism from scholars and legislators for several reasons. First, such treatment occasionally made lump-sum distributions more advantageous than periodic payments subject to annuity treatment.[77] This result frustrated the fundamental purpose of retirement plans to provide regular retirement income. Second, conversion of ordinary income into long-term capital gain overcompensated for the bunching effect in some circumstances.[78] Third, Congress was displeased by evidence indicating that the most significant benefits accrued to taxpayers with adjusted gross

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[71] I.R.C. §§ 1301-1304 entered the Code in 1964. *See* Revenue Act of 1964, Pub. L. No. 88-272, § 232(a), 78 Stat. 19, 105-10.

[72] The rollover option first entered the Code as part of The Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2002(g)(5), 88 Stat. 829, 968-69 (enacting I.R.C. §§ 402(a), 403(a)).

[73] The House Committee on Ways and Means, in an apparent reference to the bunching problem, spoke of the "considerable inequities and hardship" produced by prior law. H.R. Rep. No. 1337, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. Code Cong. & Ad. News 4017, 4285-86.

[74] I.R.C. § 402(a)(7).

[75] *Id.* § 401(a)(9)(B)(i), (iii).

[76] *Id.* § 401(a)(9)(B)(ii).

[77] Chadwick, *Taxation of Certain Lump Sum Distributions*, 28 Tax Law., 555, 556 (1975); Sporn, *Some Proposed Revisions of the Internal Revenue Code Governing the Taxation of Deferred Compensation Arrangements*, 14 Tax L. Rev. 289, 303-06 (1959).

[78] Eckerman, *The Unrationalized Capital Gains Treatment of Lump Sum Termination Distributions from Qualified Pension, Profit-Sharing, and Annuity Plans*, 7 Syracuse L. Rev. 1, 7-16 (1955).

income of more than $50,000 and that certain recipients had received lump-sum distributions of more than $800,000.[79]

Congress first restricted long-term capital gain treatment in the Tax Reform Act of 1969 (the "1969 Act").[80] The 1969 Act continued to apply long-term capital gain treatment to the portion of any distribution attributable to pre-1970 employer contributions and accumulated earnings. However, the portion of the distribution representing post-1969 employer contributions was treated as ordinary income subject to a special seven-year forward-averaging tax. The remainder, representing investment earnings or appreciation, continued to qualify for long-term capital gain treatment.[81]

The 1969 Act established a less advantageous formula for self-employed recipients. For such individuals the entire taxable portion of lump-sum distributions was taxed as ordinary income qualifying for a five-year forward-averaging tax, and no portion was eligible for long-term capital gain treatment or for the seven-year averaging tax. In addition, self-employed individuals were made ineligible for taxation under the regular income averaging rules.[82]

The 1969 changes produced many theoretical and administrative difficulties. One theoretical objection was that the tax consequences of a lump-sum distribution depended on whether the recipient had other income in the year of distribution.[83] In addition, an unjustifiable distinction continued to exist between self-employed individuals and corporate employees.[84]

The new formulas also proved difficult to administer. The committee reports for the Employee Retirement Income Security Act of 1974 ("ERISA") stated that accountants and tax lawyers refused to attempt the computations.[85] In addition, the Treasury had

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[79] *See* H.R. Rep. No. 413, 91st Cong., 1st Sess. 154, *reprinted in* 1969 U.S. Code Cong. & Ad. News 1645, 1806.

[80] Pub. L. No. 91-172, § 514, 83 Stat. 487, 643.

[81] I.R.C. § 402(a)(5) (1970).

[82] *Id.*

[83] Chadwick, *supra* note 77, at 557.

[84] *See* H.R. Rep. No. 807, 93d Cong. 2d Sess. 145-50, *reprinted in* 1974 U.S. Code Cong. & Ad. News, 4670, 4811-15.

[85] The House Report stated:

> However, while the 1969 provisions were intended to provide more equitable treatment for such lump-sum pension distributions, they have not achieved their purpose. The Treasury has had great difficulty in providing regulations to carry out this provision. Problems have arisen both in determining the amount of the ordinary income element of distribution and in determining the precise amount of tax imposed on

difficulty formulating regulations to implement the law, especially with respect to computing the ordinary income and long-term capital gain portions of lump-sum distributions and preparing the seven-year and five-year averaging schedules. The confusion became evident when the Treasury published two sets of conflicting proposed regulations for the computation of the tax.[86]

In order to eliminate the unnecessary complexity and to increase revenue by an estimated sixty million dollars,[87] Congress enacted the ten-year averaging tax as part of ERISA's comprehensive overhaul of the legislation governing retirement plans.[88] The ten-year averaging tax has remained materially unchanged since its enactment, although Congress has done considerable "tinkering."

C. Definition of a Lump-Sum Distribution

Because lump-sum distributions from qualified plans qualify for the important tax advantages noted above, the definition of a lump-sum distribution is relatively complex, reflecting Congressional desire to minimize the potential for abuse. The first definitional requirement is that the distribution must be from a qualified pension, profit-sharing, or stock bonus plan.[89] Lump-sum distributions from IRAs, simplified employee pensions,[90] tax-sheltered annuities,[91] and most other retirement savings plans do not qualify for special tax treatment (long-term capital gain or ten-

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> account of the "ordinary income" element. Moreover, in practice the new proposed regulations have proved to be very complex and it is frequently maintained that individuals receiving lump-sum distributions have been unable to compute their taxes and that accountants and tax lawyers have been refusing to attempt the computations.

H.R. Rep. No. 807, *supra* note 84, at 38, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4704. The Senate Finance Committee reached the same conclusions. *See* S. Rep. No. 383, 93d Cong., 2d Sess. 138-39, *reprinted in* 1974 U.S. Code Cong. & Ad. News 4890, 5021-22.

[86] *See* H.R. Rep. No. 807, *supra* note 84, at 147, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4812.

[87] H.R. Rep. No. 807, *supra* note 84, at 41, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4707.

[88] Pub. L. No. 93-406, § 2005, 88 Stat. 829, 987-92 (1974).

[89] *See* I.R.C. § 402(e)(4)(A).

[90] *Id.* § 408(k). A simplified employee pension is an IRA that employers can use in lieu of a qualified plan. Employers may contribute much more than the $2,000 limitation to which individuals are subject.

[91] *Id.* § 403(b).

year averaging),[92] even though identical "bunched income" concerns exist. This is the rule even where an IRA consists exclusively of a lump-sum distribution rolled over from a qualified plan.[93]

The second requirement is that the distribution must represent the employee's entire balance in the plan.[94] An employee's accumulated tax-deductible contributions are not considered part of the account balance, although amounts attributable to employee-directed section 401(k) "cash or deferred" arrangements ("CODAs") are.[95] If a pension, profit-sharing, or stock bonus plan consists of several trusts, then the employee's balance in all trusts under the plan must be distributed.[96] Similarly, if an employer maintains multiple pension, profit-sharing, or stock bonus plans, then all qualified plans of the same kind must be treated as a single plan.[97]

The third definitional requirement is that the entire distribution must be made within a single taxable year of the recipient.[98] The distribution need not occur in the year of separation from service, nor must it be in the form of a single payment, as long as all payments are made within a single taxable year. Certain exceptions are provided, however, whereby distributions will qualify as lump-sum even though additional payments are to be made in future taxable years.[99] The obvious advantage is that where distribution is

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[92] Lump-sum distributions from certain qualified annuity plans can qualify for long-term capital gain treatment. I.R.C. § 403(a)(2). The general rule, however, is that only lump-sum distributions from qualified plans qualify for the ten-year averaging tax. For example, an employer's lump-sum payment of severance benefits does not qualify for favorable tax treatment, even though the employer might have a duty under a labor agreement to establish a qualified plan but in fact does not do so. *See* De La Fuente v. United States, 586 F. Supp. 526 (E.D.N.Y. 1984).

[93] Constanza v. Commissioner, 50 T.C.M. (CCH) 280 (1985).

[94] I.R.C. § 402(e)(4)(A).

[95] *See supra* note 58.

[96] I.R.C. § 402(e)(4)(C).

[97] *Id.*

[98] I.R.C. § 402(e)(4)(A).

[99] Rev. Rul. 60-292, 1960-2 C.B. 153. If distribution began in a prior year, subsequent distribution of the remaining account balance in one taxable year because of death, disability, or separation from service can qualify for ten-year averaging. Rev. Rul. 69-495, 1969-2 C.B. 100. If the complete distribution occurs for any other reason, however, the Service will assert that the distribution does not qualify for ten-year averaging. *See* Pvt. Ltr. Rul. 7723047.

Treas. Reg. § 1.402(a)-1(a)(6)(ii) provides that a distribution qualifies for long-term capital gain treatment even if additional payments attributable to the final year of service will deferred to a later year, the account balance can grow on a tax-deferred basis, potentially increasing the recipient's wealth.

A fourth requirement is that the distribution must not be made before the occurrence of an eligible event, defined as: (1) attainment of age 59½, (2) death, (3) permanent disability (applies only for self-employed individuals), or (4) separation from service.[100] Separation from service includes retirement and earlier separations due to termination, resignation, or lay-off.[101] Distribution need not be made in the year in which the employee separated from service or in the following year in order to be "on account of" separation from service.[102] If distribution takes place within one year of separation, post-separation investment income will also qualify for ten-year averaging.[103] In the case of a self-employed individual, only permanent disability will qualify a distribution for ten-year averaging before the taxpayer reaches age 59½ or dies.[104]

Finally, the employee must have participated in the plan for a minimum of five years before the year of distribution.[105] An exception applies if distribution occurs because of the participant's death, in which case the recipient will qualify for ten-year averaging treatment.[106] In such a case, however, only a surviving spouse may elect rollover.[107]

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be made in a future year. In private rulings the Service has permitted a distribution to be treated as a lump-sum distributions even though the recipient would receive other distributions. *See* Pvt. Ltr. Ruls. 8431084 (May 4, 1984), 8515088 (undated) (total distribution qualified for lump-sum treatment even where recipient remained a plan participant and additional amounts were added to his account balance). Moreover, a subsequent distribution of court-impounded funds will not prevent a recipient from making the election. *See* Rev. Rul. 83-57, 1983-1 C.B. 92.

[100] I.R.C. § 402(e)(4)(A). Reaching age 59 ½ is an eligible event even if the employee has not separated from service. Special Ruling (October 29, 1976), 779 Stand. Fed. Tax Rep. (CCH) ¶ 6422, at 2623.0965; *see also* Pvt. Ltr. Rul. 7748053 (Sept. 2, 1977). The United States Claims Court has held that the promotion of a common law employee to partner (self-employed individual) does not constitute separation from service. *See* Ridenour v. United States, 3 Cl. Ct. 128 (1983).

[101] *See* Rev. Rul. 57-115, 1957-1 C.B. 160.

[102] *See* Pvt. Ltr. Rul. 8339073 (June 28, 1983). The implication is that the distribution can be deferred, which may be advantageous to the recipient.

