

ESSAY

Tapping “Rainy Day” Funds for the Reluctant Entrepreneur: Downsizing, Paternalism, and the Internal Revenue Code*

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“He who risks nothing can gain nothing.”
Italian Proverb

“A fool and his money are soon parted.”
English Proverb

INTRODUCTION

Two recent and seemingly unrelated trends converge to form the basis of this essay. First, business downsizing and the concomi-

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tant discharge of white-collar middle-management employees has become a frequently reported occurrence.¹ Second, this downsizing has taken place when the overall amount of wealth accumulated in employee pension, profit-sharing, 401(k), and other retirement plans has reached record levels.² Many of the displaced employees will find other

¹ See, e.g., Rosalie Robles Crowe, *White-Collar Workers Get Boot as America Downsizes*, PHOENIX GAZETTE, Sept. 24, 1993, at D1 (reporting that from June 1992 to June 1993, white-collar salaried positions accounted for 55% of all jobs eliminated); Claudia Feldman, *The White-Collar Unemployed Blues: Support Groups Help Facilitate Job Search*, HOUS. CHRON., Dec. 19, 1993, at 1 (discussing a local dislocated worker program which helps more than 2000 clients annually; at least 50% of those seeking help are professionals and managers); Stephen Franklin, *'91 Unfolds As a Record Layoff Year*, CHI. TRIB., Sept. 21, 1991, at 1 ("[C]orporate downsizing — the laying off of thousands of workers, most of them white-collar — has become the medicine of choice for hundreds of corporations."); David Hage & Sara Collins, *Reaching Out For Help*, U.S. NEWS & WORLD REP., Nov. 23, 1992, at 67 ("Two years of weak growth have thrown 1.1 million white-collar Americans out of work — a toll that exceeds blue-collar layoffs for the first time in any post-war recession."); Earle Hitchner, *White Collar Blues: Management Loyalties in an Age of Corporate Restructuring*, NAT'L PRODUCTIVITY REV., Sept. 1, 1995, at 133 (book review) ("For the past seven years, middle management has fallen under the knife of corporate cuts as never before."); Tom Mashberg, *Massachusetts Middle Managers Cope With Job Loss*, BOSTON HERALD, Jan. 14, 1996, at 22 ("What began as a campaign by big business to go 'lean and mean' on the factory floor has bubbled over with a vengeance into the ranks of the once 'untouchables' — career white-collar middle managers."); Shannon Mullen, *Few Statistics Available to Measure Severity of Layoffs*, ASBURY PARK PRESS, May 12, 1996, at A17; Kristi Wright, *Victims of the Times*, OMAHA WORLD HERALD, Apr. 2, 1996, at 31SF ("Some of Omaha's largest companies, such as Union Pacific Corp., U.S. West Communications, and AT&T, have dismissed employees in recent years. The last major cutback came last month when Mutual of Omaha announced it would eliminate 800 positions by year end.").

² The assets of private pension funds increased from \$676 billion in 1980 to \$3.48 trillion in 1994. See Board of Governors of the Fed. Reserve Sys., *FLOW OF FUNDS ACCOUNTS* (Mar. 1995), reprinted in U.S. DEP'T OF COM., *STATISTICAL ABSTRACT OF THE UNITED STATES 1995*, at 535, No. 834 (115th ed. 1995). While the total number of plans has increased from 488,900 in 1980 to 699,300 in 1991, the number has dropped from a high of 712,300 in 1990. See U.S. DEP'T OF LAB., *PRIVATE PENSION BULLETIN* (Summer 1993), reprinted in U.S. DEP'T OF COM., *STATISTICAL ABSTRACT OF THE UNITED STATES 1995*, at 383, No. 599 (115th ed. 1995). Defined benefit plans have declined from 148,100 in 1980 to 101,800 in 1991, while defined contribution plans have seen

work,³ and some will enter early retirement. Among their ranks, however, there are those who will seize the opportunity to explore entrepreneurial options.⁴ An important ingredient for their success is, of course, the availability of capital.

One potential source of capital is qualified retirement plans. This essay explores the income tax restrictions imposed on employee pre-retirement access to qualified retirement plan assets and the policies implicit in those rules. It concludes with a discussion of the desirability

an increase from 340,800 in 1980 to 597,500 in 1991. *See id.* This trend may reflect employer flight from the complexities and restrictiveness of defined benefit plans. *See* John S. Nolan, *The Merit of an Income Tax Versus a Consumption Tax*, 12 AM. J. OF TAX POL'Y 207, 214 (1995) ("It is regrettable that we have made the rules governing defined benefit pension plans so onerous and complex that employers and employees have already moved heavily toward defined contribution plans."); Susan J. Stabile, *The 20th Anniversary of the Employee Retirement Income Security Act (1974-1994): Concluding Remarks*, 68 ST. JOHN'S L. REV. 481, 482 (1994).

³ A 1994 survey asked workers what they would do if they were laid off. Forty-nine percent of the workers expected to look for similar positions. Fourteen percent would take time off temporarily to relax and think. Thirteen percent would start their own businesses. Nine percent would look for jobs in a different field. Seven percent would return to school, four percent would retire, and four percent were unsure or did not answer. *See Workers Would Seek Same Job In Layoff, Poll Finds*, DAILY LAB. REP., Sept. 8, 1994.

⁴ *See, e.g.*, MANAGING OFFICE TECH., Jan. 1, 1994, at 68 (documenting that 8 of 10 new entrepreneurs are over the age of 40); R.E. Coleberd, *The Business Economist at Work: The Economist As Entrepreneur*, BUS. ECON., Oct. 1994, at 54; Randall Lane, *Involuntary Entrepreneurs*, FORBES, June 3, 1996, at 81 (describing how corporate downsizing directly influenced growth of cutting-edge entrepreneurial ventures in North Carolina's Research Triangle); Sheila M. Poole, *Facing the Future: Working — Some Choose to be Boss, Not Bossed*, ATLANTA J. & CONST., Feb. 13, 1994, § R, at 7; *Self-Employment Rises Among Downsized; Growth Reflects Emergence of "Gotta Be's"*, PR NEWswire, May 31, 1996. The purchase of business franchises is reportedly a popular option. *See, e.g.*, *Dropouts Drop In*, SEATTLE TIMES, Apr. 8, 1991, at B1, Duke Ratliff, *Grow Biz: A Recycling Retailer*, DISCOUNT MERCHANDISER, May 1996, at 92; Mary Rowland, *Your Own Account: Buying Your Own Franchise*, N.Y. TIMES, Mar. 10, 1991, § 3, at 14. One of the authors of this essay recently sat on an airplane beside a former middle manager with more than 15 years of experience at a large pharmaceutical company. He took a severance package and opened a "Mailboxes etc." franchise.

of modifications to such rules to support easier movement from a workplace to self-employment.

I. THE ENTREPRENEURIAL CLIMATE PRODUCED BY DOWNSIZING

Until the early 1980s, the typical employee subject to layoffs and downsizing was a blue-collar worker.⁵ The "new" downsizing candidate, however, can be a white-collar employee without a collective bargaining agreement, often a middle-manager, who has provided significant past services to the company.⁶

While many of these displaced employees seek employment with other employers, the education and experience levels of some, white-collar and blue-collar alike, them will cause them to strike out on their own. When this happens, raising capital for the new enterprise is a concern. Family, friends, the family home, and even credit cards are typical sources of entrepreneurial seed capital.⁷ Other potential sources are retirement plans, including pension, profit-sharing, 401(k), and individual retirement accounts ("IRAs"). Although these retirement assets are often highly liquid and do not present some of the difficulties of the other alternatives, the Internal Revenue Code (the "Code"), which is inextricably linked with the policies of the Employee Retirement Income

⁵ The reports are mixed. On the one hand, anecdotal data such as the experience of the Chicago Federation of Labor suggests that labor union membership has not been affected by the downsizing that has targeted white-collar middle managers. See Leon Pitt, *Chicago Federation of Labor Turns 100*, CHI. SUN-TIMES, May 17, 1996, at 16. On the other hand, blue-collar workers are still dismissed from their jobs at a higher rate than white-collar workers. See Marie Cocco, *Aunt Marie and the Myths About Downsizing*, NEWSDAY (New York), Apr. 25, 1996, at A61. Moreover, the wage gap between blue-collar and white-collar workers appears to be widening. See John Yemma, *Populist Pitch on Worker Insecurity Hits Home With the Lesser-Educated*, BOSTON GLOBE, Feb. 29, 1996, at 1.

⁶ See *supra* note 1.

⁷ See, e.g., ERIC A. SIEGEL ET AL., THE ERNST & YOUNG BUSINESS PLAN GUIDE 26 (2d ed. 1993); Jan Alexander, *Best Ways to Start a Business Now*, MONEY, Jan. 1, 1996, at 100 ("Most cash-hungry entrepreneurs turn to family, friends and credit cards as they learn firsthand that banks and investors are looking for some type of track record before they grant loans."); Mo Schumpeter, *The Unknown Entrepreneur; Step One: Seed Daze*, FORBES (ASAP Supp.), Apr. 8, 1996, at 22; Mo Schumpeter, *The Unknown Entrepreneur; Step Two: Funding Up*, FORBES (ASAP Supp.), June 3, 1996, at 22.

Security Act of 1974 ("ERISA"),⁸ generally precludes recourse to these sources or makes access very expensive in terms of taxes and penalties.

We first briefly describe some of the common retirement plans and the accompanying restrictions on pre-retirement withdrawals. We then evaluate the policies underlying such restrictions with a view toward whether they can be modified to better serve the needs of displaced workers. Finally, in connection with our proposal to improve access, we assess the recently proposed American Family Tax Relief Act's provisions dealing with tax-free withdrawals from IRAs for business start-ups.⁹

II. THE RETIREMENT PLAN MENAGERIE

In the taxation of employee deferred compensation arrangements, the great dividing line is whether a plan is "non-qualified" or "qualified."¹⁰ Non-qualified plans continue to play a significant role in compensation planning, particularly for highly compensated employees. Unfortunately, if the desired income tax result of no current income to the employee is to be achieved, the employee often must assume some risk of the employer's insolvency.¹¹ The qualified plan, on the other hand, permits

⁸ Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1994) (codified as amended in scattered sections of the Internal Revenue Code and 29 U.S.C. §§ 1001-1461 (1994)).

⁹ See *infra* notes 110, 119-20, 122-24, 127-28, 131-32 and accompanying text.

