MINNESOTA STATE INCOME TAXATION OF INDIVIDUAL RETIREMENT ACCOUNTS

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TABLE OF CONTENTS

EXECUTIVE SUMMARY

PART ONE:

BACKGROUND INFORMATION ON IRAs

I-A. Federal Tax Treatment (pp. 2 to 3)

Individual retirement accounts (IRAs) were authorized by Congress in 1974 to permit employees not covered by pensions an opportunity for tax deferred retirement savings. Amounts contributed to IRAs are deducted in computing adjusted gross income and the income earned by the account is exempt from tax. Tax is paid when the taxpayer receives distributions from the account.

In 1981 Congress significantly expanded the IRA law. The contribution limits were increased and taxpayers were permitted to contribute to an IRA even if they were covered by a pension plan.

I-B. State Tax Treatment (pp. 3 to 5)

Minnesota law originally conformed in full with the federal IRA law. In 1982 the Legislature did not adopt the new federal contribution rules. Legislation was passed, however, exempting income earned by all IRAs from taxation until distributed. As a result, Minnesota law differs from the federal income taxation of IRA contributions in two major ways: (1) employees who are covered by other pension plans are not permitted to make deductible contributions and (2) employees who are not covered by pension plans are limited to the old, lower contribution limits--the lesser of $1,500 or 15 percent of compensation (state rule) as compared with the lesser of $2,000 or 100 percent of compensation (federal rule).

II. Cost of Federal Conformity (pp. 5 to 6)

According to Revenue Department estimates, adopting the federal contribution rules would reduce income tax revenues in calendar year 1985 by $74 million. Almost a 3 percent increase in the income tax rates would be required to recover this revenue. In the long run, however, the exemption of the income earned by IRAs (which has already been adopted by the Legislature) will result in more lost income tax base than conforming to the federal contribution rules.

III. Principal Users/ Beneficiaries (pp. 7 to 15)

Nationally, the adoption of universal IRAs caused a dramatic, 256 percent increase in the number of taxpayers making IRA contributions for 1982 compared with 1981. However, the rate of increase in the use of IRAs by taxpayers who were not participants in pension plans actually slowed down.

Taxpayers with higher incomes constitute a disproportionately large share of total IRA contributors. Despite these higher rates of participation, the $2,000 maximum restricts the proportionate tax benefit of IRAs to higher income taxpayers.

Based on patterns of prior use of IRAs, the principal beneficiaries of state conformance with the federal contribution rules would be middle and higher income taxpayers who are already covered by pension plans.

PART TWO:

PUBLIC POLICY CONSIDERATIONS AND STATE TAXATION OF IRAs

I. IRAs as Savings Incentives (pp. 16 to 24)

The principal purpose articulated by congress for the establishment and expansion of the IRA law was to increase the amount of private retirement savings made by individuals. In order for such a savings incentive to be effective, two conditions must occur:

(1) Taxpayers must respond to a higher rate of return on savings by increasing their savings.

(2) The incentive must be structured so that participants receive a higher rate of return on marginal or additional savings.

Several factors suggest that the IRA law is flawed as a savings incentive:

(1) Taxpayers can receive the benefits of the law even though they do not increase their savings. For example, a taxpayer may simply shift some of his assets into an IRA or borrow money to contribute to an IRA and still receive the full tax benefit.

IRAs as Savings Incentives (Continued)	(2) Taxpayers who are already saving or who would save (without the IRA benefit) at or above the maximum IRA contribution of $2,000 will receive no increase in the return on any additional savings. (3) The IRA law provides additional income (i.e., tax reductions) to those taxpayers who have assets to shift into IRAs, can borrow funds to contribute to IRA, or who already are saving at the maximum contribution. There is no assurance that this additional income will be used for savings rather than consumption. Because of these limitations with the design of the IRA law as a savings incentive and because of the relatively small increase in rate of return provided by state conformity, state conformance with federal law probably cannot be justified on the grounds it will increase individual retirement savings.
II. Simplicity and Compliance (pp. 25 to 29)	The state's present method of taxing IRA contributions results in a great deal of additional complexity for taxpayers and the Revenue Department. In addition to complying with different contribution limits, taxpayers must determine whether or not they are participants in a pension plan under ambiguous and now obsolete federal law. Even greater degrees of complexity result from the special rules, enacted by the legislature in 1984, for participants in tax credit employee stock ownership plans. Further complexity problems will be caused by the state law governing the taxation of IRA distributions. State law permits taxpayers to subtract from IRA distributions the amount of previously taxed contributions. Because of the long term nature of many IRA accounts, compliance with this law will place extreme burdens on taxpayer and Revenue Department record keeping.

Simplicity and Compliance (Continued)	For tax year 1982 the rate of compliance with the state tax on IRA contributions was relatively low. The Revenue Department estimates that over 26,000 taxpayers did not comply with the law and that this resulted in a total tax deficiency of more than $6 million. The Department has found it necessary to undertake a substantial auditing effort in order to increase compliance with the law.
III. Equity (pp. 29 to 32)	Taxes are generally evaluated according to two principles of equity: horizontal and vertical equity. Horizontal equity demands that equals be treated equally--for example, persons with equal income should pay the same tax. Vertical equity governs the taxation of persons that are not equal--for example, persons with different amounts of income. As to vertical equity, because IRA contributions are made disproportionately by middle and higher income persons, expanding IRA availability (by, for example, conforming to federal law) would shift the relative tax burden toward lower income persons. However, the present distribution of the tax burden across different income classes could be maintained by restructuring the tax rates at the same time. Expanding IRA availability would reduce the horizontal equity of the tax if the appropriate tax base is considered to be income. (Two taxpayers with equivalent incomes may be taxed differently depending upon whether they make IRA contributions.) On the other hand, if consumption is the appropriate base for taxation, expanding IRA availability will enhance the horizontal equity of the tax. Conforming with the federal IRA rules may be justified on a less rigorous equal treatment theory. State law already permits a variety of other forms of deferred taxation

Equity (Continued)

of retirement savings. These include qualified plans, government pension plans, and tax sheltered annuities, as well as voluntary retirement savings plans such as governmental and private deferred compensation (401(k)) plans. IRAs simply make deferred taxation of retirement savings more widely available to all wage earners.

Finally, IRA conformity may be justified on a theory of interstate uniformity. Most states (35 out of 41 with general income taxes) conform with federal law in the taxation of IRAs. If a person makes contributions while subject to tax in Minnesota and receives distributions while a resident of another state, he may be subject to tax on the same income twice--both as a contribution in Minnesota and a distribution in the other state.