[103] I.R.C. § 402(e)(4)(A).

[104] *Id.*

[105] *Id.* § 402(e)(4)(H).

[106] Prop. Treas. Reg. § 1.402(e)-(2)(e)(3).

[107] *See* I.R.C. § 402(a)(5), (7); *see also id.* § 408(d)(3)(C) (prohibiting rollover of inherited IRAs except those inherited by surviving spouses). The only other situation in which someone other than the employee or surviving spouse may roll part or all of the distribution over

Failure to meet all of the requirements can be costly. If a complete distribution does not qualify and no rollover is made, then the entire amount (in excess of nondeductible employee contributions) is taxable as ordinary income,[108] which may push the recipient into a high marginal tax bracket. At best, the recipient may qualify for the general income averaging method to ease the resulting tax burden.[109] At worst, additional penalties for premature distribution may apply.[110]

D. Special Tax Benefits

1. Long-Term Capital Gain Treatment

The first advantage of lump-sum qualified plan distributions is that the taxable portion attributable to pre-1974 contributions may be eligible for long-term capital gain treatment.[111] Thus, sixty percent of the pre-1974 taxable portion is deductible from gross income.[112]

Because the Treasury had great difficulty computing the portion of a distribution that qualified for long-term capital gain treatment under the 1969 Act formula,[113] Congress enacted a simpler and more arbitrary formula in 1974. The long-term capital gain portion of a lump-sum distribution now equals the total taxable amount multiplied by a fraction consisting of (1) the number of months of active participation before January 1, 1974, divided by (2) the total

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is where the distribution is made under a qualified domestic relations order pursuant to a divorce or separation. *Id.* § 402(a)(6)(F).

[108] I.R.C. § 402(a)(7)(5). An interesting recent case involved an employee who was fired after being caught embezzling from his employer. As part of his restitution the employee endorsed to his employer a $12,260.70 check, which represented the entire balance in his profit-sharing account. Because the lump-sum distribution was made after the termination of employment, it qualified for the ten-year averaging method and the tax was only $932.67. *See* Jones v. Commissioner, 82 T.C. 586 (1984).

[109] *See infra* notes 168-75 and accompanying text.

[110] *See supra* notes 26-28 and accompanying text.

[111] I.R.C. § 402(a)(2).

[112] *Id.* § 1201(a). Congress retained long-term capital gain treatment for the portion of lump-sum distributions attributable to pre-1974 contributions despite the fact that the legislative history indicates disapproval of the conversion of ordinary income into long-term capital gain. *See* H.R. Rep. No. 807, *supra* note 84, at 37, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4703. The decision was probably made for political reasons and to protect those who had planned for their retirement distributions under pre-1974 law.

[113] *See supra* notes 80-86 and accompanying text.

months of active participation.[114] The balance of the taxable portion constitutes ordinary income qualifying for ten-year averaging treatment. Even though the amounts qualifying for long-term capital gain treatment will diminish over time, the fact that the long-term capital gain portion is computed not on the basis of actual pre-1974 contributions, but on the basis of a mechanical formula, means that a portion of post-1973 employer contributions and earnings may in fact qualify for long-term capital gain treatment.[115]

A recipient may elect to waive long-term capital gain treatment and include the capital gain portion in the ordinary income portion in order to qualify for ten-year averaging.[116] This is generally advantageous where the effective tax rate from the ten-year averaging method is less than forty percent of the recipient's marginal tax rate. For example, if a recipient received a $100,000 lump-sum distribution in 1985 and elected ten-year averaging for the entire amount (including the long-term capital gain portion), the tax on the distribution would be $14,594 or 14.59%. This would be the tax regardless of any other income that the taxpayer might have. Under the rule of thumb just stated, the recipient should elect ten-year averaging if his marginal tax rate is greater than 36.48% (40% x 36.48% = 14.59%). Another consideration is that the long-term capital gain deduction is an item of tax preference, which may subject the recipient to the alternative minimum tax,[117] whereas the tax benefit from the ten-year averaging method is not a tax preference item.

2. *Ten-Year Averaging*

The second advantage of lump-sum distributions is that an individual, estate, or trust may elect to have the taxable portion of the distribution that is attributable to post-1973 contributions and earnings (the "ordinary income portion") taxed under the ten-year averaging method.[118] The ten-year averaging method is a separate

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[114] Prop. Treas. Reg. § 1.402(a)-1(a)(9). The definition of active participation is contained in *id.* 1.402(e)-2(d)(3)(ii).

[115] *See* Satterfield, *Federal Income Taxation of a Lump Sum Distribution From a Qualified Employee Benefit Plan*, 35 Baylor L. Rev. 413, 435 n.120 (1983).

[116] I.R.C. § 402(e)(4)(L).

[117] *See id.* §§ 55, 57(a)(9)(A).

[118] *Id.* § 402(e)(1). The legislative history suggests that Congress neither was aware of the

tax[119] computed as if an unmarried taxpayer with other ordinary income totalling the zero bracket amount had received the distribution evenly over ten years. The tax is therefore ten times the tax that an unmarried individual would pay on the sum of the zero bracket amount and one tenth of the distribution. The ten-year period was chosen because it approximates the remaining life expectancy of a sixty-five-year-old and therefore reflects the period over which the income would be distributed if no lump-sum distribution occurred.[120]

The long-term capital gain portion attributable to pre-1974 contributions is included with other income unless the recipient elects ten-year averaging for that portion as well.[121] Special rules apply if estate taxes are attributable to the distribution[122] or if the distribution includes an annuity contract,[123] U.S. Retirement Bonds,[124]

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interplay between the rollover option and the special averaging tax, nor recognized that enactment of the rollover option made the special tax obsolete. The principal reason for enacting the rollover option was to facilitate "portability," the ability to transfer pension assets as employees changed jobs. S. Rep. No. 383, *supra* note 85, at 30, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4913.

[119] The ordinary income portion is deducted from the taxpayer's other income. Because the ten-year averaging tax is computed separately, *see* I.R.C. §§ 62(11), 402(e)(3), the tax paid on a lump-sum distribution is almost solely a function of the amount of the distribution. Many states' legislatures, such as California's, are aware that the tax is separately computed and have imposed their own special taxes. However, other states, such as Missouri, which determine state income tax liability exclusively on the basis of the federal definition of taxable income, fail to tax any portion of lump-sum distributions when the ten-year averaging tax is elected. *See* Appendix I for a table containing the federal tax due on lump-sum distributions received in 1985.

[120] H.R. Rep. No. 807, *supra* note 84, at 150-51, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4815-16.

[121] I.R.C. § 402(e)(4)(L).

[122] If there are estate taxes associated with a lump-sum distribution from a deceased employee's account, the taxable amount subject to ten-year averaging must be reduced by the estate taxes attributable to the distribution. I.R.C. § 691(c)(5). This provision reduces the amount eligible for ten-year averaging and reduces the amount of estate tax that can be deducted against ordinary income with respect to a decedent.

[123] If a lump-sum distribution includes an annuity contract, the current actuarial value of the annuity contract does not qualify for ten-year averaging. The annuity contract will affect the computation of the tax, however, because it is included in the total taxable amount. I.R.C. §§ 402(e)(2), (4)(A); Prop. Treas. Reg. § 1.402(e)-2(c)(1); Rev. Rul. 81-107, 1981-1 C.B. 201. The receipt of the annuity contract is not taxable (unless it is surrendered for its cash value), but the periodic payments will be taxable under the general annuity taxation rules of § 72. If, however, the contract is other than an annuity contract, such as a retirement income endowment or life insurance contract, then the cash value of the contract will be taxed under the ten-year averaging method except to the extent it is converted into an annuity contract within 60 days after the distribution of the contract. Treas. Reg. §

Series E Savings Bonds,[125] accumulated deductible employee contributions,[126] or excess benefits to a five-percent owner.[127] In addition, if a participant receives lump-sum distributions from two plans in the same taxable year (*e.g.*, a pension and a profit-sharing plan), he cannot elect ten-year averaging for one without also electing it for the other.[128] As noted above, multiple plans and multiple trusts of similar plans must be aggregated.[129]

Moreover, if a plan participant elected ten-year averaging treatment for a lump-sum distribution that occurred within six years of the close of the current taxable year, then the previous amounts must be aggregated with the distribution in the current year.[130] The effect of combining the distributions is usually to push the recipient into a higher marginal bracket than if the prior distribution had been ignored. To the extent that a participant can defer distribution beyond the six-year look-back period, he can both defer tax and reduce the effective tax rate on the distribution. Such deferral should not cause constructive receipt, in light of Congress' repeal of the "made available" rule for qualified plan distributions.[131]

If a lump-sum distribution includes employer securities,[132] the net unrealized appreciation is not taxed at the time of distribu-

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1.402(a)-(1)(a)(2).

[124] The issuance of United States Retirement Bonds, which did not qualify for ten-year averaging or long-term capital gain treatment, was terminated by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 491(a) (repealing I.R.C. § 405); *see also* § 402(e)(5). Such bonds now may be redeemed regardless of the age of the holder. Treas. Dept. News Rel. R-2785 (July 26, 1984).

[125] The Service takes the position that although Series E (and consequently, Series EE) Savings Bonds purchased with employer contributions are treated under the usual tax rules for distributions, those purchased with nondeductible employee contributions are not taxable to the employee at the time of distribution if the employee can withdraw the amount at any time. *See* Rev. Rul. 64-282, 1964-2 C.B. 112; *see also* Pvt. Ltr. Ruls. 8329087 (April 21, 1983), 8303072 (October 20, 1983).

[126] *See supra* note 58.

[127] To the extent that an individual who is a 5% owner receives amounts exceeding the benefits provided under the plan formula, the excess will be subject to the 10% penalty tax and will not qualify for ten-year averaging. I.R.C. §§ 72(m)(5)(A)(ii), 402(e)(4)(I); Treas. Reg. § 1.72-17(e)(1)(i)(b); Prop. Treas. Reg. § 1.402(e)-2(e)(4).

[128] I.R.C. § 402(e)(4)(C).

[129] *Id.*

[130] *Id.* § 402(e)(2); Prop. Treas. Reg. § 1.402(c)-2(c)(2).

[131] *See supra* notes 61-62 and accompanying text.