¹⁰ Qualified retirement plans are in turn generally divided into "defined benefit" versus "defined contribution" plans. With the former, the employer promises a target retirement benefit and then makes contributions that, with earnings, will provide such benefits; this obviously requires, among other factors, good actuarial predictions. With the latter, on the other hand, the employer promises only to contribute a certain amount to the plan, and the participants are entitled to those contributions, plus investment earnings, plus forfeitures from other participants who left the plan.

¹¹ Many executive compensation arrangements are structured as so-called "rabbi trusts" in which the employer sets aside compensation in a trust to which the employer has no further access, but to which the employer's creditors have access. The employee accepts the (hopefully) improbable risk of employer insolvency in exchange for income tax treatment that does not treat the funding of the trust as constructive receipt or economic benefit income to the employee. See, e.g., Rev. Rul. 60-31, 1960-1 C.B. 174; *Minor v. United States*, 772 F.2d 1472 (9th Cir. 1985) (holding deferred compensation plan was available to the corporation's creditors and therefore benefits did not constitute gross income).

the employer to claim a deduction at the time amounts are transferred¹² to the safety of a retirement trust that is not subject to the claims of the employer's creditors.¹³ Moreover, the employee is not taxed on the employer contribution (or subsequent earnings thereon)¹⁴ until the amounts are withdrawn,¹⁵ presumably on retirement. Qualified status turns upon compliance with a number of requirements,¹⁶ including such complex topics as participation, vesting, and funding.¹⁷

See generally Ridgeley A. Scott, *Rabbis and Other Top Hats: The Great Escape*, 43 CATH. U. L. REV. 1 (1993). "Many employers think that the Rabbi Trust option is the best compromise of tax attributes, operating expenses, coverage, and protection." *Id.* at 4-5.

¹² *See* I.R.C. § 404(a)(1)-(3) (1994). With a non-qualified plan, the employer receives a deduction only in the "taxable year in which an amount attributable to the contribution is includable in the gross income of the employee[s]." *Id.* § 404(a)(5). *Compare id.* § 83(h) (prescribing a similar rule of deductibility for property transferred in connection with performance of services).

¹³ In specifying the requirements for qualification, the statute refers to "[a] trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries." *See id.* § 401(a). The statute permits certain custodial accounts, annuity contracts, and insurance contracts to also be treated as qualified trusts. *See id.* § 401(f).

¹⁴ The pension trust itself is also exempt from income taxation. *See id.* § 501(a). There are some exceptions, including the tax on unrelated business income, *see id.* §§ 511-15, and various penalty taxes, *see, e.g., id.* § 4971 (failure to meet minimum funding standards) and § 4979 (excess contributions).

¹⁵ *See id.* § 402. Employer contributions are also exempt from federal employment taxes, *see id.* § 3121(a)(5), and federal unemployment taxes, *see id.* § 3306(b)(5).

¹⁶ *See, e.g., id.* § 401.

¹⁷ *See, e.g., id.* § 410 (minimum participation standards), § 411 (minimum vesting standards), and § 412 (minimum funding standards); *see generally* MICHAEL J. CANAN, QUALIFIED RETIREMENT AND OTHER EMPLOYEE BENEFIT PLANS §§ 7.6-.7, 7.9, 8.1-.5, 9.1, 9.6-.9 (stud. ed. 1997); JEFFREY D. MAMORSKY, EMPLOYEE BENEFITS LAW: ERISA AND BEYOND vol. 1 & 2, §§ 4.01-.07, 5.01-.03, 8.01-4 (17th ed. 1997); Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX L. REV. 435, 499 (1987) ("The nondiscrimination rules regarding vesting have been vague, have lacked uniformity and have generated uncertainty."); Regina T. Jefferson, *Defined Benefit Plan Funding: How Much Is Too Much?*, 44 CASE W. RES. L. REV. 1 (1993) (discussing funding requirements, asset recovery and accelerated funding, and overfunding); Michael

A "qualified retirement plan" expansively encompasses traditional company pension plans, 401(k) plans, supplemental retirement annuities purchased by or for the benefit of employees of tax-exempt or educational organizations,¹⁸ and lowly IRAs.¹⁹ On the employee's part, the benign taxation scheme is disturbed if he or she receives an early distribution from the "qualified retirement plan." On the occasion of an early distribution, the Code prescribes regular taxation on the amount received,²⁰ plus imposes a ten percent penalty.²¹ Not only are outright distributions penalized, but loans from the pledging of an interest in a qualified plan are generally treated as distributions.²² One must also

W. Melton, *Making the Nondiscrimination Rules of Tax-Qualified Retirement Plans More Effective*, 71 B.U. L. REV. 47 (1991) (discussing broad-based retirement savings plans and potential alternatives); Robert Stevenson & Nancy Koppelman, *A Non-Specialists' Field Guide to Qualified and Non-Qualified Retirement Plans After Tax Reform*, 69 MICH. BUS. J. 258 (1990) (noting the ever-increasing complexity of the tax rules for retirement plans).

¹⁸ These plans are subject to I.R.C. § 403(b) and loosely resemble a cash-or-deferred arrangement best exemplified by the "401(k)" plan. *See generally* David A. Pratt, *Very Serious Business: Sense and Nonsense Under Section 403(b) of the Internal Revenue Code of 1986*, 59 ALB. L. REV. 1197, 1262-68 (1996) (discussing distribution requirements). Since the 403(b) plan is utilized primarily by non-profit organizations, we will not deal with it in the context of this essay dealing with business downsizing.

¹⁹ The "qualified retirement plan" referred to in the 10% penalty provisions of I.R.C. § 72(t) is defined in I.R.C. § 4974(c).

²⁰ If the distribution qualifies as a "lump sum distribution" the distributee may be eligible for special income tax treatment of the distribution. *See id.* § 402(d). However, the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §§ 1401(a) and 1402, 110 Stat. 1787-90 (1996), generally repealed such special treatment for tax years beginning after December 31, 1999, subject to certain transitional rules. Amounts rolled over to another plan may be exempt from tax. *See* I.R.C. § 402(c). Unless the distribution is paid directly to another eligible retirement plan, however, the payor of the distribution from the plan may be required to withhold 20% of the distribution. *See id.* § 3405(c).

²¹ *See* I.R.C. § 72(t).

²² *See id.* § 72(p)(1)(B). As a general rule, with several exceptions, a qualified plan must provide that the employee's benefits under the plan may not be assigned, alienated, or subject to attachment, garnishment, levy, execution, or other equitable process. *See id.* § 401(a)(13). The Taxpayer Relief Act of 1997 created a new exception to the general non-assignment rule, providing that an offset may be made against a plan participant's accrued benefit for amounts owed by the participant for certain crimes or violations of ERISA. *See* Taxpayer Relief

distinguish between restrictions on distributions that must be imposed by the plan itself (as part of attaining qualified status) and restrictions broadly imposed on most types of early distributions in the form of the ten percent penalty tax. Of course, there are exceptions to these general rules. Those exceptions sketch out the conflicting policy lines drawn by Congress over years of incremental tinkering to encourage the creation of retirement nest eggs but permit limited access to the funds.²³ The latest round of tinkering in this ever-evolving area, the Taxpayer Relief Act of 1997,²⁴ opened several new avenues of pre-retirement access to IRA funds.²⁵ In the materials that follow, we present an overview of the maze of restrictions on access.

A. General Pension and Profit-Sharing Plans

The Code does not prescribe limitations on early distributions (distributions before death, disability, termination of employment, or retirement) from general pension and profit-sharing plans as a requirement for qualified status, but the IRS has imposed this requirement in its rulings.²⁶ Such limitations would not be of consequence to a terminated

Act of 1997, Pub. L. No. 105-34, § 1502(b), 111 Stat. 788, 1060-61 (1997) (adding I.R.C. §§ 401(a)(13)(C) & 401(a)(13)(D)).

²³ The restrictions in part reflect a public interest in assuring some level of retirement savings to reduce the demand for public assistance. The government's role in, and the function of, restrictions placed on retirement savings access is discussed at *infra* notes 67-91 and accompanying text.

²⁴ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997).

²⁵ For a discussion of the Taxpayer Relief Act of 1997 IRA amendments, see *infra* notes 37-42 and accompanying text.

²⁶ The Treasury regulations state that a qualified pension plan is "a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement." Treas. Reg. § 1.401-1(b)(1)(i) (1976). Accordingly, in Revenue Ruling 56-693 the IRS ruled that a plan that allowed distributions before termination of employment or termination of the plan was inconsistent with the concept of a pension plan and was therefore not qualified. See Rev. Rul. 56-693, 1956-2 C.B. 282 (amended by Rev. Rul. 60-323, 1960-2 C.B. 148 (plan permitting employee withdrawal of voluntary contributions before termination of employment not qualified)). See also Rev. Rul. 69-277, 1969-1 C.B. 116 (plan permitting employee withdrawal of voluntary contributions, plus accretions in value, before termination of employment not qualified); Rev. Rul. 74-254, 1974-1 C.B. 91 (plan permitting distributions when an employee was transferred outside the coverage area of the plan but not

employee because termination is an acceptable occasion for a distribution. However, the distribution is potentially subject to the general ten percent penalty on early distributions that applies to a broad spectrum of retirement plans. The ten percent penalty will not be imposed if the distributions are: (1) made on or after the date on which the employee attains age fifty-nine-and-one-half; (2) made on or after the death of the employee or on account of the employee's disability; (3) made in a series of substantially equal periodic payments (at least annually) over the life of the employee or the joint lives of the employee and his designated beneficiary; (4) made to an employee after separation from service after attainment of age fifty-five; or (5) made in an amount not to exceed medical expenses or pursuant to a qualified domestic relations order.²⁷ Notably, the ten percent penalty provisions would apply to a lump sum distribution to a separating employee who has not reached age fifty-five.²⁸

Although the ten percent penalty and immediate income taxation can pose obstacles to taking outright distributions, loans from the plan present another option. While a qualified plan must generally prohibit the alienation of a participant's interest, an exception is provided for certain loans.²⁹ First, an exemption is available if the loan: (1) is made available to all participants on a reasonably equivalent basis; (2) is not made available to highly compensated employees (within the meaning of section 414(q)) in an amount greater than the amount made available to other employees; (3) is made in accordance with specific loan provisions in the plan; (4) bears a reasonable rate of interest; and (5) is adequately secured.³⁰ However, the exemption does not apply to loans from some plans, notably "Keogh" plans for unincorporated businesses.³¹ Second,

terminated from employment not qualified).