PART THREE:

LEGISLATIVE ALTERNATIVES

(pp. 33 to 37)

There are four basic legislative alternatives for taxation of IRAs:

(1) retention of the present system of taxation;

(2) full federal conformity;

(3) partial conformity with federal law; and

(4) full current taxation of IRA contributions and investment income.

The primary advantage of the present system is that taxpayers and administrators are familiar with the system and have generally adjusted to it. The principal disadvantage is the substantial complexity and resulting poor compliance. This problem of complexity will increase as more IRA distributions are made.

Legislative Alternatives (Continued)

The primary advantage of full federal conformity is its simplicity and consistency with the tax systems of most other states. The primary disadvantage is the very high cost; it will result in a significant erosion of the tax base requiring higher tax rates to raise the same amount of revenue. This approach will shift the relative tax burden toward lower income taxpayers. This effect could be offset by restructuring the rates.

A third alternative would partially conform to federal law by adopting the higher contribution limits, but would not permit employees covered by other pension plans to make deductible contributions. The principal advantages of this approach are that it is simpler than the current system, has a relatively low cost, and will direct tax benefits to the group of taxpayers that has the fewest opportunities for tax deferred retirement savings. Its principal disadvantage is that it is not much simpler than the present method of taxing IRAs.

A final alternative is full taxation of all IRA contributions and income. The primary advantage of this approach is that it would expand the tax base, permitting reductions in the tax rates, and is likely to be fairer than the current system or federal conformity (if one accepts the premise that comprehensive income is the appropriate tax base). The primary disadvantages are the complexity involved with taxing the investment income of IRAs and the inconsistency with the method of taxation used by nearly all other states.

MINNESOTA STATE INCOME TAXATION OF INDIVIDUAL RETIREMENT ACCOUNTS

INTRODUCTION

Since the adoption of "universal IRAs" by Congress in 1981, use of individual retirement accounts (IRAs) has grown dramatically. IRAs have been touted as the middle class tax shelter. Financial planners have widely, if not universally, recommended their use.

Primarily because of budgetary constraints, the Minnesota Legislature has not fully adopted the liberalized federal rules for IRA contributions (or the associated rules for simplified employee pensions and "HR 10" or Keogh plan contributions). However, widespread bipartisan legislative support has been expressed for state income tax conformity with the new contribution rules. During the 1983-84 session, eight separate House Files with 31 different authors were introduced providing for adoption of the federal contribution rules. The Tax Section of the Bar Association has urged conformity and newspaper accounts have reported that the Governor intends to include IRA conformity in his biennial budget recommendations for 1986-87.

This paper examines some of the public policy issues connected with (1) the state's current method of taxing individual retirement accounts and (2) adoption of the new federal IRA rules. In addition, some alternatives to Minnesota's current treatment of IRAs and full conformity are outlined.

The paper is divided into three major parts:

(1) A basic introduction to individual retirement accounts--a brief summary of how they work under federal and state law, the cost of state conformity with the federal rules and a compendium of descriptive statistics on who uses IRAs and who the primary beneficiaries would be if the state conformed with federal law;

(2) A discussion of some of the public policy issues relating to the state's method of taxing IRAs and conformity with federal law--IRAs as retirement savings incentives and an evaluation of the state's present method of taxing IRAs in light of the policy goals of simplicity and equity; and finally

(3) A discussion of alternatives for state taxation of IRAs.

PART ONE:

AN INTRODUCTION TO INDIVIDUAL RETIREMENT ACCOUNTS--A SUMMARY OF FEDERAL AND STATE LAW; THE STATE COST OF IRA CONFORMITY; THE PRIMARY USERS/BENEFICIARIES OF IRA TAX INCENTIVES

I. SUMMARY OF STATE AND FEDERAL TAX PROVISIONS

A. Federal Income Tax Treatment

Individual retirement accounts were originally authorized in 1974 as part of ERISA (the Employee Retirement Income Security Act), the federal law regulating private pension plans. IRAs were intended to equalize the treatment of employees who wished to save for their retirement but who were not covered by a pension plan.[1] The deferred tax treatment of IRAs was patterned after that accorded to qualified pension plans. This tax incentive consists of two elements: (1) Contributions made to an individual retirement account are deductible from gross income and are not taxed until withdrawn. (Similarly, contributions made by an employer to a qualified pension plan on behalf of an employee are not considered income of the employee, until he receives actual distributions from the plan. Under any standard definition of economic income, these contributions would be income of the employee at least to the extent he had a vested legal right in the pension.) (2) The investment income attributable to the account is not taxed until it is withdrawn. (Similarly, the income earned by qualifying pension trusts is exempt.)

Specifically, employees who were not covered by a qualified pension plan, government pension plan, or tax sheltered annuity plan were permitted under the 1974 legislation to contribute to an IRA and deduct from gross income the lesser of (1) $1,500 ($1,750 if the account is a spousal IRA

[1] H. R. Rep. No. 807, 93rd Cong., 2d Sess. ---, reprinted in [1974] U.S.C.C.A.N. 4670, at 4791; S. Rep. No. 383, 93rd Cong., 1st Sess. ---, reprinted in [1974] U.S.C.C.A.N. 4890, at 5013-14. In a separate printed statement Congressman Ullman, the ranking majority member of the Ways and Means Committee and one of the managers of the bill, stated: "The conference bill goes far to remove a longstanding inequity by granting individuals who are not covered by any kind of qualified pension plan a limited tax deduction for their retirement savings." Statement of Hon. Al Ullman, 120 Cong. Rec. H8702 (1974), reprinted in [1974] U.S.C.C.A.N. 5171.

covering a non-wage earning spouse) or (2) 15 percent of their "compensation" (earned income).[2] These limits were, however, significantly lower than those permitted for qualified pension plans.[3]

In the Economic Recovery Tax Act of 1981, Congress substantially expanded the individual retirement account rules. Three primary changes were made: (1) The maximum contribution was raised from $1,500 to $2,000 ($2,250 for a spousal IRA). (2) The percentage restriction was increased from 15 to 100 percent of compensation. (3) Participants in pension plans were permitted to establish IRAs. The amendments were effective for tax year 1982.