[132] "Securities" includes stock and corporate bonds or debentures with interest coupons or in registered form. I.R.C. § 402(a)(3)(A).

tion.[133] Instead, the appreciation is taxed when the securities are sold.[134] This permits recipients of distributions from stock bonus plans to qualify for deferred long-term capital gain treatment upon the eventual sale.[135] By comparison, distributions of securities other than employer securities are fully taxable upon receipt. In addition, if a distribution is not lump-sum, only the portion of net unrealized appreciation that is attributable to employer securities acquired with nondeductible employee contributions qualifies for tax deferral.[136]

The tax burden on small lump-sum distributions is reduced even further by the "minimum distribution allowance," by which a portion of small distributions is tax-free.[137] The tax-free amount is equal to the lesser of $10,000 or one half of the taxable portion of the lump-sum distribution less twenty percent of the total taxable amount in excess of $20,000. The minimum distribution allowance shrinks as the size of the distribution increases and reaches zero for lump-sum distributions of $70,000 or more.[138] As a consequence, large distributions are taxed at significantly higher effective rates than small distributions. The result is made even more dramatic by the fact that the tax is based on the steeply progressive rates for single individuals.[139]

Congress enacted the minimum distribution allowance to ensure that the tax paid by lower-income recipients would not exceed the long-term capital gain tax treatment.[140] An apparently unintentional consequence, however, is that high-income taxpayers who receive small lump-sum distributions will pay the same low tax as low-income taxpayers and will very likely pay less tax than if the distribution had been subject to long-term capital gain treatment.

A similar but more generally pertinent flaw of the ten-year averaging tax is that it is computed without regard to the recipient's other income. The rates for unmarried individuals were chosen as

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[133] *Id.* § 402(e)(4)(J); Treas. Reg. § 1.402(a)-1(b)(1).

[134] Treas. Reg. § 1.402(a)-1(b)(1).

[135] *See generally* Satterfield, *supra* note 115, at 414-20 (history of tax deferrals for distributions of employer securities).

[136] I.R.C. § 402(a)(1).

[137] *Id.* § 402(e)(1)(C), (D).

[138] *See id.* § 402(e)(1)(D).

[139] *See* Appendix I.

[140] H.R. Rep. No. 807, *supra* note 84, at 149, 152, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4814, 4817.

the standard for the averaging tax in order to treat all distributees equally,[141] but the tax favors wealthy taxpayers by ignoring the recipient's relative wealth or poverty.[142]

In addition, because the rollover option now permits any lump-sum recipient to defer tax until distributions are made from an IRA, the basic premise of the averaging tax is flawed. No rationale remains for imposing tax based on life expectancy projections at the time of distribution, since the rollover option permits distribution at the same rate as a qualified plan would allow during a recipient's lifetime.[143] Moreover, rollover is superior from a policy perspective, in that it results in the taxation of distributions at rates that reflect a recipient's other income.

To qualify for ten-year averaging, taxpayers must follow certain procedures. The recipient must elect ten-year averaging by filing Form 4972 with the income tax return for the year of distribution.[144] The election may be made only once after an individual has reached age 59½, but there is no limit on elections with respect to lump-sum distributions received earlier.[145] It may be possible to roll a lump-sum distribution over into an IRA and still elect ten-year averaging if the IRA is terminated before the end of the year.[146] If a deceased participant has multiple beneficiaries, the

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[141] "In order to treat all distributees equally, all computations of the tax on the ten-year averaging ordinary income portion are to be made on the basis of the tax schedule for unmarried individuals." H.R. Rep. No. 807, *supra* note 84, at 151, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4816.

[142] Recipients will pay the tax shown in Appendix I regardless of their other income.

[143] *See* H.R. Rep. No. 807, *supra* note 117, at 150-51, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4815-16.

[144] Temp. Treas. Reg. § 11.402(e)(4)(B)-1(c)(2).

[145] I.R.C. § 402(e)(4)(B); Temp. Treas. Reg. § 11.402(e)(4)(B)-1.

[146] If Congress does not repeal the ten-year averaging tax, the Service should issue a public ruling to reduce uncertainty generated by its private letter rulings. In Pvt. Ltr. Rul. 7951061 (September 18, 1979), the Service ruled that an individual who had rolled a lump-sum distribution over into an IRA could elect ten-year averaging if the IRA was terminated before the return was filed. It ruled that no excise or penalty taxes would be due. The investment income earned during the year by the IRA was ruled taxable as ordinary income. A similar conclusion was reached in Pvt. Ltr. Rul. 8338111 (June 23, 1983). Many individuals have planned their actions based on these rulings. The Service recently reversed itself when it released Pvt. Ltr. Rul. 8536097 (June 17, 1985) and concluded that amounts rolled over into an IRA could not be withdrawn without tax cost. Although the Service asserts that such rulings are not to be used as precedent, the Supreme Court itself has cited private letter rulings in its opinions. *See, e.g.*, Rowan Cos. v. Commissioner, 452 U.S. 247, 261 n.17 (1981). Taxpayers deserve a definitive statement of the Service's position on this issue.

personal representative may make the ten-year averaging election on behalf of all beneficiaries, and each will pay a pro rata portion of the tax on the total distribution.[147]

E. Pending Legislation

Treasury II and the House Tax Reform Bill would repeal the three-year cost recovery rule and apply the general annuity taxation rules to most distributions other than certain pre-retirement distributions. Such early distributions would be fully taxable until all employer contributions and investment income have been distributed, and only then would a distribution be treated as a non-taxable return of an employee's nondeductible contributions. This treatment is almost the inverse of the cost recovery rule and would provide an additional disincentive to use retirement plans for non-retirement purposes.

The deferral provisions that permit the net unrealized appreciation of employer securities to escape taxation until sold (or to escape taxation entirely if the participant dies owning the stock) would have been repealed under Treasury II. The full market value of the securities would thus have been taxed upon receipt.

Except for the House Tax Reform Bill, most of the major flat-tax proposals would eliminate ten-year averaging.[148] If only a single tax rate existed, bunched income would pose no problem.[149] If only a few progressive rates apply, the need for the ten-year averaging tax will still be considerably reduced if the highest marginal rate is lower than the present maximum rate of fifty percent.

Section 1122 of the House Tax Reform Bill would shorten the averaging period from ten years to five years and would also phase out long-term capital gain treatment over a six-year period. The

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[147] Prop. Treas. Reg. § 1.402(e)-3(b). The election is made on Form 5544, Multiple Recipient Special Ten Year Averaging Method. *See* Rev. Rul. 83-121, 1983-2 C.B. 74 (concerning the election of ten-year averaging by an inter vivos trust and the tax consequences to beneficiaries).

[148] Treasury II, *supra* note 17, and the Bradley-Gephardt and Kemp-Kasten bills, *supra* note 55, would all have done so.

[149] The House Tax Reform Bill, *supra* note 17, Treasury II, *supra* note 17, and the Bradley-Gephardt proposal, *supra* note 55, retain a limited number of tax brackets, with a top marginal rate of 38% (House Tax Reform Bill). Although the Kemp-Kasten bill appears to have a single tax rate, the interrelationship of the social security tax and a proposed surtax causes the bill to have three marginal rates.

effect of such a change is illustrated in Appendix III. Although the five-year averaging formula would increase the effective tax rate on lump-sum distributions now taxable under the ten-year formula, the tax still fails to take into account the recipient's wealth or poverty.

Thus, as the computations demonstrate and as will be shown below, even if the forward averaging formula is shortened to five years and even if the highest marginal tax rates are not changed, the special tax treatment should be repealed. It interferes with congressional tax and economic policy by permitting individuals to shift income from their normal rates to lower rates, and by encouraging early distributions of retirement savings. Existing alternatives make special tax concessions for lump-sum distributions unnecessary and, as they now stand, inequitable.

V. Implications of Ten-Year Averaging for Tax Policy

A. *Existing Alternatives Make a Special Tax Unnecessary*

Before Congress provided special tax concessions for lump-sum distributions in 1942, recipients of such distributions had no alternative to including the full taxable portion in income in the year of distribution. Over the years since 1942 Congress has provided alternate forms of relief, many of which further the policy of favoring the accumulation of retirement savings more than the ten-year averaging tax does. The three most important alternatives are the rollover election, general income averaging, and the designated beneficiary provisions.

1. Rollover

Rather than pay tax in the year of distribution, a plan participant may defer tax by rolling over all or part of the taxable portion of a lump-sum distribution into a qualified trust, IRA, or annuity plan described in section 403.[150] The rolled-over amount will continue to grow on a tax-deferred basis and will not be taxed until distributed. Although amounts rolled over into qualified plans continue to qualify for future ten-year averaging, distributions from

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[150] I.R.C. § 402(a)(5). A lump-sum distribution may be rolled over into several IRAs if the taxpayer wishes. *See* Rev. Rul. 79-265, 1979-2 C.B. 186.

IRAs, with one exception, are fully taxable as ordinary income.[151]

When Congress enacted the rollover option in 1974 as part of ERISA, it apparently was not aware that the option eliminated the need for a special lower tax on lump-sum distributions. Congress' main concern was to enhance the portability of retirement savings (*i.e.*, the ability to transfer retirement savings as employees change jobs), rather than to provide an alternative to the lump-sum averaging tax for retirees.[152] The net effect of the rollover rules, however, has been to enable a plan participant or a surviving spouse to avoid tax completely in the year of distribution, thereby eliminating the bunching problem that led to special tax concessions. Because plan participants can withdraw as much or as little as they need from rolled-over IRAs (subject to the minimum distribution requirements),[153] the rollover option achieves Congress' goal of assuring employees a regular source of retirement income. It also eliminates the rationale for computing a special tax "as if" distribution had occurred over ten years.

To qualify for rollover, the distribution must meet the lump-sum definition (with exceptions discussed below) and must be transferred to an eligible retirement plan within sixty days after distribution.[154] The maximum that can be rolled over is the fair market value of the property distributed, reduced by employee contributions other than accumulated deductible employee contributions.[155] If only part of the lump-sum distribution is rolled over, the taxable portion retained by the recipient is eligible neither for ten-year averaging nor for long-term capital gain treatment, but is

[151] If an IRA contains only a rollover distribution from a qualified plan, the amount in the IRA can later be rolled over into another qualified plan, preserving the opportunity for lump-sum ten-year averaging treatment. I.R.C. § 408(d)(3)(A)(ii); Rev. Rul. 79-265, 1979-2 C.B. 186. If, however, any part of the distribution is attributable to contributions made on behalf of an employee when he was a key employee in a top-heavy plan, then that portion cannot be rolled over into a qualified plan. I.R.C. § 402(a)(5)(F). Congress may in the future choose to restrict the limitation on key employees to 5% owners.

[152] *See* S. Rep. No. 383, *supra* note 85, at 30, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4913; *see also supra* note 118.

[153] *See supra* notes 35-54 and accompanying text.

[154] I.R.C. § 402(a)(5)(C). A district court has interpreted the 60-day requirement to permit an executor to roll a lump-sum profit-sharing plan distribution over into an IRA if the recipient dies within the 60-day period. *See* Gunther v. United States, 83-1 U.S.T.C. ¶ 9252 (W.D. Mich. 1982). For special rules for sales of distributed property during the 60-day rollover period, see I.R.C. § 402(a)(6)(D).