²⁷ See I.R.C. § 72(t) (1994). Distributions are permitted in an amount not to exceed the medical expense deduction allowable under I.R.C. § 213. See *id.* § 72(t)(2)(B). Distributions from an IRA did not previously qualify for this treatment, but recent legislation has modified the rule. See *infra* note 75.

²⁸ See I.R.C. § 72(t)(2)(A)(v). On the other hand, for separating employees who have reached age 55 but have not reached age 59½ and plan to use the distribution immediately, a rollover into an IRA can be a trap. If the distribution is placed in the IRA, it cannot be withdrawn without penalty before age 59½ unless it is taken as a lifetime annuity. See *id.* § 402(d)(4).

²⁹ The loan must be exempt from tax under § 4975 of the Code. See *id.* § 401(a)(13)(A).

³⁰ See *id.* § 4975(d)(1).

³¹ The language at the end of I.R.C. § 4975(d) curiously denies the

the loan also must meet the limitations imposed by the Tax Equity and Fiscal Responsibility Act of 1982,³² codified in section 72 of the Code. In that regard, the loan cannot exceed the lesser of: (a) \$50,000 reduced by the excess of the highest outstanding balance of plan loans during the one-year period prior to the day the loan was made over the outstanding balance of plan loans on the date the loan was made; or (b) the greater of one-half of the present value of the nonforfeitable accrued benefit of the employee under the plan or \$10,000.³³ In addition, the loan must, by its terms, be repaid within five years, on a substantially level amortization, unless the proceeds are used to acquire a dwelling unit to be used as the principal residence of the participant.³⁴

B. Individual Retirement Accounts

Although IRAs are not subject to restrictions on early distributions as a requirement for qualified plan status, they are subject to the ten percent early distribution penalty, with certain modifications.³⁵ Participant loans are not permitted under individual retirement accounts.³⁶

exemption for loans to owner-employees, which would include a sole proprietor and certain partners and shareholders of S corporations. *See id.* § 4975(d).

³² Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 236(a), 96 Stat. 324 (1982).

³³ *See* I.R.C. § 72(p)(2) (1994).

³⁴ *See id.* § 72(p)(2)(B). The IRS has issued proposed regulations that supply a number of additional requirements, the details of which are beyond the scope of this essay. *See* Prop. Treas. Reg. § 1.72(p)-1, 60 Fed. Reg. 66,233 (1995). *See generally* Kathleen A. Odle & Ronald M. Pierce, *The New Regulations Governing Qualified Plan Participant Loans*, 26 COLO. LAW. 73 (1997) (suggesting principal residence loan period of up to 15 years is acceptable and refinancing generally will not qualify).

³⁵ Several exceptions from the 10% penalty do not apply to IRAs. The exception for distributions to employees after separation from service after attainment of age 55, distributions for medical expenses, and qualified domestic relations orders distributions do not apply. *See* I.R.C. § 72(t)(3)(A). Recent legislation has modified the rule with respect to medical expenses. *See generally infra* note 78. The proposed section 404 of the American Family Tax Relief Act would significantly broaden the range of distributions for which the penalty would not be imposed, particularly with respect to business start-up costs. *See infra* notes 110, 119-20, 122-24, 127-28, 131-32 and accompanying text. As discussed in the text that follows, the Taxpayer Relief Act of 1997 created several new exceptions to the imposition of the 10% penalty.

³⁶ *See* I.R.C. § 72(p)(4)(A). However, a short-term 60-day, nontaxable use

The Taxpayer Relief Act of 1997 introduced a number of IRA changes that are relevant to this discussion. First, with respect to the "traditional" IRA that had been a feature of the Code since 1974, the ten percent penalty for early distributions was curtailed with respect to distributions to purchase a home³⁷ or to finance higher education.³⁸ Notably, in both circumstances the funds can be used by family members other than the taxpayer and still qualify for the exception. Second, a new type of IRA, the so-called "Roth IRA," was introduced to the Code.³⁹ Prominent features of the Roth IRA are that all contributions are nondeductible⁴⁰ and "qualified" distributions (including earnings on contributions) are nontaxable.⁴¹ Roth IRAs are subject to the same ten percent early distribution penalty as the regular IRA.⁴²

of the IRA proceeds can be accomplished by distributing the proceeds of the IRA to the taxpayer, followed by a rollover of those funds to another IRA within 60 days of receipt. *See id.* § 402(c).

³⁷ Under the new provision, a "qualified first-time homebuyer distribution" is not subject to the 10% penalty for distributions in tax years beginning after December 31, 1997. There are, of course, a number of conditions. First, the distribution must be used to acquire the principal residence of a first-time home buyer within 120 days of receipt of the distribution. Second, the home buyer can be the distributee, his or her spouse, or a child, grandchild, or ancestor of the distributee or of his or her spouse. Third, lifetime withdrawals by the distributee for this purpose cannot exceed \$10,000. *See Taxpayer Relief Act of 1997*, Pub. L. No. 105-34, § 303(c), 111 Stat. 788 (1997) (adding I.R.C. §§ 72(t)(2) and 72(t)(8)).

³⁸ Under the new provision, the 10% penalty does not apply if the distribution is used for "qualified higher education expenses," which include tuition, fees, room and board (subject to some limitations), books, supplies, and equipment at a post-secondary educational institution. There is no other limit imposed on the amount of the distribution, and the student can be the distributee, his or her spouse, a child, or a grandchild. *See id.* § 203(b) (adding I.R.C. § 72(t)(7)).

³⁹ *See id.* § 302(a) (adding I.R.C. § 408A).

⁴⁰ *See id.* (adding I.R.C. § 408A(c)(1)).

⁴¹ *See id.* (adding I.R.C. § 408A(d)(1)(A)). Distributions that are not "qualified" are penalized by earnings on contributions being included in income. Distributions are treated as made first from contributions. *See id.* (adding I.R.C. § 408A(d)(1)(B)). A distribution is "qualified" only if it is made at least five years after the contribution to the Roth IRA and is made (1) on or after the date the distributee attains age 59½; (2) on or after the date of the death of the participant; (3) on account of the participant's disability; or (4) as a qualified first-time home buyer distribution. *See id.* (adding I.R.C. § 408A(d)(1)(B)(2)).

⁴² The statute provides that "[e]xcept as provided in this section, a Roth IRA

C. *Cash or Deferred Arrangements — 401(k) Plans*

With respect to employee contributions to a cash or deferred arrangement, generally referred to as a "401(k) plan,"⁴³ several classes of distributions are permitted under the requirements for qualified plan status. Imposition of the ten percent penalty is a separate matter discussed later. Even if the ten percent penalty does not apply, the distributions are otherwise subject to income taxation. Distributions may be made upon: (1) separation from service, death, or disability; (2) certain plan terminations or sales of the business; (3) attainment of age fifty-nine and one-half; or (4) hardship of the employee.⁴⁴ Employer contributions, however, may not be distributed on account of hardship.⁴⁵

Eliminating the hardship exception for employer contributions was a purposeful change enacted by Congress in the Tax Reform Act of 1986.⁴⁶ "Congress believed that it was necessary to restrict the availability of hardship withdrawals under a qualified cash or deferred arrangement to ensure that the favorable tax treatment for retirement savings is limited to savings that are, in fact, used to provide retirement income."⁴⁷ Congress, therefore, drew the line between employer contributions and elective employee contributions, restricting access to employer contributions but permitting limited access to employee contributions. That distinction makes sense in terms of providing incentives for employee elective contributions.⁴⁸

shall be treated for purposes of this title in the same manner as an individual retirement plan." *Id.* (adding I.R.C. § 408A(a)). The I.R.C. § 4974(c)(4) listing of individual retirement accounts under I.R.C. § 408(a) (which are in turn subjected to the 10% penalty of I.R.C. § 72(t)) would, by reason of I.R.C. § 408A(a), apparently include Roth IRAs. That conclusion is supported by the Senate Finance Committee Report, in referring to additional exceptions for the Roth IRA from the 10% early withdrawal tax for first-time home buyers and long-term unemployed individuals (which were deleted in the Conference Committee). *See* Committee on Finance, United States Senate, Revenue Reconciliation Act of 1997, S.B. 949, Report 105-33, June 20, 1997, 30-32.

⁴³ *See generally* John Rubino, *Getting the Most Out of Your 401(k)*, YOUR MONEY, June/July 1996, at 61.

⁴⁴ *See* I.R.C. § 401(k)(2) (1994).

⁴⁵ *See id.* § 401(k)(2)(B)(i)(IV).

⁴⁶ Tax Reform Act of 1986, Pub. L. No. 99-514, § 1116(b)(1), 100 Stat. 2085, 2454 (1986) (codified as amended in scattered sections of 26 U.S.C.).

⁴⁷ STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 635 (Comm. Print, 1987).

⁴⁸ Otherwise, employees could be reluctant to make elective contributions

With respect to the hardship exception to early distributions, the 401(k) regulations provide an extensive treatment of the meaning of "hardship."⁴⁹ The general rule is that "a distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need."⁵⁰ The regulations present several situations that would be deemed "immediate and heavy financial need." These include expenses for medical care, the purchase of a principal residence, payment of post-secondary education expenses, and "[p]ayments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence."⁵¹ Financing a new business is thus not expressly included as a financial need.⁵²

Even if there is a financial need, the employee must also demonstrate that the distribution is required to meet that need — that it cannot be satisfied by other resources that are readily available to the employee. As the regulations illustrate, "a vacation home owned by the employee and the employee's spouse generally will be deemed a resource of the employee."⁵³ The regulations provide that a distribution is deemed necessary to satisfy financial need if four requirements are satisfied. First, the distribution is capped by the employee's immediate and heavy

that would be "locked up" until they near retirement age. *See infra* note 98.

⁴⁹ See Treas. Reg. § 1.401(k)-1(d)(2) (1994).

⁵⁰ *Id.* § 1.401(k)-1(d)(2)(i).

⁵¹ *Id.* § 1.401(k)-1(d)(2)(iv)(A).