The 1981 legislation effected a substantial transformation in the policy underlying and purpose for individual retirement accounts. Whereas the 1974 legislation was based on the notion of equalizing the tax treatment of employees whose employers did not provide pension plans, the 1981 legislation was intended simply to increase the level of savings for retirement generally. The Senate Finance Committee Report (the IRA amendments originated in the Senate) in stating the reason for the 1981 IRA amendments indicated that individual savings are an important means of providing for retirement income and "that the present level of individual savings is too inadequate [sic] for this purpose."[4] The committee further found that the rules for individual retirement savings were too restrictive because they did not "sufficiently promote personal savings by employees who participate in employer-sponsored [pension] plans."[5]

B. <u>State Tax Treatment</u>

In 1975 the Minnesota Legislature provided for conforming state tax treatment of individual retirement accounts.[6] Because the Minnesota income tax base is defined by reference to federal adjusted gross income (FAGI) and because IRA contributions are deducted in computing FAGI,

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[2] Earned income generally includes wages, salaries, and self-employment income. It does not include interest, dividends, royalties, rents, and so forth. See, e.g., I.R.C. §401(c)(2). Under amendments adopted by Congress in 1981, I.R.A. contributions can also be made as a percentage of alimony (up to $1,125, $2,000 beginning in 1985 after the 1984 amendments) under certain circumstances. I.R.C. §§219(b)(4) and (f)(1).

[3] For example, the limit imposed on contributions to defined contribution qualified plans was the lesser of 25 percent of compensation or $25,000 (indexed for inflation). I.R.C. §415(c)(1) (1976).

[4] S. Rep. No. 144, 97th Cong., 1st Sess. 112, reprinted in [1981] U.S.C.C.A.N. 108, at 214.

[5] <u>Id</u>.

[6] 1975 Minn. Laws, ch. 349 §4.

adoption of the new federal rules defining adjusted gross income provided for state recognition of IRAs.

In 1982 the Legislature explicitly rejected the congressional expansion of the deduction of IRA contributions.[7] In adopting the new federal law defining adjusted gross income, the Legislature provided that taxpayers must add to their FAGI the amount of the IRA contributions that would not qualify under prior federal law. However, because no similar provision was made for the investment income earned on funds in IRAs, this income was exempted from taxation until distributed to the taxpayer. In 1983, the Legislature further provided that distributions from IRAs are not taxable to the extent they represent recovery of contributions that were subject to state taxation.[8]

Thus, the Minnesota taxation of IRAs may be summarized as follows for taxpayers who otherwise qualify to contribute to an IRA under the federal rules:

(1) For taxpayers who are covered by a qualified pension plan, government pension, or tax sheltered annuity plan--

(a) All contributions must be added to FAGI, and are subject to taxation;

(b) Income earned by the assets of an IRA is exempt until distributed; and

(c) Distributions from an IRA are deductible from FAGI until the full amount of contributions added back under (a) have been recovered.

(2) For taxpayers who are <u>not</u> covered by a qualified pension plan, government pension, or tax sheltered annuity plan--

(a) Contributions must be added to FAGI and are subject to tax to the extent they exceed the lesser of (i) $1,500 ($1,750 for a spousal IRA) or (ii) 15 percent of compensation;

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[7] 1982 Minn. Laws, ch. 523, art. XL §1, codified at Minn. Stat. §290.01(20a)(19) (1983 Supp.). One limited exception to this was enacted in 1984 for some participants in tax credit employee stock ownership programs (ESOPs). These employees are not considered to be covered by a qualified pension plan solely as a result of the ESOP. 1984 Minn. Laws, ch. 502, art. 2 §3. This provision is described more fully below in Part Two, section II, part A.

[8] 1983 Minn. Laws, ch. 342, art. 1 §4, codified at Minn. Stat. §290.01(20b)(19) (1983 Supp.). For purposes of computing Minnesota gross income these contributions are recovered first out of any distributions from the IRA.

(b) All income earned by the assets of an IRA is exempt until distributed; and

(c) Distributions from an IRA are deductible from FAGI until the full amount of contributions added back under (a) have been recovered.

II. STATE COST OF IRA CONFORMITY

The Research Office of the Department of Revenue has estimated that complete conformity with the federal individual retirement rules would reduce income tax revenues by approximately $74.3 million for calendar year 1985, if no compensating changes were made.[9] This estimate includes the cost of conforming treatment of simplified employee pension plans and Keogh plans, a $1.7 million cost.[10] To put this cost into perspective, a three percent increase in the income tax rates would be required to hold income tax revenues approximately constant.[11] Alternatively, full conformity could be funded by reducing the personal credit by about $20.

Three aspects of these estimates should be recognized. First, the estimates of IRA costs beginning in 1981 have significantly underestimated the participation rates. As a result, the actual costs have consistently exceeded estimates.[12] However, after two years of experience with universal IRAs it seems likely that projections of future participation patterns will be more reliable.

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[9] Research Office, Minn. Dep't. of Revenue, Individual Income Tax Minnesota Modifications, Deduction, Credits--Federal Conformity Issues, 2 (Aug. 15, 1984) (mimeo).

[10] Research Office, Minn. Dep't. of Revenue, Revenue Analysis Summary--Income Tax IRA Contributions (Ap. 13, 1983) (mimeo). This estimate may now be low given the increased estimates of IRA costs generally in the August, 1984 analysis. See Note 12.

[11] In order to maintain roughly the present income distribution of the income tax burdens, the rate increase would have to be imposed disproportionately on the middle and upper income individuals. See section III below which indicates IRA deductions are taken predominantly by middle and upper income individuals. Funding IRAs by reducing the personal credit would, by contrast, redistribute the tax burden toward lower income individuals.

[12] For example, the fiscal year 1985 cost of IRA conformity was estimated to be $20.8 million in 1981 and was reestimated at $46.2 in 1983. Research Office, Minn. Dep't. of Revenue, Analysis of 1981 Federal Update Bill, 5 (Oct. 12, 1981) (mimeo); Research Office, Minn. Dep't. of Revenue, Analysis of S.F. 27 (Revised), 1 (Ap. 28, 1983) (mimeo). These estimates should be contrasted with the current estimate of $74.3 million for calendar year 1985, a six month later time period. Since these estimates were based on the federal government's estimates, they simply represent an inability of the Treasury Department and Joint Tax Committee staff to anticipate the dramatic expansion of IRA participation in response to the 1981 changes in the law.

Secondly, the conformity cost estimates reflect only the deduction for contributions. As total IRA assets increase, the exemption of investment income earned by IRAs will constitute the more significant loss of tax base.[13] A simple example will illustrate the relative value of the deductibility of contributions versus the exemption of investment income. If a taxpayer annually contributes $2,000 to an IRA and earns interest income on the account at an 8 percent annual rate, compounded quarterly, the account will be worth approximately $102,000 at the end of 20 years. Of this total interest income constitutes slightly over 60 percent ($62,000). If the time period is extended or the interest rate assumption raised, the proportion of investment income to contributions will rise. For example, if the assumption is extended to 30 years, the total value of the account increases to over $256,000, over three-quarters of which is investment income.