[155] I.R.C. § 402(a)(5)(B).

fully taxable as ordinary income.[156] Beginning in 1985, plan administrators are required by law to provide written explanations to recipients informing them that tax will be deferred if the distribution is rolled over within sixty days of receipt.[157] Administrators must also disclose whether the distribution is eligible for ten-year averaging or for long-term capital gain treatment and must describe the effects of such treatment.[158]

If a lump-sum distribution qualifies for the ten-year averaging method, the recipient generally has the option of rolling the distribution over instead. An exception applies where the lump-sum distribution is made because of the participant's death. In such a case, any individual, trust, or estate may use the ten-year averaging method, but only a surviving spouse may roll over an inherited lump-sum distribution.[159] Except for this limitation, eligibility for rollover is generally more liberal than for ten-year averaging. For example, an employee need not have participated in the plan for five years before the year of the lump-sum distribution.[160] In addition, a taxpayer may roll over any number of times after age 59½, whereas ten-year averaging can be elected only once after 59½.[161] Moreover, rollover is not subject to the ten-year averaging requirement that all similar qualified plans be aggregated. If an employer maintains both a purchase money pension plan and a defined benefit pension plan, and if an employee's entire balance in the purchase money plan is distributed, then the distribution may be rolled over even where no total distribution from the defined benefit plan has occurred.[162]

Rollover also includes more eligible events than ten-year averag-

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[156] *Id.* § 402(a)(6)(C).

[157] *Id.* § 402(f), enacted as part of the Retirement Equity Act of 1984, Pub. L. No. 98-397, § 207(a), 98 Stat. 1449, 1451.

[158] *Id.*

[159] I.R.C. § 402(a)(7). The Technical Corrections Bill of 1985, H.R. 1800, 99th Cong., 1st Sess., § 152(a), (b) (incorporated as House Tax Reform Bill, *supra* note 17, § 1552(b)(4)), provides that surviving spouses may roll inherited distributions over only into IRAs and not into qualified plans.

[160] I.R.C. § 402(a)(5)(E)(i)(II).

[161] *See id.*; Rev. Rul. 82-153, 1982-2 C.B. 86.

[162] I.R.C. § 402(a)(6)(E). If there is a complete distribution from the defined benefit plan in a subsequent year, that distribution also may be rolled over. However, neither distribution will qualify for ten-year averaging, since amounts were received from two pension plans (similar types of qualified plans) in two taxable years. S. Rep. No. 1031, 96th Cong., 2d Sess. 7-8, *reprinted in* 1980 U.S. Code Cong. & Ad. News, 7332, 7337-38.

ing. A participant may roll over a complete distribution not only upon death, disability, separation from service or reaching age 59½, but also upon complete termination of a plan (or in the case of a profit-sharing or stock bonus plan, upon complete discontinuation of contributions).[163] The Tax Court and the Second Circuit have held that this is the result even where the termination is attributable to the loss of tax-exempt status, but recently the Fifth, Sixth, and Seventh Circuits have held to the contrary.[164] Special rules apply for plan terminations caused by the sale of a subsidiary or a substantial portion of a corporation's assets.[165]

The 1984 Act added another situation in which rollover but not ten-year averaging is available: a partial distribution from a qualified plan. To qualify, the distribution must constitute at least fifty percent of the employee's current balance in the plan, the distribution must not be one of a series of periodic payments, the amount must be rolled over into an individual retirement account or individual retirement annuity (no other qualified plans are eligible), and the employee must elect rollover treatment.[166] Rollover of a partial distribution involves a substantial cost, however, in that no subsequent distributions from the plan will qualify for ten-year averaging or long-term capital gain treatment.[167] The law thus encourages rollover of partial distributions only where the recipient is certain that he will not wish to elect ten-year averaging or long-term capital gain treatment for any future lump-sum distributions.

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[163] I.R.C. § 402(a)(5)(E)(i), (6)(A), (B). A complete discontinuance of contributions to a profit-sharing or stock bonus plan can constitute a complete termination of the plan. *See* Treas. Reg. § 1.401-6(c). Pension plans subject to the minimum funding standards are also subject to the sanctions in § 412 if contributions are discontinued. The Service takes the position that lump-sum distributions made because of plan terminations do not qualify for ten-year averaging. *See, e.g.*, Pvt. Ltr. Rul. 8214003 (Dec. 16, 1982).

[164] The Tax Court held that the taxability of a distribution from a plan which has lost its tax-exempt status is determined at the time that the contributions were made to the plan rather than at the time of distribution. It further held that the portion of the account balance representing employer contributions and trust earnings prior to disqualification was eligible for rollover treatment. *See* Boggs v. Commissioner, 83 T.C. 132, *appeal dismissed*, (6th Cir. Apr. 29, 1984); *see also* Greenwald v. Commissioner, 366 F.2d 538 (2d Cir. 1966). *Contra* Baetens v. Commissioner, 777 F.2d 1160 (6th Cir. 1985); Benbow v. Commissioner, 774 F.2d 740 (7th Cir. 1985); Woodson v. Commissioner, 651 F.2d 1094 (5th Cir. 1981). In any case, the portion of the distribution representing subsequent contributions and earnings is not eligible for rollover but is taxable.

[165] I.R.C. § 402(a)(6)(B).

[166] *Id.* § 402(a)(5)(D).

[167] *Id.* § 402(a)(5)(D)(iii).

Such a situation might exist where an employee is over 59½ and is covered by both pension and profit-sharing plans. The employee might elect ten-year averaging for a complete distribution from one plan, while remaining eligible for partial rollover of a distribution from the other.

2. Income Averaging

Recognizing that the determination of tax liability by reference to annual accounting periods[168] causes bunched income to be taxed at a higher rate than if received in a series of annual installments, Congress enacted the general income averaging provisions as part of the Revenue Act of 1964.[169] The income averaging formula attempts a modified multi-year approach by permitting individual taxpayers to take into account the income of the three preceding years in determining the marginal rate applicable to income received in a high-income year.[170] The three tax years preceding the computation year constitute the "base";[171] a taxpayer qualifies for income averaging if the income in the computation year exceeds 140% of the average income of the base years by at least $3,000.[172]

For those plan recipients who cannot or will not elect rollover treatment, income averaging offers an opportunity to minimize the bunching problem that in 1942 led to preferential treatment for lump-sum distributions.[173] A conceptual advantage of the general income averaging formula is that it takes other income of the recipient into account, whereas the ten-year averaging method does not.[174] Beneficiaries who receive distributions because of the death of a plan participant can apply the general income averaging provisions to a series of equal withdrawals over the required five-year distribution period, substantially minimizing the bunching effect

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[168] *Id.* § 441.

[169] Pub. L. No. 88-272, § 232, 78 Stat. 106, 106-12 (1964), codified at I.R.C. §§ 1301-1305.

[170] There is no corresponding provision to amend tax returns filed in earlier high-income years for substantial declines in income in later years. For a discussion of the tax policy implications, see Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity,* 1984 Duke L.J. 509, 568-73 (1984).

[171] I.R.C. § 1302(b)(1), (c)(2).

[172] *Id.* § 1301.

[173] *See supra* notes 68-72 and accompanying text.

[174] *See supra* note 119 and accompanying text.

that such distributions might otherwise have.[175] Most of the flat-tax proposals that Congress has recently been considering would repeal the general income averaging statutes, since relief from bunched income is not essential if only a few tax brackets with relatively low rates apply.

3. Death of the Plan Participant

Only plan participants and surviving or divorced spouses may roll over lump-sum or partial distributions under present law.[176] If the ten-year averaging tax were repealed, other beneficiaries receiving lump-sum distributions upon a participant's death could incur sizable tax liabilities, since they have no alternative under present law to including the taxable portions in ordinary income in the year of receipt.

Although it is debatable whether non-spouse beneficiaries who inherit property should enjoy special tax benefits, Congress has demonstrated its concern by granting them special tax treatment.[177] Maintaining the ten-year averaging tax solely to protect these recipients is unjustifiable, however, since adequate alternate protections already exist. First, distributions can be made over as many as five years, rather than in one lump sum, to mitigate the bunching effect.[178] Second, individuals can apply the general income averaging provisions to a series of equal annual withdrawals over the five-year distribution period, to reduce the bunching effect even further.[179] Third, if the plan participant has named a "designated beneficiary," payment can be made over an extended period, and the five-year distribution requirement is effectively avoided.[180] The appropriate solution is not to retain ten-year averaging to protect recipients who are ineligible for rollover. Rather, if special treatment is warranted for inherited accounts generally, Congress should expand eligibility for rollover and other tax deferrals.

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[175] *See supra* note 51 and accompanying text.
[176] I.R.C. § 402(a)(5), (6)(F), (7).
[177] Individuals, trusts, and estates qualify for ten-year averaging. *Id.* § 402(e).
[178] *Id.* § 401(a)(9).
[179] *See supra* notes 168-75 and accompanying text.
[180] *See supra* notes 43-54 and accompanying text.

B. Tax Policy Objectives

U.S. tax policy can be seen as aimed at four broad objectives: efficiency, simplicity, equity (both horizontal and vertical), and stimulation of the economy.[181] In order to make a well-reasoned decision as to possible modification or repeal of the ten-year averaging tax, Congress must examine how the repeal or continued existence of the tax will affect each of its four policy objectives.

1. Economic Efficiency

One of the primary objectives of any tax system is to keep necessary interference with the efficient allocation of resources to a minimum.[182] There is general agreement, however, that every tax system will have some effect on the economy, since taxpayers will structure their affairs so as to minimize their taxes in order to maximize their after-tax wealth.[183]

The ten-year averaging tax has no significant negative impact on the allocation of resources. Perhaps some individuals contribute more to qualified plans than they otherwise would in order to shift income from a high tax bracket to a lower one, but this effect is slight compared to the dramatic positive effect that retirement plans have on the economy. Even if the ten-year averaging tax were repealed, employees and individuals would continue to contribute to qualified retirement plans. The truth of this assertion can be seen by analogy in the tremendous public acceptance that IRAs have received, even though IRA distributions are not eligible

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[181] 1984 Joint Comm. Report, *supra* note 15, at 2-7.

[182] 1 Treasury I, *supra* note 17, at 13-20.

[183] The 1984 Joint Committee Report, *supra* note 15, states:

> The concept of economic efficiency uses as a benchmark the production of goods and services which would occur in a market economy in the absence of taxes. Economists generally regard this allocation of resources as a useful reference point because, under certain conditions, it insures that available economic resources are arrayed in such a way as to produce the highest possible amount of consumer satisfaction. Relative to this benchmark, taxes change the incentives to engage in various types of economic activity (*e.g.*, work, investment, consumption of specific goods and services), which reduces the ability of the economy to satisfy consumer demands. Thus, some inefficiency is inherent in virtually all taxes which are acceptable from the equity standpoint. However, a major goal of tax policy is to reduce this inefficiency to as low a level as possible.

1984 Joint Comm. Report, *supra* note 15, at 6.

for averaging.[184] The repeal or modification of the ten-year averaging tax should not dramatically affect the existing allocation of resources.