⁵² Of course, if the participant were to invest most other funds in a new business, even to the point of being on the verge of losing his or her personal residence, these provisions would be invoked. Also, with respect to education expenses that easily qualify for the hardship exception, is it less risky for a 45-year-old to go to law school, for example, and try a career as an attorney, than it is for the same person to start a business with the knowledge and experience that he or she already has? The case of the misguided career student aside, it is difficult to argue that a taxpayer's retraining is a foolish use of funds — otherwise, in a strict case, we condemn the taxpayer to penury, with no viable career, biding time until he or she can tap retirement funds. In that regard, the Taxpayer Relief Act of 1997 permits the distribution of IRA funds for post-secondary education, free of the 10% early withdrawal penalty. However, this provision is much broader in that it also permits the taxpayer to pay education expenses from the IRA for his or her spouse, children, and grandchildren. *See supra* notes 37-42 and accompanying text.

⁵³ Treas. Reg. § 1.401(k)-1(d)(2)(iii)(B).

financial need.⁵⁴ Second, the employee must have "obtained all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently available under all plans maintained by the employer."⁵⁵ Third, "the plan and all other plans maintained by the employer limit the employee's elective contributions for the next taxable year to the applicable limit under section 402(g)⁵⁶ for that year minus the employee's elective contributions for the year of the hardship distribution."⁵⁷ Fourth, "the employee is prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least twelve months after receipt of the hardship distribution."⁵⁸

Even if the plan permits a distribution, one must still contend with the ten percent early distribution penalty. The inconsistencies are apparent and remain so after the Taxpayer Relief Act of 1997. Failure to "repair" these inconsistencies is, in our view, a lost opportunity for a more coordinated approach among the various retirement plan provisions. For example, although a 401(k) plan may permit a distribution at any time on account of financial hardship or separation from service, the ten percent penalty may be imposed because the Code contains no financial hardship exception and immunizes separations from service *only* after age fifty-five.⁵⁹ Conversely, while the ten percent penalty may be avoided by accepting an annuity over one's life, the 401(k) provisions would not permit such a distribution without separation from service.⁶⁰

Participant loans are generally treated in the same manner as general pension and profit-sharing plan loans. There is new interest in this area, with some banks reportedly offering credit card access to 401(k) secured loans.⁶¹ While the IRS has yet to rule on the plan, the "concept has already polarized the pension community"⁶² foreshadowing the paternalistic arguments discussed below, opponents of such easy access

⁵⁴ See Treas. Reg. § 1.401(k)-1(d)(2)(iv)(B).

⁵⁵ *Id.*

⁵⁶ The limit prescribed in the Code is \$7000, subject to adjustment for cost-of-living increases. See I.R.C. § 402(g) (1994). For tax years beginning in 1995, this limit is \$9240.

⁵⁷ Treas. Reg. § 1.401(k)-1(d)(2)(iv)(B).

⁵⁸ *Id.*

⁵⁹ See *supra* note 28 and accompanying text.

⁶⁰ See *supra* note 44 and accompanying text.

⁶¹ See Rod Garcia, *Practitioners Debate Virtues of Pension Plan Loan Credit Cards*, 72 TAX NOTES 19 (1996).

⁶² *Id.*

loans assert policy concerns. "'It's nuts!' said Ted Benna, president of the 401(k) Association, based in Philadelphia. 'It flies in the face of national retirement policy. My biggest concern is that credit card users often are not able to pay off their credit card loans.'"⁶³

Other commentators disagree, asserting that greater access promotes more employee participation. "'In 401(k)s that permit loans, 78 percent of workers contribute on average, vs. 71 percent in plans that don't allow loans.'"⁶⁴ In specific defense of the credit card loan, a bank credit card manager said, similarly, "'[i]f you give [younger workers] a better vehicle that enables them to borrow and save, [that] will increase their ability to save, and they will be more inclined to do it.'"⁶⁵

D. Life Insurance Products

In an attempt to lend some coherence to the area of retirement savings, Congress has extended some of these same principles, notably the ten percent early distribution tax, to life insurance products of a kindred nature, such as the tax deferred annuity and endowment contract. These topics are, however, beyond the scope of this essay ⁶⁶

III. THE PATERNALISTIC HAND

A. The Governmental Stake

The overall American retirement security system is often compared to a "three-legged stool," of which Social Security is one leg, employer-sponsored retirement plans are a second leg, and private individual

⁶³ *Id.*

⁶⁴ Anne Willette, *401(k) Plans Gain New Popularity As More People Tap Savings For Cash*, DENV POST, July 7, 1996, at G5 (quoting consultant Access Research).

⁶⁵ Matt Murray & Vanessa O'Connell, *Banc One to Test A Credit Card Tied to 401(k)*, WALL ST. J., June 24, 1996, at A7C (quoting Karen Barrett, Banc One trust card manager). "Currently, about 81% of employers with 401(k) plans allow employees to borrow against their accounts. About a fifth of plan participants have loans outstanding, with most borrowers being lower-paid employees." *Id.* (citing survey of 267 companies by human resource consulting firm William M. Mercer, Inc.).

⁶⁶ For a discussion of the income tax treatment of life insurance product loans and distributions, see Wayne M. Gazur, *Death and Taxes: The Taxation of Accelerated Death Benefits for the Terminally Ill*, 11 VA. TAX REV 263 (1991).

savings (including home equity) are the final leg.⁶⁷ The Social Security system is the largest and most paternalistic program, generally mandatory for employers and employees alike. While income tax incentives for retirement savings existed prior to 1974, in that year the federal government assumed an even larger role in the area of employer-sponsored retirement savings with the enactment of ERISA⁶⁸ and creation of the Pension Benefit Guaranty Corporation ("PBGC").⁶⁹

The cost of encouraging and implementing the private retirement system is significant. It includes regulatory costs incurred by the Department of Labor and the Internal Revenue Service, compliance and outright benefit funding costs by private employers,⁷⁰ and the taxes not collected (that is, subsidies) incurred by federal and state government under the favorable treatment of retirement contributions.⁷¹ Governmen-

⁶⁷ Retirement income sources would also include the Supplemental Security Income program, Food Stamp program, and other public aid programs. See generally Nancy J. Altman, *The Reconciliation of Retirement Security and Tax Policies: A Response to Professor Graetz*, 136 U. PA. L. REV. 1419, 1420-21 (1988).

⁶⁸ ERISA was enacted for several reasons. The legislation responded to reported abuses of plan assets and unfair employee forfeiture schemes. See *Cause and Effect*, FORBES, Oct. 1, 1975, at 21 (stating that the core of the bill's support was the "idea of cleaning up the Teamsters"). Another goal was to expand the coverage of employer-sponsored retirement plans. See Michael S. Sirkin, *The 20th Anniversary of the Employee Retirement Income Security Act (1974-1994): The 20 Year History of ERISA*, 68 ST. JOHN'S L. REV. 321, 323 (1994).

⁶⁹ The PBGC was established for two major purposes: (1) to provide participants and beneficiaries certain minimal guarantees as to receipt of benefits; and (2) to provide a mechanism for administration and distribution of benefits if the plan is unable to pay. The PBGC resembles federal bank deposit insurance organizations because it collects premiums from employers (excluding plans maintained by professional service employers that have no more than 25 participants, governmental and church-sponsored plans, and defined contribution plans) and in return, it insures that pension benefits will be paid even if the employer becomes insolvent or is otherwise unable to fully fund its pension liabilities. See 29 U.S.C. §§ 1301-1461 (1994).

⁷⁰ In 1991 employers contributed \$111.1 billion to private pension plans. See PENSION AND WELFARE BENEFITS ADMINISTRATION, U.S. DEP'T OF LAB., PRIVATE PENSION PLAN BULLETIN (1993), reprinted in U.S. DEP'T OF COM., STATISTICAL ABSTRACT OF THE UNITED STATES 1995, No. 599, at 383.

⁷¹ For 1997, the revenue cost of the exclusion from tax of pension contributions and earnings on accumulations reached \$59.49 billion for employer plans, \$6.12 billion for IRAs, and \$5.195 billion for Keoghs. See U.S. OFF. OF

tal encouragement of retirement savings is not, however, confined to ERISA and the income tax code. For example, to protect at least some of a debtor's nest egg from creditors, the bankruptcy law⁷² and some state laws⁷³ exempt retirement assets from the claims of creditors.

Before 1996, one could have stated that, with few exceptions, the retirement savings provisions were not aimed at encouraging Americans simply to save, but to save specifically for *retirement*. For example, until the enactment of the Small Business Job Projection Act of 1996, the tax statutes forced mandatory withdrawals after attaining the age of seventy-and-one-half, even if the employee had not retired, by imposing penalties for a failure to do so.⁷⁴ Hence, one was discouraged from letting funds

MGMT. & BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT, *reprinted* in U.S. DEP'T OF COM., STATISTICAL ABSTRACT OF THE UNITED STATES 1995, No. 523, at 339. To the extent that a state's income tax base is linked with federal taxable income, state governments also forego tax revenues attributable to retirement contributions.

⁷² So-called "ERISA-qualified" plans are excluded from the bankrupt's estate. *See* Patterson v. Shumate, 504 U.S. 753, 760 (1992). However, not all retirement plans enjoy that status. *See generally* Mary Ann Jackson, Patterson v. Shumate: *What Happens to Pension Benefits in Bankruptcy?*, 47 ARK. L. REV. 449, 468-75 (1994) (observing that if a plan does not meet the definition of an employee benefit plan prescribed by ERISA, it would not be excludable from the bankrupt's estate except under certain provisions of state spendthrift trust law or some other "applicable nonbankruptcy law"); Jeanne Cullinan Ray, *Protecting Pension Assets in Personal Bankruptcy*, 68 ST. JOHN'S L. REV. 409, 425-26 (1994) (noting that IRAs are includable in the bankrupt's estate by case law); Carla Michele Schiff, Note, *Protecting Non-ERISA Pension Funds From the Reach of Creditors in Bankruptcy*, 11 BANKR. DEV. J. 155 (1995) (discussing the predicament of small business owners, sole practitioners, and other non-ERISA pension fund holders who cannot exclude funds from their bankruptcy estate).

⁷³ *See, e.g.*, COLO. REV. STAT. ANN. §§ 13-54-102, -54-104, -54.5-101 (West 1997) (exempting non-qualified plans and Individual Retirement Accounts). For a brief discussion of the interplay of state and federal law in this area, see Kelly Reiman, *Rights of the Debtor and Creditor to Retirement Plan Benefits: An Update*, COLO. LAW., May 1996, at 45.