Thirdly, demographics play an important role in these relative costs. Each year total IRA assets increase or decrease by the sum of additional contributions and income earned on the IRAs during the preceding year, less distributions. As a result, exempted investment income earned by IRAs will increase until annual IRA distributions equal the annual amount of contributions and income earned--a point likely to be long in the future, given the age profile of the population. The "baby boom" generation is a long way from retirement age and has not yet entered the stage of the life cycle where savings for retirement would be expected to increase. Given this situation, a conservative estimate would be that in the 1990s income tax rates will need to be 7 to 10 percent higher to finance full IRA conformity--deduction of contributions and exemption of investment income.

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[13] In 1983 the estimated cost of the exemption of interest earned on IRAs was roughly equivalent to the cost of full conformity for deductions for fiscal year 1985--$48.1 versus $46.2 million. Research Office, Minn. Dep't. of Revenue, Analysis of A Proposal to Disallow Deduction of All IRA Contributions and Their Interest, 1 (Ap. 28, 1983) (mimeo); Research Office, Minn. Dep't. of Revenue, Analysis of S.F. 27 (Revised), supra note 12. This estimate did not include the cost of exempting dividends and capital gains; however, it did include the gain from disallowing IRA deductions permitted under current law and the interest income earned by "old" IRA assets. Since the estimate of IRA contributions in earlier periods proved to be significantly low, this estimate of the cost of the exemption is likely also to be low. If the cost of full conformity is roughly $74 million in 1985, the investment income exemption seems likely to approach $85 million.

III. USE OF IRAS: WHO ARE THE PRIMARY USERS/BENEFICIARIES OF IRA TAX DEFERRAL?

A. Pre-1982 IRAs

The use of IRAs in the years 1975-81, when they were available only to individuals who were not covered by a pension plan, was modest. In 1975 roughly 2.5 percent of taxpayers who were eligible made contributions to IRAs. By 1981 this percentage had grown to approximately 7 percent of those eligible or 3.4 million taxpayers.[14] As demonstrated by Table 1, IRA contributions were made disproportionately by taxpayers with higher incomes. Over 71 percent of the taxpayers making IRA contributions had incomes over $25,000. Similarly, 60 percent of the total dollar amount of IRA contributions were made by taxpayers with adjusted gross incomes of $30,000 or more.

TABLE 1
Filers Making IRA Contributions
1981

Adjusted Gross Income Range	Number	Pct. of Total	Amount*	Pct. of Total
$0 UNDER $10,000	193,584	5.8%	$ 157,538	3.4%
$10,000 UNDER $20,000	580,053	17.5	681,752	14.7
$20,000 UNDER $50,000	1,966,513	59.4	2,801,538	60.4
$50,000 UNDER $100,000	552,026	16.7	906,303	19.5
$100,000 OR MORE	94,966	2.9	192,888	4.2

*Expressed in thousands.

Data: Department of the Treasury, Individual Income Tax Return Statistics of Income 45 (1981).

B. 1982-83 IRA Use

With the expansion of IRA eligibility to taxpayers covered by pension plans, the number of filers making contributions to IRAs grew dramatically, increasing from 3.4 million in 1981 to 12.1 million in 1982, a 256 percent increase.[15] Preliminary data indicate that usage increased to

[14] Employee Benefit Research Institute, Individual Retirement Accounts: Characteristics and Policy Implications 4 (July, 1984) [hereinafter cited as EBRI Report].

[15] Dep't. of Treasury, Individual Income Tax Returns Statistics of Income 45 (1981); Dep't. of Treasury, Statistics of Income Bulletin 18 (Winter 1983-84).

12.8 million in 1983, a 6.7 percent increase.[16] As a percentage of those eligible, participation increased from 7 percent in 1981 to approximately 15 percent in 1982.[17] (Data on participation by those eligible is not yet available for 1983.)

1. Distribution of IRA Contributions by Income

Table 2 and Figure A display 1982 IRA contributions by income level. Despite the burst of new taxpayers making IRA contributions, the income distribution of contributors remained roughly parallel to the pre-1982 experience. In other words, most IRA contributions still tended to be made by taxpayers at the higher income levels. Indeed, the income distribution of contributors shifted slightly toward the higher income levels. Roughly 60 percent of all IRA contributions were made by filers with adjusted gross incomes of $25,000 or more, while more than 70 percent of filers have AGIs under $25,000. Figure B compares the percentage of filers within each income group making IRA contributions to its percentage of all filers. For taxpayers with AGIs of $50,000 or more, approximately 56 percent made IRA contributions, while for taxpayers with incomes under $20,000, less than 4 percent made IRA contributions. However, of the total amount contributed to IRAs, about two-thirds was contributed by taxpayers with gross incomes of $25,000 or more. This is in rough proportion to their share (61 percent) of total adjusted gross income of all taxpayers.

Thus, middle and high income taxpayers comprise a disproportionate share of the total contributors to IRAs, while they contribute amounts roughly in proportion to their share of total adjusted gross income. This seeming incongruity may be explained by two factors. First, high and middle income taxpayers are more likely to contribute to IRAs because they are subject to higher tax rates and thus realize a larger tax benefit. They are also more likely to have sufficient assets or disposable income to fund contributions. However, a second factor, the $2,000 maximum, prevents high income taxpayers from contributing amounts in proportion to their incomes. As a result, although many more middle and high income individuals make IRA

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[16] Dep't. of Treasury, "Individual Income Tax Returns, 1983 Taxpayer Usage Survey," Statistics of Income Bulletin 53 (Summer, 1984).

[17] EBRI Report, supra note 14, at 4; Department of Treasury, Statistics of Income Bulletin 17-18 (Winter, 1983-84).