2. *Simplicity*

The recent flurry of flat-tax simplification proposals appears to reflect an increasing desire on the part of the public for a simplified tax system. The primary objections to the present complex system are that it increases both compliance and collection costs and contributes to public perceptions of inequity.[185] If two similarly situated taxpayers pay different amounts of tax because only one has knowledge of a technical tax benefit provision or interpretation, the perceived inequity may cause the taxpayer who pays more tax to reduce his compliance.[186] Voluntary compliance is essential to the effective operation of our income tax system, since taxpayers compute their own tax liabilities.

Where a taxpayer qualifies for ten-year averaging, a seasoned tax return preparer can usually compute the tax with little difficulty. Simplicity was one of Congress' primary objectives in 1974, because of the confusion that had resulted from the 1969 Act formula. A taxpayer intending to make the probably once-in-a-lifetime[187] decision to use ten-year averaging is still likely to find

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[184] *See supra* notes 15-16 and accompanying text.

[185] Commissioner of Internal Revenue Roscoe L. Egger, Jr. recently disclosed the results of a public opinion survey that concluded that:

> (1) 4 out of 5 taxpayers believe that the federal tax system benefits the rich and is unfair to the ordinary worker;
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> (2) 3 out of 4 taxpayers believe that the tax law is unfair in their particular income situation;
>
> (3) a majority believe that more than 25% of the public are cheating on their taxes and the incidence of cheating is increasing;
>
> (4) nearly 20% of those surveyed admit to cheating on their own returns; and
>
> (5) 9 out of 10 respondents believe that simplifying the tax system would help the Service collect taxes.

See Federal Taxes Bulletin 27 (P-H) ¶ 60,473-75 (June 13, 1985) [hereinafter cited as P-H Bulletin 27].

[186] The IRS estimated that the percentage of total income tax liability voluntarily paid by taxpayers has fallen from 84% in 1974 to 82.1% in 1980, and is projected to decline to 81.6% in fiscal year 1986. Each one percent reduction in compliance represents a revenue reduction of $5 billion. The total lost revenue was $29 billion in 1974, $62 billion in 1980 and a projected $92 billion by fiscal year 1986. *See id.* ¶ 60,474.

[187] A recipient may make the election only once after reaching age 59½. I.R.C. § 402(e)(4)(B).

Form 4972 confusing, however, and thus he may turn to a tax return preparer for assistance. Moreover, even an experienced tax return preparer may find the computation difficult if complications are present, such as distributions of annuity contracts, appreciated employer securities, or U.S. Series E bonds.[188]

Even if the averaging computation itself is simple, the issue of whether a particular lump-sum distribution qualifies can be very complex. Because large amounts of money may be at stake, many taxpayers will find it advantageous to consult tax professionals to determine whether the lump-sum distribution qualifies for ten-year averaging.

Recipients are also likely to hire tax professionals to plan the appropriate action to maximize their after-tax wealth. For example, rather than receive regular distributions during retirement (Congress' purpose in granting incentives for retirement savings plans), the recipient may seek maximum after-tax cash flow by paying the low ten-year averaging tax and investing the after-tax amount in tax-exempt securities[189] or in a tax-deferred annuity.[190] Among the many factors that contribute to the complexity of the planning are life-expectancies, distribution amounts, interest rates, and projected tax rates during retirement.

Appendix II contains graphs analyzing these variables and indicating where paying the ten-year averaging tax benefits taxpayers more than spreading distributions throughout retirement. The graphs demonstrate that the ten-year averaging tax primarily benefits high-income taxpayers and those who intend to spend a distribution over a short time. The graphs also highlight the troublesome problems of a special tax concession that creates incentives for recipients to request a complete distribution of their retirement savings rather than to receive periodic retirement income.

As with any tax, ten-year averaging imposes administrative burdens on the Service. While the Service's computers can verify the accuracy of the mathematical computations on Form 4972 and probably also cross-check an employee's Form 4972 with informa-

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[188] *See supra* notes 122-36 and accompanying text.

[189] *Recipient of Lump-Sum Distribution Has Choice of 2 Complex Investment Strategies,* Wall St. J., Mar. 5, 1984, at 33, col. 4; *Monthly Checks or a Lump Sum?,* 1985 Money Guide 33, 33-38 (1984).

[190] Hoyt, *Choosing Between Special Ten-Year Averaging and Deferring Tax Through a Rollover,* 60 J. Tax'n 90 (1984).

tion on his employer's Form 1099R, difficulties will arise if the employer has erred. For example, the Service may not discover until audit that the employee had not completed five years of service or that other technical failures threaten the taxpayer's eligibility for the election.[191]

Ten-year averaging is yet another complex addition to the Code. Although simplicity is probably the least important of the four policy objectives,[192] it is nonetheless a significant objective and supports other reasons for repeal of the ten-year averaging method.[193]

3. *Equity*

a. *Horizontal Equity*

Horizontal equity exists where two similarly situated taxpayers pay the same amount of tax.[194] The perception of horizontal equity is crucial to public compliance with a voluntary income tax system. If, for example, a taxpayer discovers that an identically situated person has paid less tax than he has, the taxpayer's faith in the tax system is diminished and his resistance to avoidance incentives is weakened.

Under present law many situations arise in which similarly situated taxpayers incur different tax liabilities. For example, a fully employed wage earner will pay more tax than a neighbor who receives an identical amount of income, part of which is comprised of tax-free unemployment compensation from a state or federal agency.[195] Similarly, a tenant will pay more in taxes than a homeowner across the street who incurs identical housing expenses. Even though their monthly payments are the same, the homeowner may deduct the interest portion of his mortgage payments,

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[191] For a summary of cases interpreting the tax consequences to a plan that loses its tax-exempt status, see *supra* note 164.

[192] The Joint Committee on Taxation concluded: "A very simple tax system, however, may rank low from the equity and efficiency viewpoints. . . . [A]s with other elements of tax policy, a balance must be struck among competing objectives." 1984 Joint Comm. Report, *supra* note 15, at 6.

[193] The principal issue is whether the equitable concern to provide relief from the effect of bunched income outweighs the need for a simplified tax code. Since this article concludes that a remedial tax for lump-sum distributions is unjustified, the complexity of the ten-year averaging method certainly is unwarranted.

[194] 1984 Joint Comm. Report, *supra* note 15, at 4.

[195] *See* I.R.C. § 85.

but the renter may not deduct any of his rent.[196] Taxpayers may be willing to accept certain differences that result from rules designed to provide needed stimulus to particular economic activity. When the exclusions, exemptions, and deductions become too numerous, however, taxpayers may perceive the tax system as unfair because it benefits some individuals more than, or to the exclusion of, themselves.[197]

b. *Vertical Equity*

Vertical equity exists only where individuals with more income use a greater proportion of their income to pay taxes than those with less income. The progressive tax brackets are the core of the policy favoring vertical equity.

There is of course debate as to whether the rate structure should be progressive at all. Some of the flat-tax proposals pending in Congress would apply a single rate to all income.[198] Several economists argue that a single rate may help to avoid the distortion of incentives to work and save that are produced by a progressive rate structure (*i.e.*, the economic efficiency principle).[199] Even those who favor a progressive rate structure disagree over the proper degree of progressivity. The trend over the past twenty years has been to reduce the highest marginal tax rates, in the belief that high rates discourage work and savings, particularly among working women.[200] The outcome of the debate over whether to reduce the highest marginal tax rate will reflect a choice balancing the social goal of vertical equity against the economic goal of efficiency.[201]

c. *Ten-Year Averaging and Principles of Equity*

One of the most serious problems posed by the ten-year averaging tax is that it violates the principles of horizontal and vertical

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[196] *See id.* §§ 163, 263.
[197] *See supra* note 185.
[198] *See supra* note 149.
[199] *See* 1984 Joint Comm. Report, *supra* note 15, at 5.
[200] *Id.* at 12-14.
[201] Despite the maximum 50% marginal tax rate for high-income individuals, the wealthiest of Americans pay tax at an average effective rate of only 24.8% because of the availability of deductions, most notably the capital gain deduction. *Id.* at 15.

equity. This is ironic since the tax was created to cure inequity that resulted when a recipient was pushed into a high tax bracket upon receipt of a large lump-sum distribution representing many years of accumulated income. However, the manner in which the ten-year averaging tax operates has led to the other extreme: recipients are taxed at rates that bear no relationship to their total income. The sole operative variable is the amount of the distribution itself.

The horizontal equity problem can be illustrated with the following question: why should an individual who has and will always be taxed at a fifty-percent marginal rate pay a lower rate of tax on a lump-sum distribution, when an identically situated taxpayer will pay the full fifty-percent rate on the same distribution occurring over two or more years?

The policy of ten-year averaging is similar to that of general income averaging, but the ten-year averaging tax has more flaws. Both types of averaging are designed to cure the problem that arises where taxable income is measured in annual accounting periods, rather than over an extended period during which high-income and low-income years will average out. The major difference between the provisions is that while general income averaging takes into account a taxpayer's entire income during the base period, the ten-year averaging formula ignores all income of the taxpayer that does not qualify for ten-year averaging. The premise of the formula is that the recipient will have no other income during retirement;[202] this premise, however, represents an entirely unfounded assumption. The principles of horizontal and vertical equity are therefore violated.

Assume for example that two executives have both been in the fifty-percent marginal tax bracket during their working careers and will both be in the same bracket throughout retirement. Assume also that each has a balance of $20,000 in his profit-sharing account. If the first executive withdraws the amount over a period of years (as few as two years), all withdrawals will be taxed at the fifty-percent rate. In contrast, if the second executive withdraws the amount in one year, the withdrawal will qualify as a lump-sum distribution and he will pay a tax of $1,100 in 1985, at an effective

[202] *See* H.R. Rep. No. 807, *supra* note 84, at 150-51, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4815-16.

rate of only 5.5%. Appendix I demonstrates this result. Because two individuals in virtually identical economic circumstances are subject to radically different tax consequences, the principle of horizontal equity is breached.

Similarly, a factory worker in the twenty-percent marginal tax bracket who receives an identical $20,000 lump-sum distribution will pay the same $1,100 ten-year averaging tax as the wealthy executive. This situation violates the principle of vertical equity because the income received by the lower-income worker is taxed at the same rate as that received by the wealthy executive.[203] Furthermore, if the factory worker had poor tax advice and received the distribution over two or more years, he would pay tax at the higher twenty-percent rate.

The retirement savings laws produce inconsistent results also. Although distributions from qualified plans qualify for ten-year averaging, distributions from simplified employee pensions (a form of IRA that employers sometimes use in lieu of qualified plans)[204] do not. Although the two retirement savings vehicles are quite similar (both may receive large employer contributions and accumulate income tax-free), the tax effects to recipients of distributions from these plans can be dramatically different.