⁷⁴ The purpose of these savings plans is not capital formation or estate enhancement; instead, it is to fund retirement. Accordingly, I.R.C. § 401(a)(9) requires that qualified plans generally provide that the whole interest of each employee be distributed entirely or as an annuity with reference to a "required beginning date" which must occur no later than April 1 of the calendar year following the calendar year in which the employee attains age 70½. *See* I.R.C. § 401(a)(9) (1994). Moreover, the employee, upon tardy receipt of such benefits,

accumulate. While a comfortable retirement was a goal of the system, a very comfortable retirement, at the expense of the fisc, was not. Consequently, the taxation provisions continue to dictate a number of limitations on the size of allowable benefits and contributions.⁷⁵ Moreover, if a participant's benefits exceeded certain amounts during the payment period, or the remaining accumulation exceeded certain parameters upon the participant's death, the tax system imposed an excise tax.⁷⁶ That particular tax was swept away in the Taxpayer Relief Act of 1997.⁷⁷

is assessed a penalty. *See id.* § 4974(a). However, for years beginning after December 31, 1996, participants in qualified plans are no longer required to begin receiving distributions after attaining age 70½ if they are still employed. This liberalization does not apply to Individual Retirement Accounts or to five percent owners. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1404(a), 110 Stat. 1755, 1791 (1996) (amending I.R.C. § 401(a)(9)(C) (1994)).

⁷⁵ For example, I.R.C. § 404(l) limits compensation that may be considered as a base for qualified plan contributions to \$150,000 (plus inflation adjustments). *See* I.R.C. § 404(l). I.R.C. §§ 401(a)(16) and 415 provide additional limitations on benefits and contributions. *See id.* §§ 401(a)(16), 415.

⁷⁶ If the participant received distributions from all qualified plans and IRAs in excess of \$150,000 in one year (the actual limit is the greater of \$150,000 or \$112,500 adjusted for inflation; as of 1994 the inflation adjusted limit had reached \$148,500), the excess was subject to a 15% additional tax. If upon death the balance of the retirement benefits exceeded the present value of a single life annuity with annual payments equal to the \$150,000 annual distribution limitation, the excess was subject to a 15% additional estate tax. *See id.* § 4980A. Legislation in 1996 suspended the 15% excise tax on excess distributions for distributions during years beginning after December 31, 1996, and before January 1, 2000, but the estate tax excise remained in place. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1452(b), 110 Stat. 1755, 1816 (1996) (amending I.R.C. § 4980A by adding new subsection (g)). *See generally* Susan E. Kuhn, *Footloose and Tax-Free*, FORTUNE, Feb. 3, 1997, at 147 (observing that some fund holders will be able to save money by withdrawing large amounts subject to the income tax, but not the added excise tax).

⁷⁷ The excess distribution tax was repealed for excess distributions received after December 31, 1996, and the excess retirement accumulation tax was repealed for estates of decedents dying after December 31, 1996. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 105th Cong., 1st Sess., § 1073(c) (repealing I.R.C. § 4980A). The Senate Finance Committee Report provides several justifications. "The Committee believes that the limits on contributions and benefits applicable to each type of vehicle are sufficient limits on tax-deferred savings. Additional penalties are unnecessary, and may also deter

The Taxpayer Relief Act of 1997 blurred the distinctions between classes of savings even further by eliminating the ten percent early withdrawal penalty for IRAs on the distribution of funds to purchase a new home or finance post-secondary education.⁷⁸ Although a home can be considered a retirement asset and a good education a base for the production of current income and retirement savings, these provisions permit the purchase of homes for ancestors, children, and grandchildren (albeit limited to an aggregate of \$10,000) and the purchase of education for children and grandchildren. Although politically expedient, these exemptions further clutter the already complex retirement provisions of the Code and dilute the protections for the retirement nest egg. In contrast, although Congress actively considered the funding of entrepreneurial enterprises, it neglected to adopt any provisions that respond to the start-up capital needs of displaced workers.

B. Defending Paternalism

The government's encouragement of the private retirement system is based on paternalistic intentions. The existence of a private retirement plan is itself paternalistic — employees are forced to save rather than consume; they must accept future retirement benefits in lieu of current cash compensation. At first blush, we would bypass the well-developed

individuals from saving. The excess accumulation and distribution taxes also inappropriately penalize favorable investment returns." SENATE COMM. ON FINANCE, REVENUE RECONCILIATION ACT OF 1997, S. REP. NO. 105-33 (1997).

⁷⁸ See *supra* notes 37-42 and accompanying text. These types of modifications had been proposed in an endless stream of bills bearing a number of names, including the "Super-IRA," "IRA-Plus," "Family Savings Account," and "American Dream Savings Account." For a history of these proposals and an assessment, see Jane G. Gravelle, Congressional Research Service, *Individual Retirement Accounts (IRAs) and Related Proposals*, reprinted in TAX ANALYSTS, TAX NOTES TODAY, Mar. 29, 1995, available in LEXIS, Fedtax Library, TNT File, elec. cit. 95 TNT 61-25. In her concluding remarks, Ms. Gravelle observes that the proposed liberalized access rules "for other purposes than retirement dilute[] the focus of the provision on preparing for retirement." *Id.* at 14. Nevertheless, even before the broad amendments introduced by the Taxpayer Relief Act of 1997, the Health Insurance Portability and Accountability Act expanded the use of IRA funds by eliminating the 10% additional tax on distributions from an IRA that are used to pay medical expenses in excess of 7.5% of adjusted gross income and to pay certain health insurance premiums. See Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, § 361, 110 Stat. 1936, 2071-72 (1996) (amending I.R.C. § 72(t) (1994)).

debate over the desirability of "paternalism"⁷⁹ and focus on the more narrowly paternalistic aspects of limitations on access to retirement assets. The validity of the entire system, however, is brought into question by discussions of pre-retirement access — the power to dissipate assets is the power to destroy the system and its paternalistic intentions.

The proponents of government intervention in the private retirement system assert that without it, Americans would not provide for their retirement because they lack discipline⁸⁰ or suffer from short-sightedness.⁸¹ On the other hand, paternalism in the retirement context has been criticized for not allowing people to make their own mistakes and for being easily circumvented by those determined to avoid the restrictions.⁸²

⁷⁹ "[Paternalism] can be defined in relatively neutral terms as interference with a person's freedom of action out of a desire to protect that person's welfare, interests, or values (as perceived by the paternalistic actor)." Jendi B. Reiter, *Citizens or Sinners? — The Economic and Political Inequity of "Sin Taxes" on Tobacco and Alcohol Products*, 29 COLUM. J.L. & SOC. PROBS. 443, 451 (1996). See also Alice G. Abreu, *Taxes, Power, and Personal Autonomy*, 33 SAN DIEGO L. REV. 1, 35-36 nn.72-74 (1996) (discussing several definitions of paternalism). For many, paternalism often has an immediate negative connotation. It represents a loss of liberty and control by the affected individual. In fact, the root of the word itself has a male gender bias.

⁸⁰ "Without employer retirement plans, it is far from clear whether individual workers will maintain the same disciplined pattern of savings throughout their working years." Nolan, *supra* note 2, at 215.

⁸¹ It is sometimes asserted that two such judgmental defects are short-sightedness and selfishness — a tendency to overdiscount future consumption through a myopic failure to save and a tendency to undervalue dependents' consumption. As such, tax subsidies for retirement savings or for dependent care services may be justified as attempts to maximize life-time or household satisfactions. Peter J. Wiedenbeck, *Paternalism and Income Tax Reform*, 33 U. KAN. L. REV. 675, 685 (1985). "Such 'paternalism' is perhaps justified because of the perceived inability of individuals to anticipate and accommodate their future needs and because of the failure of Social Security to adequately replace preretirement income." Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable As a Means of Increasing Retirement Income? Should It Continue?*, 49 TAX. L. REV. 1, 3 (1993). See Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Policy*, 58 U. CHI. L. REV. 1275 (1991) (attempting to reconcile economic theory that free actors are assumed to choose the best economic course of action with paternalistic retirement policies).

⁸² See Halperin, *supra* note 81, at 3 n.10 (summarizing the anti-paternalist

A thoughtful discussion of the arguments supporting the forced purchase of retirement benefits has been provided by Professor Bankman.⁸³ First, effective planning might otherwise be distorted through factual mistakes concerning future income, health and life expectancy, inflation, and the investment rate of return, to name but a few.⁸⁴ In that regard, a recent survey found that workers expected that government and employers would provide sixty-three percent of their retirement income, with individual earnings and investments producing the balance of thirty-seven percent. Other studies show, however, that individual earnings and investments actually account for about forty-six percent of retirement income.⁸⁵ Second, the employee may have "an erroneous belief as to the importance of income upon retirement."⁸⁶ Third, the employee may suffer from death-related anxiety, resulting in myopic behavior.⁸⁷ Fourth, while there is some evidence that employees

positions, including assertions that workers would seek employment without forced retirement savings plans or would borrow to maintain high present consumption). It has been argued that the paternalism reflected in the tax on tobacco products restrains individual choice and is undemocratic. *See* Reiter, *supra* note 79, at 451-60. To give each American power over his or her Social Security benefits (through a type of IRA account) rejects paternalism and was the basis of 1996 Republican presidential candidate Steve Forbes' reform proposal. In response to the assertion that the American people cannot be trusted to invest their own money, Forbes states, "By that standard, we shouldn't be trusted to handle our paychecks, to choose our own leaders, to pick our own careers and spouses." Steve Forbes, *How to Replace Social Security*, WALL ST. J., Dec. 18, 1996, at A20. While advocating permitting people to choose a retirement age "above a certain age, say 60," Mr. Forbes states that "they could not withdraw their money until a certain age." *Id.* Of course, paternalism is a difficult habit to break, so "[t]he federal government would guarantee a minimum safety net for protection." *Id.* The debate of the level of safety in that net would be interesting. *But see* Karen C. Burke & Grayson M.P. McCouch, *Privatizing Social Security: Eight Myths*, 74 TAX NOTES 1167, 1171 ("Retirement security could be undermined if participants were permitted to make withdrawals from their individual accounts prior to retirement or to receive lump sum distributions upon retirement.").

⁸³ *See* Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790 (1988).

⁸⁴ *See id.* at 816.

⁸⁵ *See* *Workers Have Inflated Expectations of Retirement Income, Survey Shows*, 20 PENS. & BEN. REP. (BNA) No. 49, 2580 (Dec. 13, 1993).