TABLE 2

IRA Contributions 1982

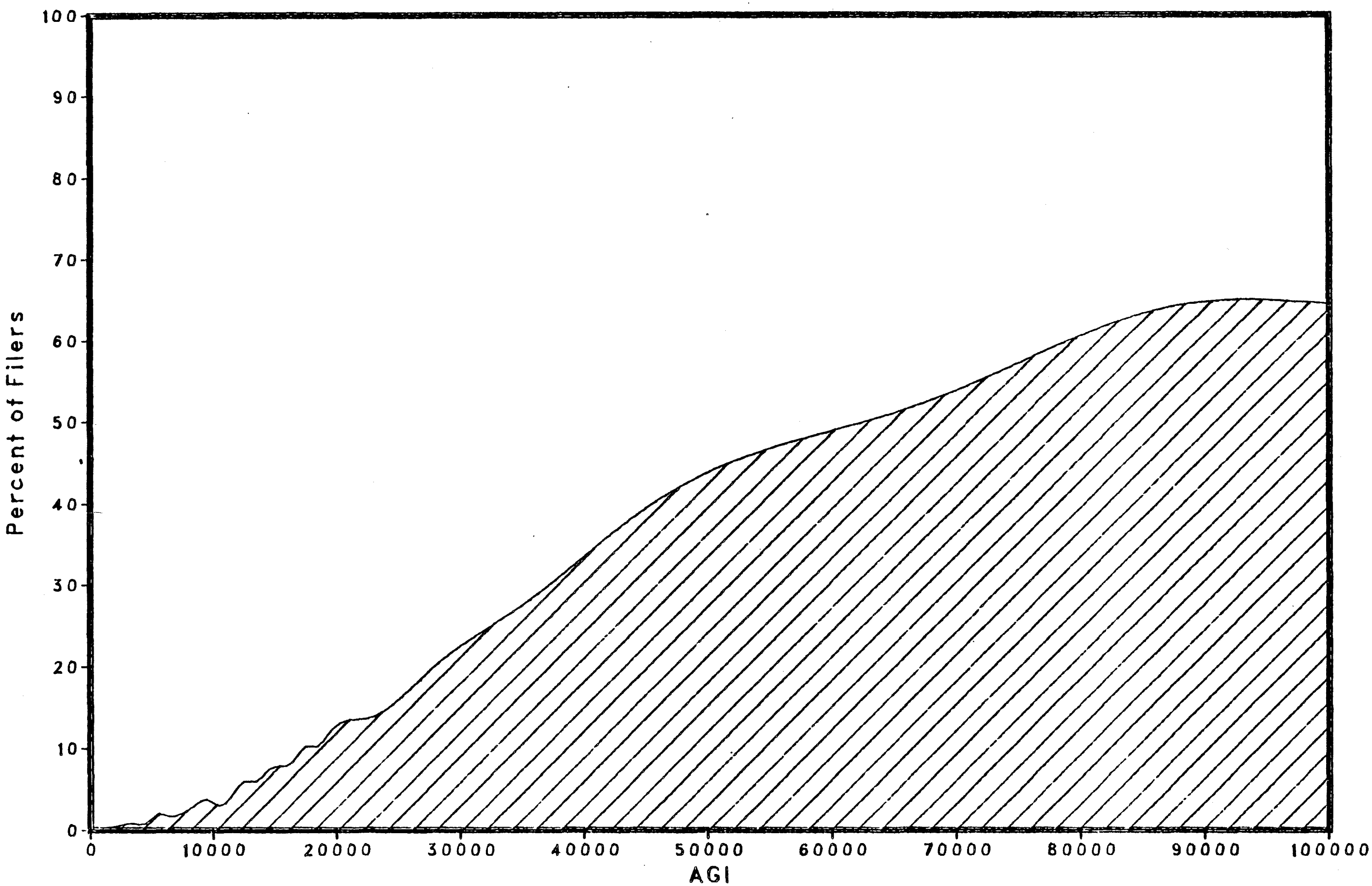
	ALL FILERS				FILERS MAKING IRA CONTRIBUTIONS				
AGI RANGE	NUMBER	PCT. TOTAL	AGI*	PCT. OF TOTAL	NUMBER	PCT. OF TOTAL	PCT. OF FILERS**	AMOUNT IRA DEDUC.*	PCT. OF TOTAL
0 OR UNDER	822,704	0.9%	$ 23,553,456	-1.3%	26,330	0.2%	3.2%	$ 57,631	0.2%
$1 UNDER $5,000	17,170,819	17.9	44,202,931	2.4	100,782	0.9	0.6	204,569	0.8
$5,000 UNDER $10,000	17,086,410	18.0	126,414,388	6.8	435,089	3.7	2.5	690,532	2.4
$10,000 UNDER $15,000	14,242,682	15.1	176,657,486	9.6	730,563	6.0	5.1	1,265,296	4.5
$15,000 UNDER $20,000	10,502,432	11.0	182,090,397	9.8	1,019,741	8.4	9.7	1,761,757	6.5
$20,000 UNDER $30,000	16,356,451	17.2	405,720,743	22.0	2,667,312	22.1	16.3	5,472,832	19.3
$30,000 UNDER $40,000	9,809,629	10.3	338,176,424	18.3	2,684,843	22.2	27.4	6,398,203	22.5
$40,000 UNDER $50,000	4,691,587	4.9	207,926,018	11.3	1,849,696	15.3	39.4	4,854,442	17.1
$50,000 UNDER $100,000	3,804,140	4.0	241,593,792	13.1	2,112,326	17.1	55.5	6,254,105	22.0
$100,000 OR MORE	747,648	0.8	148,562,392	8.0	471,324	3.9	63.0	1,366,671	4.8

*Expressed in thousands.

**Percentage of all filers within the AGI range with IRA contributions.

Data: Preliminary Income and Tax Statistics for 1982 Individual Income Tax Returns, Statistics of Income Bulletin 19-20 (Winter, 1983-84).

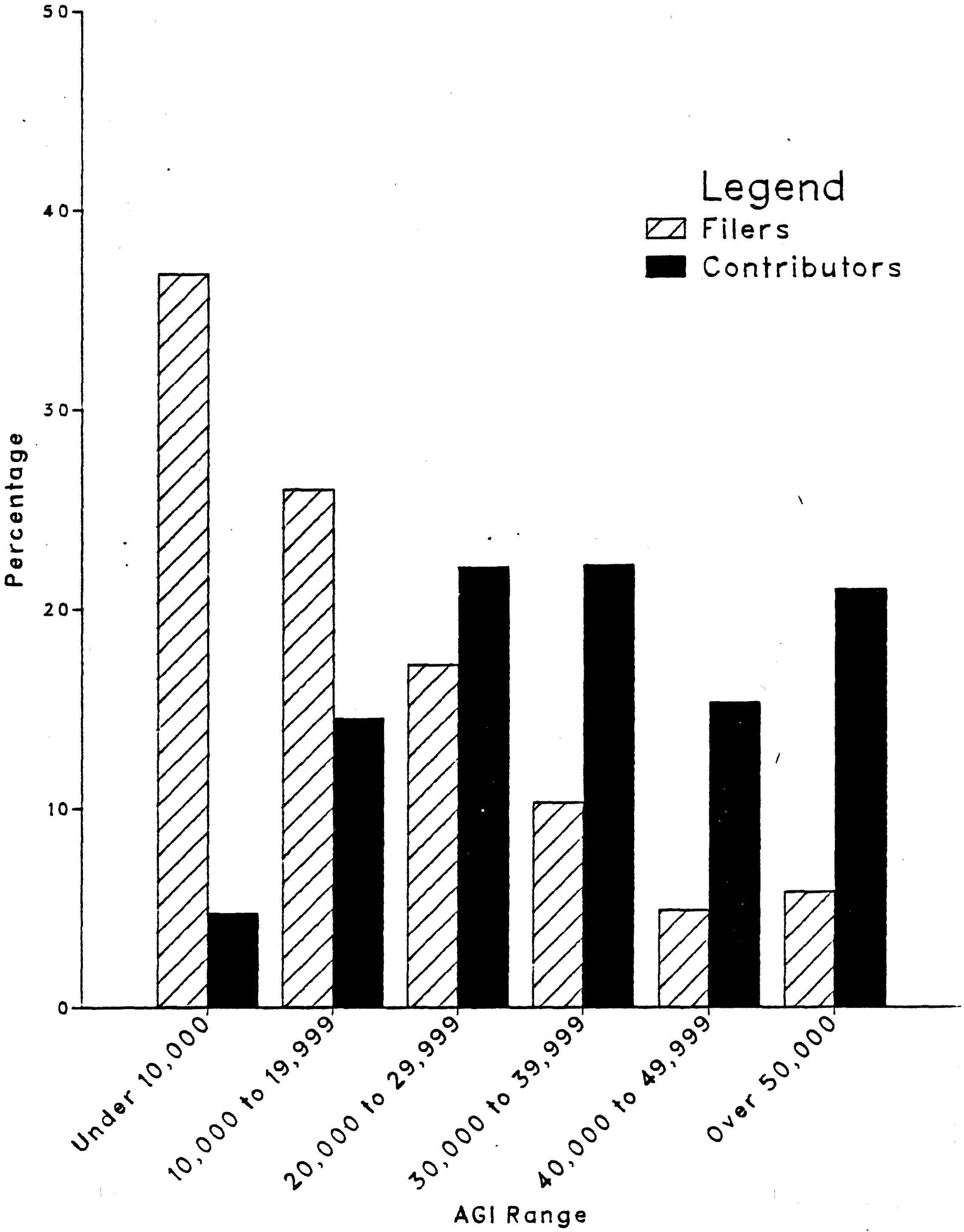
FIGURE A
Percentage of Filers Making IRA Contributions by Income Levels