4. *Behavior Effects*

Although the principles of efficiency, simplicity, and equity are the fundamental goals of a well-reasoned revenue system, Congress has often used the Code to promote specific behavior among tax-

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[203] Normally a high-income executive will have a larger account balance than a lower-paid employee at the same company because contributions to accounts are usually based on compensation. *See* I.R.C. § 401(a)(5). It is possible for a key executive to have a small account balance, however, if contributions have been small or the term of employment was short. In addition, employees often have flexibility in manipulating account balances to their advantage, particularly key employees at smaller companies. Such companies can, for example, establish large pension plans as the primary source of retirement income and smaller profit-sharing plans as a source for lump-sum distributions. The plans are sufficiently dissimilar that distributions will not have to be aggregated in order to qualify for ten-year averaging. *See id.* § 402(e)(4)(C). In addition, by including a "cash or deferred arrangement" with the profit-sharing plan, employees can direct additional funds into their accounts. *See id.* § 401(k). Where a lump-sum distribution is contemplated, the ten-year averaging tax facilitates conversion of ordinary compensation income into the lower-taxed lump-sum distribution.

[204] I.R.C. § 408(k).

payers for economic and social purposes. The argument favoring use of the tax laws for such purposes is that such use is more efficient in certain situations than collecting tax revenue and spending it through government-administered programs.[205]

Unlike many other provisions of the Code,[206] however, the ten-year averaging tax was apparently not intended to produce any behavioral effect on taxpayers. The tax was enacted solely for purposes of equity; Congress had concluded that it was "unfair" for people to be pushed into abnormally high marginal tax brackets by receiving many years of tax-sheltered income in one year.[207] In contrast, in allowing retirement plans and IRAs to shelter tax-deductible contributions and accumulated income Congress intended to stimulate retirement savings. The ten-year averaging tax is simply a consequence of more important provisions and is not itself designed to have an effect on taxpayer behavior. Moreover, as noted earlier, repeal or modification of the ten-year averaging tax would probably not affect dramatically the level of contributions to retirement plans.[208]

The ten-year averaging tax probably frustrates more than it furthers public policy in favor of accumulation of retirement savings. The primary reason for encouraging retirement savings through qualified plans is to assure employees regular retirement income. As the graphs in Appendix II demonstrate, many retirees will accumulate greater wealth by withdrawing their retirement savings in one lump sum and paying the tax upon withdrawal, rather than by receiving regular retirement income from a plan. A possible consequence is that some retirees may quickly spend the lump sum, leaving them without a steady source of retirement income.[209]

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[205] For example, it may be more effective to continue the child and dependent care credit under § 21, which allows taxpayers to claim tax credits for day-care expenditures, than to implement a federal day-care program. Similarly, the § 30 research and development credit may encourage businesses to increase their R&D efforts in a manner more consistent with their business opportunities than direct expenditure on a federal program might.

[206] *See, e.g.*, I.R.C. §§ 117 (fellowships), 119, 120, 124, 125, 129 (certain fringe benefits).

[207] S. Rep. No. 383, *supra* note 85, at 141, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 5024; H.R. Rep. No. 807, *supra* note 84, at 150, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4815.

[208] *See supra* notes 15-16 and accompanying text.

[209] The Treasury has used this argument as part of its proposal to repeal the ten-year averaging tax:

> The special ten-year averaging and capital gain provisions for lump sum distributions (including lump sum distributions before retirement) encourage individuals to

By comparison, the rollover option provides incentives that further congressional policy. Although money left in an IRA or qualified plan continues to accumulate tax-free earnings, withdrawals are fully taxable. Retired taxpayers therefore have an incentive to withdraw amounts gradually. The repeal of the special tax for lump-sum distributions will further congressional policy, not hinder it.

VI. Reform

To simplify the Code, to promote equity, and to further the congressional objective of providing a regular source of income to the nation's retirees, the following reforms should be considered.

A. Repeal of the Ten-Year Averaging Tax and Long-Term Capital Gain Treatment

The ten-year averaging tax and long-term capital gain treatment for lump-sum distributions from qualified plans should be repealed, regardless of what marginal tax rates may exist in future years. Distributions should instead be fully taxable when received, although distributions of at least fifty percent of an account balance should remain eligible for rollover.

The same three concerns that led Congress to restrict long-term capital gain treatment for lump-sum distributions in 1969 apply today to the ten-year averaging tax. First, ten-year averaging frequently makes lump-sum distributions more advantageous than periodic distributions.[210] Second, the tax permits individuals to shift income from their normal brackets to lower brackets.[211]

> withdraw tax-favored funds from the retirement income stream and thus are inconsistent with the policy to provide individuals with income throughout the entire period of retirement. The original purpose of the capital gain and ten-year averaging provisions was to mitigate the effect of the progressive tax structure on individuals receiving all of their benefits in a single year. The same purpose is now served, however, by permitting individuals to roll over distributions into an IRA. This results in the individual being taxed only as amounts are subsequently withdrawn from the IRA.

Treasury II, *supra* note 17, at 345.

[210] The graphs in Appendix II demonstrate mathematically the circumstances in which a recipient will have greater after-tax cash flow by receiving a lump-sum distribution and paying the ten-year averaging tax than by rolling the distribution over into an IRA.

[211] The computations in Appendices I and III present the ten-year averaging tax for distributions ranging between $10,000 and $990,000. The amount of tax on a distribution is

Third, the benefits of the tax are greatest for those with high incomes.[212]

Of even greater significance is the fact that ten-year averaging and long-term capital gain treatment no longer serve a useful purpose. Since existing alternatives provide recipients with adequate relief from bunching, there is no need for a reduced tax on lump-sum distributions. The purpose of the ten-year averaging tax was to compute the tax on a lump-sum distribution "as if" the recipient had received equal installments over ten years.[213] Today it is possible for virtually every employee, surviving spouse, and designated beneficiary to defer tax by receiving distributions over ten or more years. Ten-year averaging as it now stands serves only to offer recipients an alternative of paying less tax than if they had received regular distributions from their retirement savings plans.

Furthermore, present law is complex and inconsistent. Although bunching concerns apply equally to qualified plans, simplified employee pensions, IRAs, and surrendered life insurance policies, only lump-sum distributions from qualified plans are eligible for ten-year averaging. In 1984, Congress further narrowed the applicability of the ten-year averaging tax by making it unavailable in cases where a portion of the account had been distributed earlier because of a partial rollover[214] or a qualified domestic relations order incident to a divorce.[215] Gradual restrictions on the availability of the tax may indicate a move to repeal it, but meanwhile the resulting narrow rule increases the complexity of the Code and sets tax traps for the unwary.

B. Liberalization of the Rollover and Tax Deferral Rules

1. Once-in-a-Lifetime Rollover Election and Direct Transfers to IRAs

Particularly if ten-year averaging is repealed, the rollover rules should be liberalized to cover situations where recipients inadvertently fail to follow the technical rollover procedures. This problem

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fixed, regardless of the amount of other income the recipient may have.

[212] *See* Appendix II.

[213] *See* H.R. Rep. No. 807, *supra* note 84, at 150-51, *reprinted in* 1974 U.S. Code Cong. & Ad. News at 4815-16.

[214] I.R.C. § 402(a)(5)(D)(iii).

[215] *Id.* § 402(e)(4)(M).

is already solved in theory by the requirement that plan administrators inform distribution recipients in writing that they may roll lump-sum or partial distributions over within sixty days. Situations still may arise, however, where eligible recipients innocently fail to meet the requirements. For example, a plan administrator may fail to send the required notice (the penalty is only ten dollars per failure)[216] or the recipient may not receive or understand the notice. If the ten-year averaging tax is repealed, unsophisticated plan participants may suffer the hardship of having bunched income taxed at high marginal rates.

For such situations, Congress should consider enacting a once-in-a-lifetime rollover election that could be made as late as the filing of the return, including extensions. This election would remedy the harshness of the sixty-day rollover time limit and would put recipients on notice that they must act on future distributions within sixty days. Nor should such a provision create any substantial revenue loss, since income earned during the year from investments made with the distribution proceeds would be fully taxable until the proceeds were rolled over.

If ten-year averaging is repealed, an additional option Congress should consider is to require qualified plans to make direct transfers to an IRA if more than half of a recipient's account balance will be distributed in a given taxable year. The taxable portion of a distribution could be sent to the financial institution or institutions of the recipient's choice, unless he consents in writing to receive the distribution personally. The recipient could then withdraw as much or as little from the IRA as was needed, knowing that each withdrawal would be fully taxable. Such direct transfers would alleviate the complexity of making a rollover and, by increasing the recipient's awareness of the tax consequences, would provide incentives to withdraw amounts gradually so as to retain tax-sheltered resources in the IRA for future retirement needs.

2. *Inherited Accounts*

Individuals inheriting distributions from qualified plans or IRAs also should be able to roll the lump-sum or partial distributions over into IRAs, subject to the minimum distribution requirements

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[216] I.R.C. § 6652(i).

that apply to designated beneficiaries. Under existing law, only surviving spouses may roll over lump-sum distributions made by reason of death. Other designated beneficiaries can, however, avoid the rule requiring distribution of a deceased employee's entire interest within five years, provided (1) that distributions commence within one year after the employee's death, or (2), if distributions to the employee had already begun, that the distributions continue at least as rapidly to the designated beneficiary.

No justification exists for forcing qualified plans to incur the administrative expense of maintaining accounts for non-spouse beneficiaries. Designated beneficiaries should be allowed to roll inherited distributions over into IRAs so as to have greater flexibility in selecting investments and in timing withdrawals. Failure to withdraw the minimum required under the designated beneficiary provisions could subject the beneficiary to a fifty-percent excise tax on the IRA, while leaving him free to withdraw at a faster rate with impunity. If rollover is expanded to cover inheritance by designated beneficiaries, then the mandatory notice should be expanded correspondingly.

C. *Reforms if Ten-Year Averaging Is not Repealed*

1. *Treatment as a Tax Preference Item*

Some portion of the tax benefits that recipients of plan distributions derive from the ten-year averaging tax should be treated as an item of tax preference, potentially subject to the twenty-percent alternative minimum tax. Policy concerns analogous to those that caused long-term capital gains to be classified as an item of tax preference (*e.g.*, concern over taxpayers' ability to convert ordinary income into lower-taxed long-term capital gains) apply to the ten-year averaging tax.

The simplest and fairest tax-preference solution would be to treat the entire taxable portion of lump-sum distributions of less than $238,000 as an item of tax preference.[217] The ten-year averag-

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[217] The $238,000 threshold is the point at which the ten-year averaging tax exceeds 20% of the distribution. *See* Appendix I. At this point the need for a 20% alternative minimum tax lapses. The 238,000 figure would of course have to be adjusted periodically to reflect changes in tax rates. Adjustments might also be required because of special aspects of computing the ten-year averaging tax, such as the exclusion of the long-term capital gain portion or the special adjustments for annuity contracts or estate taxes associated with the

ing tax could then be applied as a credit against any increase in tax attributable to the alternative minimum tax. The benefit of ten-year averaging would then potentially be subject to a twenty-percent tax rate. The taxpayers most likely to incur the tax would be those with other items of tax preference and small lump-sum distributions. Small distributions would have the lowest effective tax rate, particularly if the minimum distribution allowance is retained.