⁸⁶ Bankman, *supra* note 83, at 817

⁸⁷ *See id.* at 818.

do not under-save, the overall evidence is not conclusive.⁸⁸ Fifth, "forced savings of individuals in their working years might plausibly reduce the amount of support required after retirement."⁸⁹

The fifth argument, that the government encourages private retirement savings to avert ultimate reliance on public assistance programs, acknowledges that Social Security benefits are inadequate to meet all retirement income needs, but also assumes that the government must or will continue public welfare programs for the support of indigent elderly. However, with respect to the plight of poorer workers, observers note that private retirement plans have never covered more than fifty percent of the private work force, and lower paid workers are a disproportionate number of those lacking coverage.⁹⁰ Professor Bankman concludes that "[w]hile there are many good arguments in favor of forced saving, none of those arguments is without difficulty. Perhaps the most that can be said is that the cumulative weight of the arguments, considered in light of the potential misery faced by the elderly poor, plausibly supports a regimen of forced saving."⁹¹

The private retirement system is admittedly imperfect. It is overly complex and displays other problems.⁹² Still, there have been some

⁸⁸ See *id.* at 818-20.

⁸⁹ *Id.* at 821. Similar arguments have been made in support of tax incentives for life insurance — that life insurance may enable the insured's family to avoid becoming dependent on governmental assistance. See Gazur, *supra* note 66, at 317.

⁹⁰ See Halperin, *supra* note 81, at 5. A review of a recent book, *Will America Grow Up Before It Grows Old?*, cited a shocking statistic: "Only 30% of American families save for the future at all; and even among that 30%, the median amount saved is just \$1,000. Half of all adults in their late 50s have less than \$10,000 socked away." David Frum, *The Bankruptcy Around the Corner*, WALL ST. J., Oct. 16, 1996, at A18. Moreover, with respect to poorer workers, an employer can "integrate" Social Security contributions into the overall private retirement plan, paying more on behalf of workers whose pay exceeds the Social Security taxable wage base, to the relative disadvantage of workers earning less than that base. See generally Ellen E. Schultz, *The Pension Eraser: "Integrating" Social Security Can Cut Benefits*, WALL ST. J., Mar. 12, 1997, at C1.

⁹¹ Bankman, *supra* note 83, at 821.

⁹² See, e.g., Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851 (1987) (arguing that a coordinated approach to retirement security is required, including Social Security, rather than focusing primarily on the income tax aspects). See Bankman, *supra* note 83, at 834 (concluding that the anti-discrimination rules are ineffective and counter-productive, and that a mandatory universal pension plan should be

successes,⁹³ and the system, in some form, should and will continue. The primary issue for this essay, therefore, is whether liberalizing the restrictions on distributions can be accomplished without increasing the ultimate demand for public assistance.

C. *The Liberalization Debate*

Arguments advanced in favor of loosening the restrictions on access to retirement savings require a degree of optimism about human nature. According to these arguments, the availability of funds to a budding entrepreneur can make that person's life more fulfilling and ultimately financially secure if the enterprise is successful. That success would be spread to other family members and to new employees of the enterprise whose jobs might not otherwise have been created — thereby reducing their probability of resorting to public assistance. Even if one is skeptical of such rosy predictions, the current system imposes no penalties or limitations whatsoever on spendthrift behavior after age fifty-five or fifty-nine-and-one-half, depending on the type of retirement plan in question, at which point many plans permit a lump-sum payout.⁹⁴ Unless one can argue that the "follies of youth" still plague forty to forty-five-year-old individuals but not those ten to fifteen years older, the current system provides little added protection. This is particularly true when viewed in terms of the extended life expectancies of Americans — at the age of fifty-nine-and-one-half the participant has on average twenty to twenty-five more years to live (and, pessimistically, engage in spendthrift behavior).⁹⁵

studied).

⁹³ "Indeed a study by Stanford University economist John Shoven concluded that but for employer-sponsored retirement plans, the United States would have actually experienced net negative savings for the 1980s." James Klein, *ERISA at 20: A Look Back and A Look Ahead*, 66 TAX NOTES 1991, 1992 (1995). See also *supra* note 2, detailing the dramatic rise in the level of private retirement plan assets.

⁹⁴ See *supra* text accompanying notes 26-34.

⁹⁵ For a white male or female reaching age 59 in 1990, the remaining life expectancy was projected as 19.7 and 23.8 years, respectively. U.S. NAT'L CTR. FOR HEALTH STAT., VITAL STATISTICS OF THE UNITED STATES, *reprinted in* U.S. DEP'T OF COM., STATISTICAL ABSTRACT OF THE UNITED STATES 1996, Table No. 120, at 89 (116th ed. 1996) (listing life expectancies by race, sex and age).

Finally, one must also speak in terms of overall incentives for retirement savings on the part of Americans. It is frequently asserted that Americans do not save enough for retirement.⁹⁶ Assuming Americans might save more if they were assured of more access to those savings in the event of hardship, then loosening the restrictions, at least with respect to employee contributions,⁹⁷ could promote that objective.⁹⁸ The Taxpayer Relief Act of 1997's loosening of the distribution restrictions on IRAs apparently demonstrates a conclusion by Congress that Americans need the perception of future flexibility as an inducement to save for their retirement. As a result, they can now apply the funds to other uses, such as the purchase of a home for themselves, their ancestors, children, or grandchildren, or the purchase of post-secondary education for themselves, their children or grandchildren, without being subject to the ten percent early distribution penalty.⁹⁹ The provisions also imply that Congress apparently now believes that *even within the context of a retirement plan* there are activities more important than retirement needs, like buying a first home for other family members.

There is another side to the debate, born of pessimism, that has some force. Borrowing for a home or a college education is a fairly simple and predictable matter. Those events are already the subject of the 401(k) plan hardship provisions.¹⁰⁰ A successful entrepreneurial endeavor, however, involves more risk and requires considerable vision and luck.

⁹⁶ An anemic savings rate for Americans, for retirement or otherwise, has been a frequent topic in the popular press. *See, e.g.,* James Aley, *Economic Intelligence: Skampy Savings*, FORTUNE, Feb. 20, 1995, at 38; Mike McNamee & Paul Magnusson, *Let's Get Growing*, BUS. WK., July 8, 1996, at 90; Penelope Wang, *Save 15% and Still Live It Up*, MONEY, Dec. 1995, at 120.

⁹⁷ The 401(k) provisions, for example, do not permit the distribution of employer contributions on account of hardship but do permit them for employee contributions. *See supra* text accompanying notes 45-48.

⁹⁸ In the life insurance context it has been asserted that the liquidity available through policy loans is an important factor in the acquisition of insurance, particularly for the less wealthy. *See* Gazur, *supra* note 66, at 319. In discussing "tactics for attracting more people to 401(k) plans" in light of the fact that 25% of eligible employees still do not participate in them, one commentator reported that the availability of plan loans is an important factor. Anne Willette, *401(K) Plans Try New Ways to Entice Workers*, USA TODAY, July 24, 1996, at B1 ("Employees want to get their money if they need it."). There is some evidence suggesting that plan participation, particularly for lower paid workers, increases with loan availability. *See supra* notes 64-65 and accompanying text.

⁹⁹ *See supra* notes 37-38 and accompanying text.

¹⁰⁰ *See supra* notes 49-58 and accompanying text.

In view of the sobering statistics concerning the failure rate of new businesses,¹⁰¹ it is questionable whether the retirement nest egg — in which the government is a partner — should be made available as risk capital. Moreover, by any measure, accessing these funds is expensive; even if the distribution is permitted without penalty, it is still subject to income tax (federal, state, or local) that can deplete over one-third of the sum received.

No matter what side of the debate one favors, it should be acknowledged that even the current impediments to early distributions — current income taxation plus a ten percent penalty¹⁰² — are apparently not enough of an obstacle to the use of retirement funds by determined participants. Congress imposed the ten percent penalty out of concern that high income taxpayers could use retirement plans more as a tax deferred savings plan, rather than as a *retirement* plan.¹⁰³ Participants reportedly

¹⁰¹ Statistics on the rate of business failures turn upon the terminology used to describe the failure. By some counts, business failures are limited to filed bankruptcies or situations in which creditors were involved in the winding up of the business. A number of failures, however, do not involve insolvency; the businessperson simply shutter the business after paying all of the obligations of the business. "Experts generally agree that 80% of all startup businesses fail within the first five years of their existence." Bryan E. Milling, *How Contractors Can Succeed in Business By Not Failing: When Employees Start Their Own Companies*, AIR CONDITIONING, HEATING & REFRIGERATION NEWS, Apr. 29, 1996, at 5; see also Charles Bunker & Guy Fowler, *Weight Gained in the U.S.*, FIN. TIMES (London), Oct. 31, 1995, at 12 (citing U.S. Small Business Administration report that "shows 24% of new businesses failed in their first two years and 63% within six years"). But see Wilma Randle, *New Business Owners: Who Succeeds and Why*, WORKING WOMAN, Mar. 1996, at 34 (citing two studies: one showing 70% of new businesses still running after one year and another showing that of 3000 start-up businesses studied over a three-year period, "77% survived, 19% folded and 4% were sold.").

¹⁰² See *supra* notes 21-23 and accompanying text.

¹⁰³ In considering the necessity of withdrawal restrictions, [t]he absence of withdrawal restrictions in the case of some tax-favored arrangements allows participants in those arrangements to treat them as general savings accounts with favorable tax features rather than as retirement savings arrangements. Moreover, taxpayers who do not have access to such arrangements, in effect, subsidize the general purpose savings of those whose employers maintain plans with liberal withdrawal provisions.

Although the committee recognizes the importance of encouraging taxpayers to save for retirement, the committee also believes that tax

continue, however, to take distributions, paying the income tax and the ten percent penalty “‘Surprisingly, less than 50% of those who receive distributions from a retirement plan roll the eligible assets into an IRA.’”¹⁰⁴ A truly pessimistic and paternalistic approach to this issue would impose even greater restrictions on pre-retirement access to retirement funds; although the ten percent penalty might be much too benign, we are not proposing such an increase. Because the private retirement system is not mandatory and participation is enhanced in part by some access to those funds in emergency situations,¹⁰⁵ stricter withdrawal rules could reduce the level of participation. The point at which a greater distribution penalty would create meaningful reductions in participation, however, is a matter of conjecture. Still, recognizing that the current system does not insure the preservation of retirement assets as an absolute matter puts the risks that could be created by liberalizing access through our proposals in better focus.