Data: Dept. of Treasury, "Statistics of Income Bulletin" (Winter, 83-84)
Graphics: Minnesota House Of Representatives Research Department

FIGURE B

Distribution of Taxpayers Making IRA Contributions Relative to Distribution of All Filers



Data: Dept. of Treasury, "Statistics of Income Bulletin" (Winter 83-84)
Graphics: Minnesota House of Representatives Research Department

contributions, the $2,000 maximum prevents IRA contributions from having a powerful influence on the distribution of tax liability relative to adjusted gross income.[18]

Based on preliminary data, the income distribution of filers making IRA contributions in 1983 appears to have changed only slightly.[19] Lower income filers have increased their proportion of contributions somewhat. For example, the percentage of filers with adjusted gross incomes of less than $15,000 making IRA contributions increased from 2.6 to 3.1 percent in 1983, compared with 1982. Similarly, the percentage of IRA contributions made by taxpayers with adjusted gross incomes of less than $20,000 increased from 19.2 percent in 1982 to 21.2 percent in 1983. The data are displayed in Appendix A. Given the short history of the availability of universal IRAs, it is not clear whether this shift is simply a transient phenomenon.

2. IRA Usage by Employees Not Covered by Pension Plans

Supporters of the expansion of IRAs to taxpayers covered by pension plans argued that this would increase the use of IRAs by those not covered by pension plans because of the increased advertising and visibility of IRAs generally.[20] It is not clear whether the 1981 changes in the law have had this effect. Although the Internal Revenue Service does not provide comparable data for 1982, the results of a Census Bureau survey of the use of individual retirement accounts indicate that the percentage of persons not covered by pension plans who contributed to an IRA in 1982 increased significantly. According to I.R.S. data, approximately 7 percent of those eligible contributed to IRAs in 1981, while the survey results indicate a 12.1 percent usage rate by those not covered by pensions.[21] It is not clear, however, whether the I.R.S. and the survey data are comparable. The 1981 I.R.S. data indicate 48 million taxpayers were not covered by a pension plan and received compensation making them eligible to make IRA contributions. By contrast, the survey data indicate that only 31 million were not

[18] IRA contributions rise as a percentage of AGI for incomes of $75,000 or less. Above this point the $2,000 maximum takes effect and contributions decline as a percentage of AGI. Undoubtedly, the availability of the deduction for IRA contributions makes the distribution of income tax burdens less "progressive." It would be possible to quantify this effect by, for example, computing Suits Indexes for the tax system with and without the deduction. See Suits, Measurement of Tax Progressivity, 67 Amer. Econ. Rev. 747 (1977). As indicated in the text, because of the $2,000 maximum this effect is likely to be modest.

[19] Department of Treasury, Statistics of Income Bulletin 53 (Summer, 1984).

[20] EBRI Report, supra note 14, at 5.

[21] Id. at 4, 9-10.

covered by pension plans and were otherwise eligible to make contributions. Furthermore, the survey results indicated that 3.7 million IRA contributors were not covered by pension plans. This represents a 9.6 percent growth in the number of persons making IRA contributions over 1981. However, the similar rate of increase for 1981 over 1980 without an intervening change in the law was 33 percent (from 2.6 to 3.4 million).[22] Thus, the rate of increase in IRA use by uncovered employees actually slowed in 1982 compared with 1981.

The income distribution of filers not covered by pensions and making IRA contributions is displayed in Table 3 based on the Census Bureau survey as reported by the Employee Benefit Research Institute.[23] The distribution is somewhat less heavily weighted toward the higher income levels than for all IRA contributions generally.

TABLE 3
IRA Usage for Workers not Covered by Pensions by Earnings for 1982

	Employment		IRA Usage		
Earnings Levels	Number (000s)	Distribution (percent)	Number (000s)	Distribution (percent)	Within Earnings Levels (percent)
TOTAL	30,998	100.0	3,745	100.0	12.1
$1 TO 4,999	6,248	20.2	341	9.1	5.5
$5,000 TO 9,999	7,770	25.1	520	13.9	6.7
$10,000 TO 14,999	6,387	20.6	627	16.7	9.8
$15,000 TO 19,999	3,113	10.0	614	16.4	19.7
$20,000 TO 24,999	1,831	5.9	352	9.4	19.2
$25,000 TO 29,999	1,021	3.3	303	8.1	29.7
$30,000 TO 49,999	929	3.0	358	9.6	38.5
$50,000 AND OVER	215	0.7	102	2.7	47.4

3. IRA Contributions by Age

The 1983 Census Bureau survey, in addition, provided information on the age break-down of contributors to individual retirement accounts. Not surprisingly, middle-aged individuals (age 45 to 65) constitute the greatest proportion of the contributors to IRAs. This is consistent with the life-cycle theory of consumption/savings patterns. Under this hypothesis, young adults spend more heavily on

[22] Department of Treasury, Individual Income Tax Returns Statistics of Income 49 (1980); Department of Treasury, Individual Income Tax Returns Statistics of Income 45 (1981).