The only disadvantage of treating the benefit of ten-year averaging as an item of tax preference is that such treatment would further complicate the Code. It is difficult, however, to justify classifying the long-term capital gain deduction attributable to the pre-1974 portion of a lump-sum distribution as a tax preference item while at the same time exempting the tax benefit attributable to the post-1973 portion. Again, this is a situation where equitable considerations outweigh the policy favoring simplicity.

2. Disqualification of Section 401(k) Cash or Deferred Arrangements

The portion of a lump-sum distribution that is attributable to the employee-directed amounts of a CODA should not qualify for ten-year averaging. Instead, that portion should be treated in the same way as accumulated employee-deductible contributions (IRA substitutes), which are presently ineligible for the special ten-year tax, but are eligible for rollover.[218] Like accumulated employee-deductible contributions, CODAs allow employees to direct a portion of their compensation into their profit-sharing accounts. Because such amounts qualify under present law for ten-year averaging, employees near retirement can convert ordinary compensation income into deferred income ultimately to be taxed at the low ten-year averaging rate. Such conversion violates fundamental principles of fairness. Moreover, the revenue loss is significant, since many corporations offer these arrangements to their employees.

3. Elimination of the Minimum Distribution Allowance

The minimum distribution allowance offers disproportionately

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distribution.

[218] I.R.C. § 402(e)(4)(A), (5)(B).

large tax savings for small distributions. It was originally intended to serve as a means to approximate long-term capital gain treatment for small distributions to low-income taxpayers. Since its enactment in 1974, however, numerous rate reductions have occurred, with the cumulative effect of eliminating any need for the allowance. Without the minimum distribution allowance, effective tax rates for 1985 lump-sum distributions of $70,000 or less would range between 11% and 13.66%, instead of today's 5.5% to 13.66% range. Under the present rate structure, a taxpayer with an account balance of $20,000 or less is virtually always better off receiving a complete distribution and paying the ten-year averaging tax.

VII. Conclusion

Alternatives that moderate the tax burdens of lump-sum distributions, especially the rollover option, have eliminated the need for a special tax in the year of receipt. The enthusiastic acceptance by the American public of IRAs, which are eligible to receive rollovers, strengthens this conclusion.

Rollover specifically furthers the purpose of providing a regular source of retirement income. Favorable tax treatment of lump-sum distributions, in contrast, provides after-tax cash for any purpose after an individual has reached age 59½. In its present form, the ten-year averaging tax is an unnecessary bonus enabling certain individuals to pay less tax than if they had received regular retirement income, as the graphs in Appendix II demonstrate.

Regardless of what marginal tax rates may exist in the future, ten-year averaging (as well as the five-year averaging proposed in the House Tax Reform Bill) and long-term capital gain treatment for lump-sum distributions should be repealed in order to promote equity and simplicity in the Code and to further Congress' objective of providing retirees with regular retirement income. At the same time, in order to alleviate possible hardship from the inadvertant failure to qualify for rollover, the rollover procedures should be liberalized.

Appendix I

TEN-YEAR-AVERAGING TAX FOR LUMP SUM DISTRIBUTIONS RECEIVED IN 1985

AMOUNT OF DISTR.	TEN-YEAR AVG TAX	EFFECTIVE TAX RATE
10,000.00	550.00	5.50
20,000.00	1,100.00	5.50
30,000.00	2,527.11	8.42
40,000.00	4,206.94	10.52
50,000.00	5,910.06	11.82
60,000.00	7,710.06	12.85
70,000.00	9,564.00	13.66
80,000.00	11,164.00	13.96
90,000.00	12,794.00	14.22
100,000.00	14,594.00	14.59
110,000.00	16,394.00	14.90
120,000.00	18,386.00	15.32
130,000.00	20,386.00	15.68
140,000.00	22,620.00	16.16
150,000.00	24,920.00	16.61
160,000.00	27,220.00	17.01
170,000.00	29,655.00	17.44
180,000.00	32,255.00	17.92
190,000.00	34,855.00	18.34
200,000.00	37,455.00	18.73
210,000.00	40,055.00	19.07
220,000.00	42,655.00	19.39
230,000.00	45,627.00	19.84
240,000.00	48,627.00	20.26
250,000.00	51,627.00	20.65
260,000.00	54,627.00	21.01
270,000.00	57,627.00	21.34
280,000.00	60,795.00	21.71
290,000.00	64,195.00	22.14
300,000.00	67,595.00	22.53
310,000.00	70,995.00	22.90
320,000.00	74,395.00	23.25
330,000.00	77,795.00	23.57

AMOUNT OF DISTR.	TEN-YEAR AVG TAX	EFFECTIVE TAX RATE
340,000.00	81,555.00	23.99
350,000.00	85,355.00	24.39
360,000.00	89,155.00	24.77
370,000.00	92,955.00	25.12
380,000.00	96,755.00	25.46
390,000.00	100,555.00	25.78
400,000.00	104,355.00	26.09
410,000.00	108,235.00	26.40
420,000.00	112,435.00	26.77
430,000.00	116,635.00	27.12
440,000.00	120,835.00	27.46
450,000.00	125,035.00	27.79
460,000.00	129,235.00	28.09
470,000.00	133,435.00	28.39
480,000.00	137,635.00	28.67
490,000.00	141,835.00	28.95
500,000.00	146,035.00	29.21
510,000.00	150,235.00	29.46
520,000.00	154,435.00	29.70
530,000.00	158,635.00	29.93
540,000.00	162,835.00	30.15
550,000.00	167,035.00	30.37
560,000.00	171,739.00	30.67
570,000.00	176,539.00	30.97
580,000.00	181,339.00	31.27
590,000.00	186,139.00	31.55
600,000.00	190,939.00	31.82
610,000.00	195,739.00	32.09
620,000.00	200,539.00	32.35
630,000.00	205,339.00	32.59
640,000.00	210,139.00	32.83
650,000.00	214,939.00	33.07
660,000.00	219,739.00	33.29
670,000.00	224,539.00	33.51
680,000.00	229,339.00	33.73
690,000.00	234,139.00	33.93
700,000.00	238,939.00	34.13
710,000.00	243,739.00	34.33
720,000.00	248,539.00	34.52
730,000.00	253,339.00	34.70
740,000.00	258,139.00	34.88
750,000.00	262,939.00	35.06
760,000.00	267,739.00	35.23
770,000.00	272,539.00	35.39
780,000.00	277,339.00	35.56

AMOUNT OF DISTR.	TEN-YEAR AVG TAX	EFFECTIVE TAX RATE
790,000.00	282,139.00	35.71
800,000.00	286,939.00	35.87
810,000.00	291,739.00	36.02
820,000.00	296,539.00	36.16
830,000.00	301,391.00	36.31
840,000.00	306,391.00	36.48
850,000.00	311,391.00	36.63
860,000.00	316,391.00	36.79
870,000.00	321,391.00	36.94
880,000.00	326,391.00	37.09
890,000.00	331,391.00	37.23
900,000.00	336,391.00	37.38
910,000.00	341,391.00	37.52
920,000.00	346,391.00	37.65
930,000.00	351,391.00	37.78
940,000.00	356,391.00	37.91
950,000.00	361,391.00	38.04
960,000.00	366,391.00	38.17
970,000.00	371,391.00	38.29
980,000.00	376,391.00	38.41
990,000.00	381,391.00	38.52

APPENDIX II

Comparison of the Tax Benefits of Ten-Year Averaging and the Treatment of Regular Retirement Income

The graphs below show the circumstances in which after-tax cash flow under the ten-year averaging method is greater than that from periodic distributions from a qualified plan or IRA, and vice versa. The curves follow points where the annual after-tax cash flow from equal, fully taxable, quarterly distributions from a qualified plan or IRA equals the annual after-tax cash flow from quarterly distributions from an annuity purchased with the proceeds remaining after paying the ten-year averaging tax on a lump-sum distribution received in 1985.

The graphs assume that all investments produce the same rate of return and that equal quarterly distributions begin immediately after the lump-sum distribution. They also assume that the entire lump sum is either taxed under the ten-year averaging method or is rolled over. Thus, if the distribution includes a portion eligible for long-term capital gain treatment, the tables assume that ten-year averaging was elected for that portion. They also assume that the distribution is not subject to estate tax and did not include an annuity contract, employer securities, U.S. Retirement Bonds, Series E or EE Savings Bonds, excess key employee benefits, or accumulated deductible employee contributions for which special rules exist.[219]

The first step in using the graphs is to predict the rate of return to be earned from investing in a qualified plan, IRA, or annuity over the expected distribution period (admittedly a risky proposition). Three rates of return are presented (five, ten and fifteen percent) so that graphs for projected rates falling within this range can be interpolated.

The second step is to determine the amount of the lump-sum distribution and the expected distribution period (presumably the recipient's life expectancy). Locate the point on the graph that marks the intersection of these two variables.

Third, predict the amount of other income that the recipient will have during the distribution period. Four amounts are presented on the graphs: $10,000, $30,000, $50,000, and $100,000. If the point identified in step two falls below the line representing the amount of other income, then ten-year averaging is superior to rollover. If the point rests above the line, rollover is superior.

Assume for example that the rate of return on investments will be ten percent over the next fifteen years and that a given individual receives a fully taxable $250,000 lump-sum distribution from a profit-sharing plan in 1985. Assume that the individual wishes to invest the money and receive equal quarterly payments over fifteen years. The intersection of $250,000 and fifteen years on the ten-percent graph indicates that if the recipient will have other income of $30,000 or more, then the annual after-tax cash flow will be higher by electing ten-year averaging and purchasing an annuity than by rolling the distribution over into an IRA or qualified plan. The converse is true if other income will be $10,000 or less.

Although ten-year averaging was intended to replicate the tax that would have been paid if distributions were made over ten years,[220] the graphs demonstrate that the ten-year averaging tax simply offers recipients an unnecessary bonus. The best measure of

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[219] *See supra* notes 122-35.