D. *Some Guidelines*

If the access rules are to be liberalized, some guidelines are suggested by the foregoing discussion.

incentives for retirement savings are inappropriate unless the savings generally are not diverted to nonretirement uses. One way to prevent such diversion is to impose an additional income tax on early withdrawals from tax-favored retirement savings arrangements. For the same reasons, the committee believes it is appropriate to limit the extent to which participants may make hardship withdrawals from a qualified cash or deferred arrangement.

Moreover, the committee is concerned that the present-law level of the additional income tax appears in many instances to be an insufficient deterrent to the use of retirement funds for nonretirement purposes, because for taxpayers whose income is taxed at a higher marginal rate, the sanction may be neutralized by the tax-free compounding of interest after a relatively short period of time, particularly with respect to amounts contributed to a retirement arrangement on a before-tax basis.

S. REP. NO. 99-313, at 612-13 (1986).

¹⁰⁴ Dom Del Prete, *Retirement's New Realities: Piecing Together Your Retirement Puzzle*, FIDELITY FOCUS, Spring 1997, at 7, 11 (quoting Paul Yakoboski of the Employee Benefits Research Institute). While all of the distributions would be subject to ordinary income tax, some could be exempt from the additional 10% penalty due to the employee's age or the method of payment. See I.R.C. § 72(t)(2) (1994).

¹⁰⁵ See *supra* note 98 and accompanying text.

1. *Plan Loans Offer Some Comparative Benefits*

As discussed earlier,¹⁰⁶ the current rules permit loans against some retirement plan assets (IRAs are an exception), but limit the loan amount to \$50,000. One could tinker with the loan provisions, increasing the limit and requiring a showing of hardship. From the standpoint of protecting the retirement fund, there is little difference between a loan and an outright distribution because in the event of default the loans are ultimately secured by the participant's plan account.¹⁰⁷ On the other hand, there could be some benefit from the discipline instilled by the presence of an interest-bearing loan with required amortization payments, as opposed to an unrestricted lump sum distribution.¹⁰⁸ Loans also offer income tax benefits under the current system because they are not taxable events; needed capital is not paid out in the form of income taxes. Also, if an incremental change is preferred, the loan area is much more circumscribed and would not require significant amendments to the overall distribution rules.

Loans offer an additional advantage — if the venture is successful and the loan is repaid, the funds are returned to the retirement plan.¹⁰⁹ In comparison, the proposed American Family Tax Relief Act, one of many "Super-IRA" proposals that preceded the ultimate enactment of the Taxpayer Relief Act of 1997, provided that distributions from individual retirement plans used for "business start-up costs" would be free of both tax liability and the ten percent early distribution penalty.¹¹⁰ However,

¹⁰⁶ See *supra* notes 29-34 and 61-65 and accompanying text.

¹⁰⁷ A difference could arise if the default occurs several years into the venture because current law requires level amortization over five years, and in that case some repayments could already have been made. See *supra* note 34.

¹⁰⁸ This seems to be a very marginal benefit, but in the 401(k) credit card loan debate, see *supra* notes 61-65 and accompanying text, Howard Phillips, former President of the American Society of Pension Actuaries, observed that "[c]redit card companies are experts in getting the money back; employers are not." Garcia, *supra* note 61, at 19.

¹⁰⁹ If the loan is not repaid, it is treated as a taxable distribution. However, the participant should be able to claim aggregate losses from the failed venture as an offset. If access to the loan in the first place were significantly restricted, as in our proposal at *infra*, notes 133-38 and accompanying text, it would be appropriate to waive the additional 10% penalty on the deemed distribution arising from loan defaults.

¹¹⁰ See American Family Tax Relief Act, S.2, 105th Cong. § 404 (1997) (introduced on Jan. 21, 1997 by Senators Roth and Lott) [hereinafter American

as a tax-free distribution, it does not provide for the return of the funds to the retirement plan. Although the participant may be as wealthy as before, the amount of retirement funds set aside is reduced.

2. *Plan Assets Should Be Last Resort*

As already embodied in the 401(k) hardship rules, any changes to the loan or distribution rules should require a showing of circumscribed need, such as the start-up of a viable business *and* that the participant has exhausted all other potential sources of assets. As far as the requirement of demonstrating a viable business start goes, this will be a hollow requirement unless someone evaluates the merit of the proposal. The IRS is not equipped for that task from a skills standpoint. Even if it were, it is questionable whether the agency workload would permit prompt processing of requests. The plan administrator probably would be no better suited for the business plan evaluator role. Requiring that a description of the proposal, if not a business plan, accompany the loan

Family Tax Relief Act]. Section 404(a) of the legislation would amend I.R.C. § 408(d) by adding a new subsection 408(d)(8) that creates a tax exemption for tax distributions "from an individual retirement plan to the extent the aggregate amount of such payments and distributions does not exceed the business start-up costs of the taxpayer for the taxable year." *Id.* § 404(a). "Business start-up costs" are defined as

any amount which is paid or incurred in connection with a trade or business with respect to which the taxpayer is a 50-percent owner, and on or before the date which is one year after the date on which the active conduct of such trade or business began (as determined under section 195(c)).

Id. Perhaps demonstrating the care (or lack thereof) taken in drafting this statute, the proposed section caption of 408(d)(5) uses the phrase "business start-up expenses," rather than the operative term of the statute, "business start-up costs." Inasmuch as the distribution is not taxable, the provision denies a deduction or an increase in basis in assets acquired, to the extent the expenditure is made with funds that otherwise would have been a taxable distribution. *See id.* This provision, with its dollar-for-dollar reduction in expenses or basis, penalizes the taxpayer in an amount greater than the foregone tax on the distribution if the reduced expenditures would have been eligible for a tax credit, rather than a deduction. *See, e.g.,* I.R.C. § 44 (1994) (credit for expenditures to provide access to disabled individuals). The 10% penalty is eliminated for these withdrawals by a conforming amendment to I.R.C. § 72(t). *See American Family Tax Relief Act, § 404(b)(2).*

application could instill some rigor, but the effect would be marginal if there were no underwriting review with a denial of the loan request as a possible consequence.

Some form of "certification" by private lenders or the Small Business Administration would produce a great deal of complexity and raise the issue of why the private sector and the Small Business Administration are not ultimately better funding sources. On the other hand, we already have noted proposals by banks for credit card loans secured by 401(k) accounts.¹¹¹ While the loan processing capabilities of the banks are thereby harnessed, the underwriting procedures may be largely perfunctory in light of the secured nature of these loans.¹¹² If private lenders could be induced to participate in making entrepreneurial plan-secured loans,¹¹³ measures could be adopted to ensure that the lending institution diligently scrutinizes the loan application. This could be done by prescribing minimum underwriting standards and procedures¹¹⁴ or by permitting only partial security for the loan with the lending institution assuming the risk of the loan balance.¹¹⁵ Inasmuch as a participant under current law can borrow as much as \$50,000 against his or her plan account with little restraint, small venture capital loans could be exempted from the stringent underwriting requirements.¹¹⁶

¹¹¹ See *supra* notes 61-65 and accompanying text.

¹¹² One of the authors borrowed against his 403(b) account. He had only to complete several forms, and the loan was made within a matter of weeks. It was never suggested that rejection was a possibility so long as the income tax rules for the loan were followed.

¹¹³ The details would need to be worked out, but the lending institution possibly could act as an agent of the plan administrator, processing the loan from the plan to the participant. The interest rate charged by the plan would be increased to provide a profit to the lending institution.

¹¹⁴ For example, the federal government guarantees 100% of the amount of real estate loans made to eligible veterans by private lenders. See 38 U.S.C. § 3710(a) (1994) (guaranteeing loans for the purchase or construction of homes). Restrictions are placed on the private lender to preclude reckless extensions of credit. See 38 C.F.R. § 36.4337 (1995) (prescribing underwriting standards and lender certifications for veteran's loans).

¹¹⁵ Under the Small Business Administration ("SBA") loan guarantee program, for example, the SBA guarantees 90% of loans up to \$155,000, and 85% of loans in excess of \$155,000, up to \$750,000. See COMMERCE CLEARING HOUSE, INC., BUSINESS STRATEGIES ¶¶ 759.2-759.39 (summarizing SBA loan programs).

¹¹⁶ For example, the SBA offers special programs for loans under \$50,000 ("Small Loan Program") and for loans of less than \$100,000 ("FASTRAK" and

In contrast, the American Family Tax Relief Act¹¹⁷ proposal is very indulgent of new business starts. It does not require disposal of the vacation home, the boat, the recreational vehicle, non-retirement stock market speculations, and so forth. There is no need to miss a vacation. Instead, the taxpayer is permitted to deplete his or her retirement assets with impunity¹¹⁸. One could speculate that without the discomfort imposed by a last-resort rule, there is less planning and thought in connection with the viability of the proposed venture — an easy money, credit card mentality extended to retirement assets.

3. *Simplicity is a Virtue*

The plight of displaced employees who could become successful entrepreneurs (but for adequate capital) is a small problem in relative terms. One potentially risks the welfare of the retirement system as a whole in trying to accommodate their unique situation. Accordingly, any changes should be as simple as possible, with the least amount of disruption to the overall retirement savings scheme. The authors acknowledge, however, that any proposal for meaningful change, no matter how simple, comes at the price of additional administrative costs and burdens.

Due to the absence of meaningful limits, the American Family Tax Relief Act¹¹⁹ approach probably wins on simplicity terms if compared with a loan underwriting approach. However, the proposed legislation would still have created plenty of uncertainty for planners.

The pivotal definition is “business start-up costs of the taxpayer.”¹²⁰ “Of the taxpayer” works well for a sole proprietorship or perhaps for a pass-through entity such as a partnership or limited liability company. But, if the business is conducted by a corporation, a separate taxable entity, what are the costs “of the taxpayer” individually (inasmuch as it

“LowDoc” programs), which require simplified application forms and more flexible private underwriting. *See id.* at ¶¶ 759.34-.35.

¹¹⁷ *See supra* note 110 and accompanying text.

¹¹⁸ Admittedly, some personal assets, like the family home, are quasi-retirement assets. Others, like the vacation home, boat, and recreational vehicle, are primarily consumption. Retirement plan assets are arguably special. They enjoy some exemptions from regular creditor and bankruptcy remedies. *See supra* notes 72-73 and accompanying text.