[23] EBRI Report, supra note 14, at 10.

consumption--acquiring and furnishing a home, raising children, and so forth--while middle-aged individuals allocate more of their income to savings in anticipation of retirement. The survey results are displayed in Table 4.

TABLE 4
IRA Usage by Age for 1982

	Employment		IRA Usage		
Age	Number (000s)	Distribution (percent)	Number (000s)	Distribution (percent)	Within Age Group (percent)
TOTAL	98,964	100.0	16,713	100.0	16.9
LESS THAN 25 YEARS	19,127	19.3	445	2.7	2.3
25 TO 34 YEARS	28,773	29.1	3,108	18.6	10.8
35 TO 44 YEARS	21,484	21.7	3,967	23.7	18.5
45 TO 54 YEARS	15,493	15.7	4,532	27.1	29.3
55 TO 64 YEARS	11,218	11.3	4,169	24.9	37.2
65 YEARS AND OVER	2,870	2.9	491	2.9	17.1

C. State Tax Treatment: Who Would Benefit by Conforming to the Federal Rules?

Two principal categories of taxpayers would benefit by the state adopting federal IRA contribution rules. The first and most significant of these consists of taxpayers who are covered by a qualified plan, government pension, or tax sheltered annuity plan. As outlined above, these taxpayers have a slightly higher distribution of income than all taxpayers.[24] One would also expect employers who provide pensions as a fringe benefit to be larger and more stable employers, on the average.

The second category consists of taxpayers who are permitted to make contributions under the old federal rules, but who make or wish to make contributions in excess of the $1,500 or 15 percent of compensation limits. As one would expect, the federal IRA contribution data indicate that the proportion of taxpayers contributing the maximum $2,000 or $4,000 (for married couples filing jointly with two earners) rises with income. For example, preliminary 1983 data indicate that for taxpayers with IRA contributions and incomes under $20,000, less than 53 percent made the

[24] See above section B.2.

maximum contribution, while for taxpayers with incomes over $30,000 and IRA contributions, more than 58 percent made the maximum contribution.[25] (As described above, many fewer taxpayers with incomes under $20,000 make IRA contributions in the first place.)

Table 5 displays the income distribution of state taxpayers who had additions to gross income for IRA contributions in 1982. Comparing the income distribution of IRA contributors contained in Table 2 and of taxpayers required to add back contributions to gross income for state tax purposes, it is apparent that the latter is weighted slightly more toward the upper income levels. This relationship is represented graphically in Figure C. This may be explained, on the one hand, by the fact that individuals who are not covered by pension plans tend to have somewhat lower incomes. Lower income individuals are less likely to make contributions at or near the maximum. On the other hand, it may be that compliance rates are higher for individuals with higher incomes--perhaps, more of their returns are prepared by professional tax preparers who are aware of the state add-back requirements. (The data on state additions do not include the approximately 27,000 taxpayers preliminarily determined by the department to have failed to comply with the law.)

[25] Dep't. of Treasury, "Individual Income Tax Returns, 1983 Taxpayer Usage Survey, "Statistics of Income Bulletin 53 (Summer, 1984).

TABLE 5

State Additions to Gross Income for IRA Contributions

	ALL FILERS*				FILERS WITH IRA CONTRIBUTION ADDITIONS+				
AGI CATEGORY	NUMBER	PCT. OF TOTAL	AGI**	PCT. OF TOTAL	NUMBER	PCT. OF TOTAL	PCT. OF FILERS	AMOUNT**	PCT. OF TOTAL
LOSS	31,989	1.9%	$ - 526,047	-1.6%	423	0.3%	1.3%	$ 775	0.3%
0 UNDER $5,000	345,720	20.3	1,619,842	4.8	1,692	1.1	0.5	2,909	1.0
$5,000 UNDER $10,000	277,802	16.3	2,437,276	7.2	3,828	2.1	1.4	5,127	1.8
$10,000 UNDER $15,000	229,446	13.5	3,084,925	9.1	7,761	5.1	3.4	9,478	3.3
$15,000 UNDER $20,000	185,121	10.9	3,382,899	10.0	11,940	7.8	6.4	14,634	5.1
$20,000 UNDER $30,000	285,656	16.8	7,212,071	21.3	28,713	18.7	10.1	46,888	16.2
$30,000 UNDER $40,000	181,053	10.6	6,235,594	18.5	33,915	22.1	18.7	59,872	20.7
$40,000 UNDER $50,000	87,054	5.1	3,806,008	11.3	27,060	17.6	31.1	57,775	20.0
$50,000 UNDER $100,000	67,472	4.0	4,214,694	12.5	30,974	20.2	45.9	72,649	25.1
$100,000 OR MORE	11,715	0.7	2,299,750	6.9	7,204	4.7	61.5	19,476	6.7
TOTAL	1,703,028	100.0	$ 33,766,012	100.0	153,510	100.0		289,583	