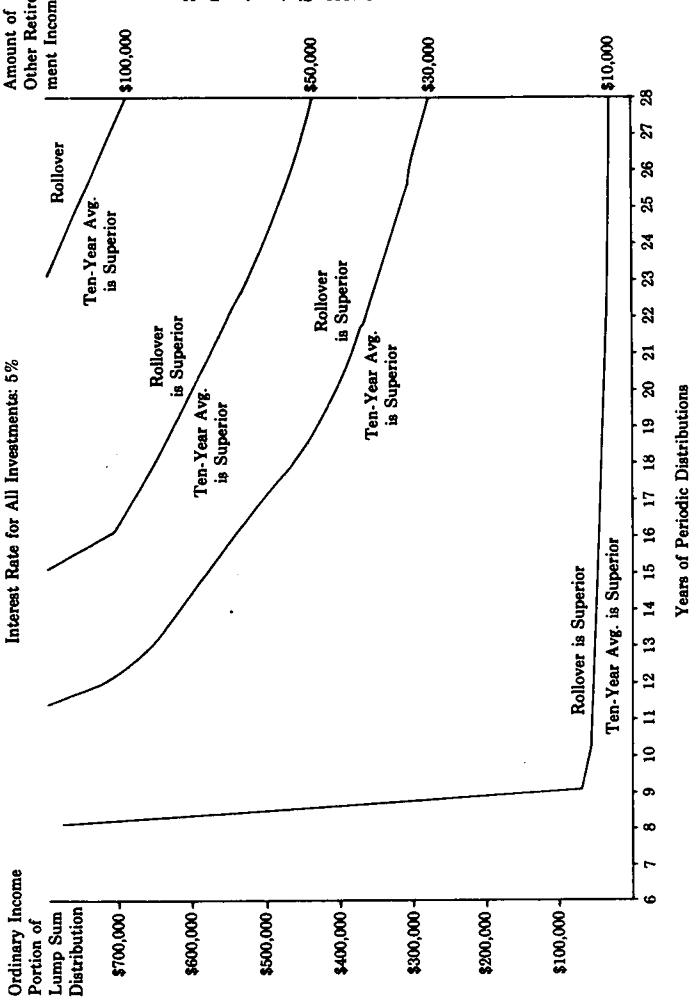
[220] *See supra* note 120.

what total tax would apply to distributions made over a ten-year period is produced by rolling a distribution over into an IRA and receiving actual distributions from the IRA over a ten-year period.

BREAK-EVEN POINTS OF AFTER-TAX CASH FLOW FROM ROLLING OVER LUMP SUM DISTRIBUTIONS RECEIVED BY MARRIED TAXPAYERS IN 1985 VERSUS PAYING THE TEN-YEAR AVERAGING TAX AND PURCHASING AN ANNUITY

(Assuming 1985 Tax Rates Continue)

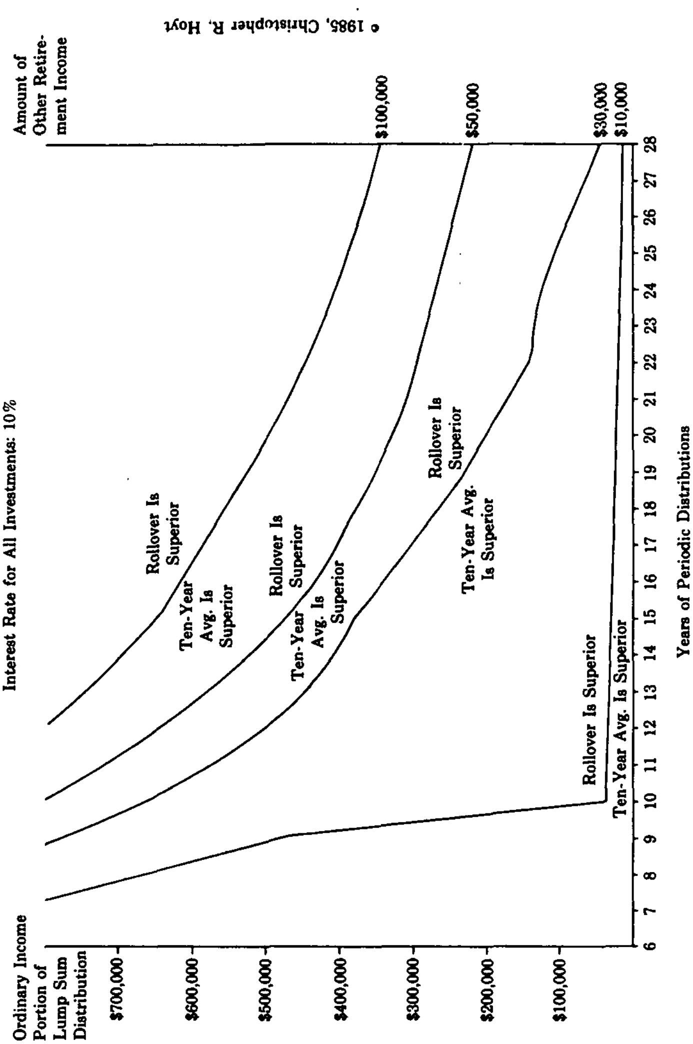
Interest Rate for All Investments: 5%



BREAK-EVEN POINTS OF AFTER-TAX CASH FLOW FROM ROLLING OVER LUMP SUM DISTRIBUTIONS RECEIVED BY MARRIED TAXPAYERS IN 1985 VERSUS PAYING THE TEN-YEAR AVERAGING TAX AND PURCHASING AN ANNUITY

(Assuming 1985 Tax Rates Continue)

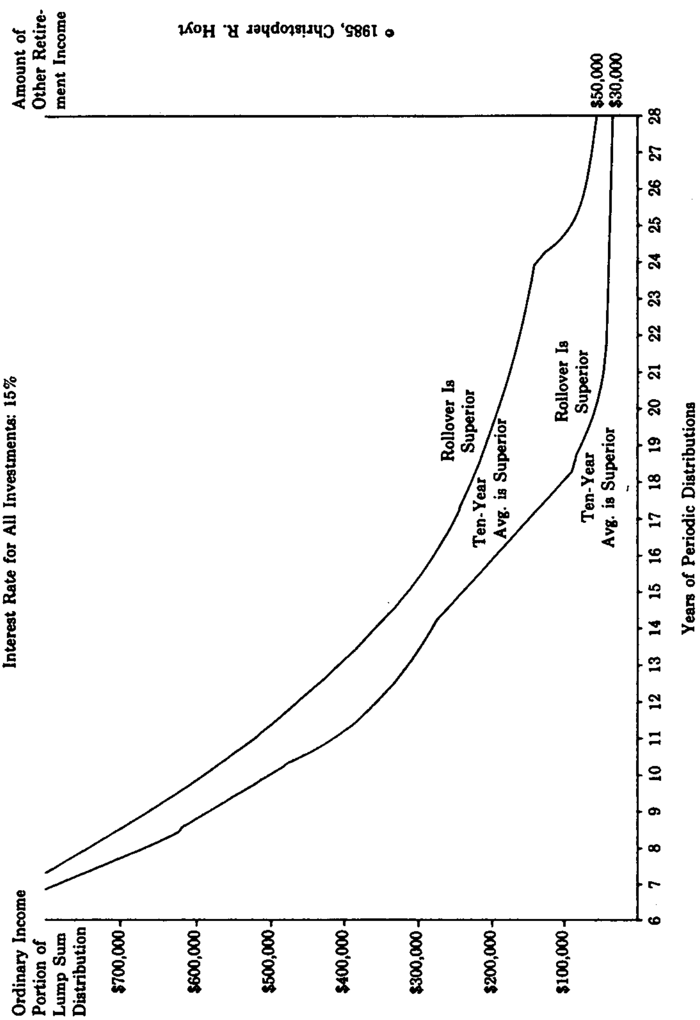
Interest Rate for All Investments: 10%



BREAK-EVEN POINTS OF AFTER-TAX CASH FLOW FROM ROLLING OVER LUMP SUM DISTRIBUTIONS RECEIVED BY MARRIED TAXPAYERS IN 1985 VERSUS PAYING THE TEN-YEAR AVERAGING TAX AND PURCHASING AN ANNUITY

(Assuming 1985 Tax Rates Continue)

Interest Rate for All Investments: 15%



Appendix III

FORWARD AVERAGING TAXES IN 1986

AMOUNT OF DISTR.	NO CHANGE OF LAW (TEN YEAR)	FIVE YEAR WITH 1986 TAX RATES	FIVE YEAR WITH HR 3838 TAX RATES
10000	550	650	750
20000	1100	1320	1500
30000	2521	3047	3300
40000	4187	4846	5100
50000	5874	6708	6900
60000	7674	8696	8700
70000	9505	11193	11250
80000	11105	13593	13750
90000	12705	16056	16250
100000	14471	18606	18750
110000	16271	21156	21250
120000	18183	23818	23750
130000	20183	26568	26250
140000	22270	29318	28750
150000	24570	32208	31250
160000	26870	35658	34750
170000	29170	39108	38250
180000	31722	42726	41750
190000	34322	46376	45250
200000	36922	50026	48750
210000	39522	53676	52250
220000	42122	57496	55750
230000	44770	61346	59250
240000	47770	65196	62750
250000	50770	69046	66250
260000	53770	72896	69750
270000	56770	76746	73250
280000	59770	80596	76750
290000	62930	84567	80250
300000	66330	88717	83750
310000	69730	92867	87250
320000	73130	97017	90750
330000	76530	101167	94250
340000	79930	105317	97750
350000	83602	109467	101250
360000	87402	113617	104750
370000	91202	117887	108490
380000	95002	122187	112290
390000	98802	126487	116090
400000	102602	130787	119890
410000	106402	135087	123690

AMOUNT OF DISTR.	NO CHANGE OF LAW (TEN YEAR)	FIVE YEAR WITH 1986 TAX RATES	FIVE YEAR WITH HR 3838 TAX RATES
420000	110202	139387	127490
430000	114282	143698	131290
440000	118482	148098	135090
450000	122682	152498	138890
460000	126882	156898	142690
470000	131082	161298	146490
480000	135282	165698	150290
490000	139482	170098	154090
50000	143682	174498	157890
51000	147882	178898	161690
52000	152082	183298	165490
53000	156282	187698	169290
540000	160482	192098	173090
550000	164682	196498	176890
560000	168882	200898	180690
570000	173082	205298	184490
580000	177768	209698	188290
590000	182568	214098	192090
600000	187368	218498	195890
610000	192168	222898	199690
620000	196968	227298	203490
630000	201768	231698	207290
640000	206568	236098	211090
650000	211368	240498	214890
660000	216168	244898	218690
670000	220968	249298	222490
680000	225768	253698	226290
690000	230568	258098	230090
700000	235368	262498	233890
710000	240168	266898	237690
720000	244968	271298	241490
730000	249768	275698	245290
740000	254568	280098	249090
750000	259368	284498	252890
760000	264168	288898	256690
770000	268968	293298	260490
780000	273768	297698	264290
790000	278568	302098	268090
800000	283368	306498	271890
810000	288168	310898	275690
820000	292968	315298	279490
830000	297768	319698	283290
840000	302568	324098	287090
850000	307368	328498	290890

AMOUNT OF DISTR.	NO CHANGE OF LAW (TEN YEAR)	FIVE YEAR WITH 1986 TAX RATES	FIVE YEAR WITH HR 3838 TAX RATES
860000	312210	332898	294690
870000	317210	337298	298490
880000	322210	341698	302290
890000	327210	346098	306090
900000	332210	350498	309890
910000	337210	354898	313690
920000	342210	359298	317490
930000	347210	363698	321290
940000	352210	368098	325090
950000	357210	372498	328890
960000	362210	376898	332690
970000	367210	381298	336490
980000	372210	385698	340290
990000	377210	390098	344090