¹¹⁹ *See supra* note 110 and accompanying text.

¹²⁰ American Family Tax Relief Act, *supra* note 110, § 404(a) (amending I.R.C. § 408(d)).

is basic corporate tax law that shareholders usually cannot claim expenses that are those of the corporation)?¹²¹ The American Family Tax Relief Act further states that "business start-up costs" means

any amount which is paid or incurred in connection with a trade or business with respect to which the taxpayer is a 50-percent owner, and on or before the date which is one year after the date on which the active conduct of such trade or business began (as determined under section 195(c)).¹²²

Perhaps the "in connection with" language saves the corporation case, particularly since the bill later expressly elaborates on the fifty percent owner test in the context of a corporation.¹²³ The balance of the language, however, is troubling.

"Business start-up costs" are not eligible if incurred more than one year after active conduct of the business begins.¹²⁴ Apparently the intent is to provide the first-year start-up capital, but no more. If that is the intent, is the rule a good one? While the first year may be the roughest, there could be other rough years ahead in which additional capital is needed.¹²⁵ Perhaps this is the provision's manner of creating some limits on dissipation of funds in losing ventures, but the one-year cut-off appears to be quite arbitrary and unrelated to the capital requirements of the business.

The one-year cut-off, if enacted, is also a tax litigation breeder. Faced with a one-year cut-off, most entrepreneurs would try to pack as many costs into the first year as possible — unnecessary machinery, inventory, pre-paid salaries, pre-paid rent, hidden cash hoards, all manner of front-loading, and so forth. That might not make business sense, and would circumvent the apparent intent of the statute, but it would be a predictable

¹²¹ See generally BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 5.04[1] (6th ed. 1994) (discussing a shareholder's ability to deduct payments of corporate expenses).

¹²² American Family Tax Relief Act, *supra* note 110, § 404(a) (amending I.R.C. § 408(d)).

¹²³ See *id.* A 50% ownership threshold is apparently utilized to promote closely held enterprises, as opposed to more passive portfolio investments. With a lesser percentage ownership stake one loses a share of the potential rewards, but one also reduces one's risk. Would 25% or some other percentage less than 50% work better?

¹²⁴ See *id.*

¹²⁵ See *supra* note 101 (discussing statistics on the rate of business failures).

taxpayer strategy With a corporation as the business, what is "any amount which is paid or incurred in connection with a trade or business"? Can the individual taxpayer claim that amounts invested in stock or debt of the corporation within the one-year period qualify, irrespective of whether the corporation has spent all of the proceeds?

Finally, the "business start-up costs" are paid or incurred in connection with "a trade or business." It seems that a given taxpayer can return to the retirement plan for funds an unlimited number of times, provided each request is for a different trade or business. First, this is unacceptable because the retirement plan is subject to dissipation by repeated failures of separate businesses formed by a single determined, yet unlucky or inept, entrepreneur. Second, toward the close of the one-year cost period, there will be great pressure placed on interpretations of whether one has a single business (for which time is running out), or whether that second location, new machine, and so forth is the start of a new, different business.¹²⁶

4. *Limits Do Serve a Purpose*

Although one could adopt a "sink or swim" approach, in our view the better course is to recognize that the public has some stake in avoiding the addition to the welfare rolls of the misguided or unlucky entrepreneur. There should be a limit on the amount that a retirement plan participant can withdraw, assuring that something will remain there for retirement. Of course, determining that amount is problematic.

The American Family Tax Relief Act,¹²⁷ in contrast, provides no limits on the amounts that can be withdrawn, except for the one-year business start-up costs requirement discussed in the immediately preceding paragraphs. Some might dismiss the importance of this lack of limits, pointing to the fact that the provisions exempting distributions from income tax are amendments to Code section 408 (dealing with the taxation of IRAs) and the provisions exempting distributions from the ten percent penalty tax are also couched in terms of "an individual retirement plan."¹²⁸ Hence, one could argue that a taxpayer should be able to

¹²⁶ The question of when one business ends and another begins plagued the corporate tax law with the liquidation/reincorporation problem and I.R.C. § 355 divisive reorganizations. See generally BITTKER & EUSTICE, *supra* note 121, at ¶ 10.08 (discussing reincorporation following liquidation), ¶ 11.04 (discussing divisions of an integrated business for purposes of I.R.C. § 355).

¹²⁷ See *supra* note 110.

¹²⁸ See American Family Tax Relief Act, *supra* note 110, § 404(a) (amending

freely access his or her own IRA funds for any purpose (as opposed to an employer-funded plan), and that the potential loss of regular IRA accounts, with \$2000 annual contributions, does not pose as great a threat to one's retirement as does tapping an employer-funded plan. We disagree. First, no more than fifty percent of Americans are covered by an employer-funded plan.¹²⁹ The IRA may be an individual's principal retirement asset. Second, those IRA funds were subsidized by an income tax deduction.¹³⁰ The government has a paternalistic stake, purchased at taxpayer expense, in preserving those assets for retirement purposes. Finally, we may not be dealing only with modest amounts of IRA funds. Although the companion "IRA Plus" proposal does speak to rollovers of funds from non-IRA Plus sources,¹³¹ the business start-up cost provisions apparently do not. It seems that a participant could receive a lump-sum distribution from an employer-funded retirement plan, roll it over into an IRA,¹³² and then access that IRA, without limitation, under the proposed provisions.

E. A Modest Proposal

Based on the foregoing guidelines, we propose that the potential capital needs of the displaced worker with entrepreneurial ambitions could be addressed by some simple changes to the access rules for retirement funds. First, we would focus our efforts on the loan provisions, not on the distributions side. We do this principally for the reasons advanced above — added rigor, simplicity, and income tax advantages. Second, we would adopt a different limitation for entrepreneurial loans, eliminating the \$50,000 cap¹³³ and the limitation of one-half of the

I.R.C. § 408(d)) and § 404(b) (amending I.R.C. § 72(t)(2)).

¹²⁹ See *supra* note 90 and accompanying text.

¹³⁰ See I.R.C. § 219 (1994) (allowing deductions for qualified retirement contributions).

¹³¹ See American Family Tax Relief Act, *supra* note 110, § 403(a) (inserting after I.R.C. § 408 a new section relating to IRA Plus Accounts).

¹³² See I.R.C. § 402(c) (discussing rules applicable to rollovers from exempt trusts).

¹³³ The streamlined \$50,000 loan procedure under current law would be retained for simplicity reasons (see *supra* notes 29-34 and accompanying text) and to preserve incentives for elective employee contributions (see *supra* note 98). However, the amount of additional loans qualifying under the entrepreneurial capital provisions would be reduced by loans outstanding under the simplified \$50,000 loan provisions.

participant's nonforfeitable accrued benefit. We would substitute a loan limit that would retain enough funds in the plan to maintain a certain income level (taking into account all other plans with that employer plus IRAs¹³⁴) starting at the time the employee would be eligible for Social Security retirement benefits, and including those Social Security benefits.¹³⁵ We reject alternatives such as liberal access to employee contributions, as compared with employer contributions.¹³⁶ Third, along the lines of the 401(k) hardship rules, the participant would need to demonstrate exhaustion of other sources of funds. As discussed above, private lenders could perform the underwriting, the loan could be denied if it failed to meet underwriting standards, and retirement plan assets could not secure 100% of the loan.¹³⁷ Finally, the five-year loan amortization rule should be amended to reflect a business development phase, perhaps requiring no payments for two years, followed by interest payments plus level amortization of principal over the next five years.¹³⁸

¹³⁴ The inclusion of IRAs is necessary because that is a significant asset for many workers and can also represent large plan distributions rolled over from other employer plans.

¹³⁵ While the outside limit for the loan would be tied to retirement asset levels and Social Security benefits, we would consider limiting the use of the funds to the entrepreneurial enterprise, rather than for personal consumption. The "business start-up costs" approach (*see supra* notes 120-26 and accompanying text) with some modifications (such as eliminating the one-year period) could be employed (with taxable income recapture at some point if the funds were not so expended within a certain time frame). The taxpayer would be allowed to return funds to the retirement plan in all cases, without penalty or tax, if he or she found that any portion of the funds was not needed for the venture.

¹³⁶ Such an approach would make little sense, except in terms of providing a liquidity incentive (*see supra* note 98) for voluntary employee contributions. Even if it is the employee's money in some sense, permitting "easy" withdrawals arguably frustrates public policy in protecting a retirement nest egg. The distribution would not be tied to any guiding principles, but rather to whether the particular participant had made significant voluntary contributions. The resulting permissible distribution would probably be either too small or too large for the new business needs, because its calculation would be based on history and not tied to current needs.

¹³⁷ *See supra* notes 111-16 and accompanying text.

¹³⁸ This is simple, but could be too inflexible for all circumstances. A more facts-and-circumstances approach could be adopted at the risk, however, of additional complexity.

We readily acknowledge that the requirement of a base retirement asset level, plus the exhaustion of other funds, may create a "Catch-22" for many Wealthier participants with other assets and investments would be ineligible for a loan under the exhaustion test. In contrast, while the asset exhaustion rule would not present an obstacle to less wealthy participants, the lack of other assets could reflect fewer years of employment at a substantial salary, which in turn would cause the base retirement asset level to not be met. In this regard, our proposal is admittedly conservative — though hopefully not irrelevant.

The modifications outlined above promise to provide entrepreneurial access to retirement savings while still protecting a minimum level of retirement savings. When possible, the proposal seeks simplicity and incremental, rather than wholesale, changes. Obviously there are many details that need to be worked out, particularly the private underwriting functions and the retirement income level that is to be protected. Indeed, in the economics of public policy design there needs to be some analysis of the tradeoffs involved. On the one side, successful entrepreneurial activities would increase tax revenues and decrease reliance on social welfare programs. On the other side, some failures will undoubtedly occur.

CONCLUSION

As American workers continue to grapple with the changes occurring in the workplace, there will be increasing interest in accessing retirement savings funds. In this essay we have considered the current system and its potential impact on access to funds for entrepreneurial endeavors. Although the Taxpayer Relief Act of 1997 was enacted without the troublesome American Family Tax Relief Act business start-up costs provision, the 1997 tax bill demonstrates a further erosion of the protected status of retirement funds. We propose a modest change to the system — one that will accommodate some added entrepreneurial activity without jeopardizing a minimum level of retirement security