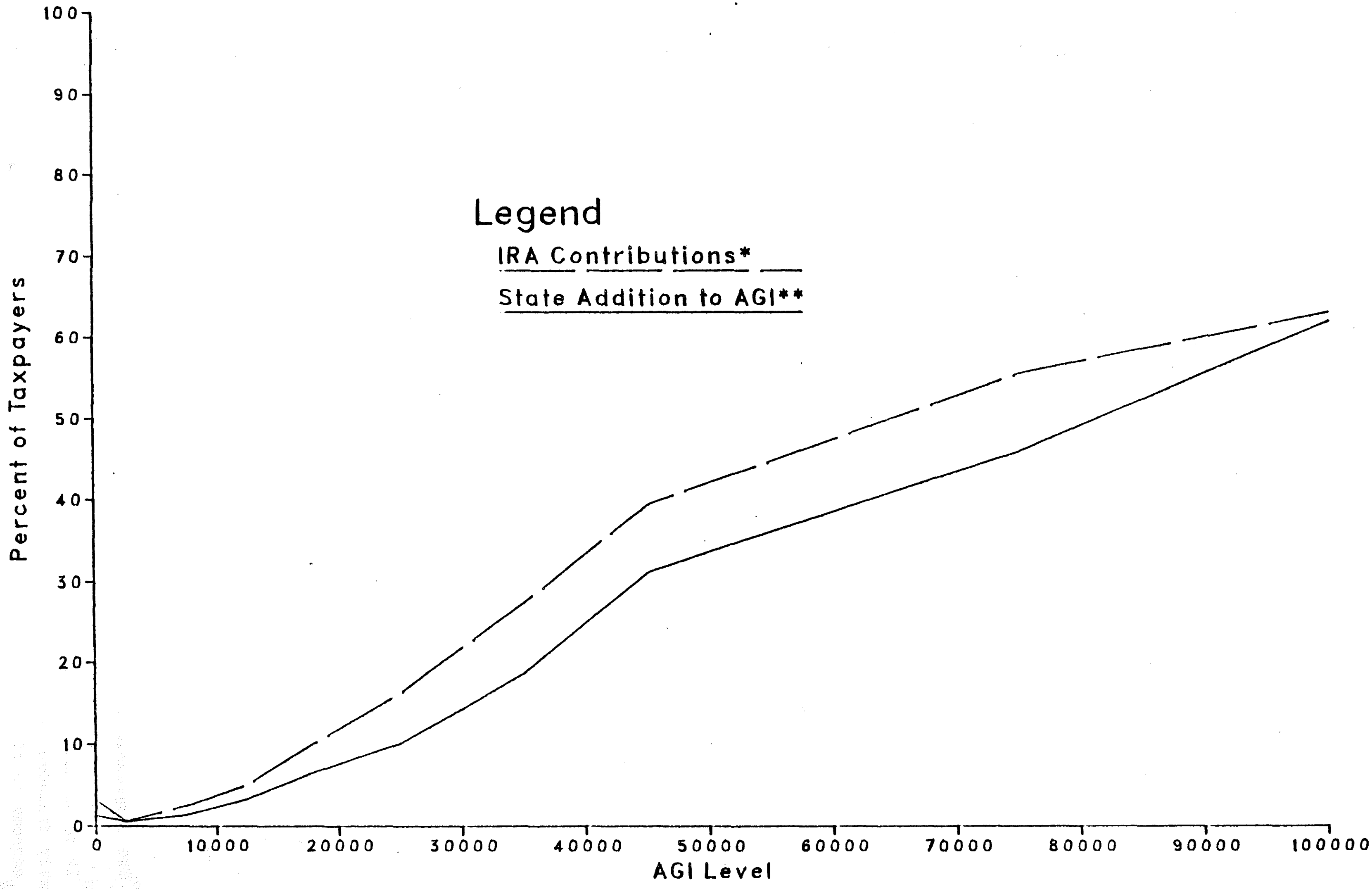
*Based on population of all filers.

**Expressed in thousands.

+Includes SEP and Keogh Plan additions. Data are derived from a sample of filers.

Source: Minnesota Revenue Dept., Individual Income Samples (June, 1984).

Percent of Taxpayers with IRA Contributions relative to Percent Paying Minn. Tax on Contributions



Data: *Dept. of Treasury, "Statistics of Income Bulletin" (Winter, 83-84)
**Minnesota Revenue Department, 1982 Income Tax Sample
Graphics: Minnesota House of Representatives Research Department

PART TWO:

PUBLIC POLICY ISSUES AND STATE TAXATION OF IRAS

This part explores some of the public policy issues associated with state taxation of individual retirement accounts. First of all, it examines whether IRAs provide an effective savings incentive--the stated reason for congressional enactment of IRAs was to stimulate savings for retirement. Secondly, Minnesota's present method of taxing IRAs is evaluated under two traditional measures of tax policy--simplicity and equity. In connection with the discussion of simplicity, compliance rates and problems with the state law are examined.

I. IRAs AND SAVING--DO IRAs ENCOURAGE SAVING?

A. General Considerations

One of the primary purposes for federal enactment of the individual retirement account provisions was to encourage or increase the amount individuals save for retirement.[26] Two general reasons have been advanced to support the government's encouragement of private retirement savings. First, increased retirement savings will reduce the pressure for directly providing governmental old age benefits under social security, medicare, and other programs. Second, overall increases in savings may be seen as a way of stimulating capital investment and, as a result, general productivity increases and economic growth.[27] Discussion of the legitimacy or value of these purposes or goals is beyond the scope of this paper.

Individual retirement accounts were designed to stimulate increases in private retirement savings by providing higher aftertax rates of return on individual retirement savings. In order for such an incentive to be successful, individuals must increase their savings in response to an increase in the net return on their savings. For example, if higher aftertax interest rates can be earned by saving for retirement, individuals must respond by reducing their current consumption and increasing their savings. There is considerable debate and conflicting evidence regarding whether higher returns induce additional savings.[28] As a result, these considerations will not be discussed.

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[26] See congressional materials cited in footnote 4.

[27] It is probably harder to make a case for this view since the revenue cost of the program is presumably financed by increasing the federal deficit which reduces the amount of savings available in the economy to finance private investment.

[28] See Jackson, Savings and Rate of Return Incentives: Estimates of the Interest Elasticity of Personal Savings (Congressional Research Services Report, 1981).

More specifically, though, it is easier to evaluate whether the IRA law operates at the margin--i.e., does it provide an incentive for additional savings? Put another way, assuming individuals do increase their savings in response to higher aftertax returns, does the IRA law provide higher aftertax returns on additional or new savings? Several factors in the individual retirement account provisions suggest that IRAs are not an effective, marginal savings incentive.

B. Factors Limiting the Effectiveness of IRAs as a Savings Incentive

1. Asset Shifting

The theory of the IRA incentive is that the increased yields on savings provided by the IRA law will induce additional savings. For example, if X finds that the return on his IRA contribution is 20 percent higher than he otherwise would have earned, he presumably will save more.

Although the IRA provisions do provide lower taxes to individuals who increase their retirement savings, they also provide similar reductions to taxpayers who have already accumulated assets and who simply shift them to individual retirement accounts without increasing their savings. Here, the $2,000 maximum is an important factor. If X has already saved $10,000 in a nontax deferred savings account, he has a strong incentive to simply shift $2,000 of this money into an IRA. This will provide him with a tax reduction ($1,000 if he is in the 50 percent bracket), but it will not increase the rate of return on any additional savings over his original $10,000 amount. As a result, X will have no real incentive to increase his savings.

This incentive to shift assets will be the strongest for individuals with the highest tax rates. For example, the aftertax cost of making a $2,000 contribution is only $1,000 for someone in the 50 percent bracket, but is $1,600 for someone in the 20 percent bracket. Individuals with higher tax rates have higher incomes and are likely to have accumulated significant assets. One study estimated that the average individual with $30,000 to $40,000 in income had accumulated about $10,000 in liquid assets.[29] Thus, the combination of these two factors and the heavy use of IRAs by higher income individuals

[29] DeMagistris & Palash, Impact of IRAs on Saving, Fed. Reserve Bank of N.Y. Qtr. Rev. 24, 29 (Winter, 1982-83).

suggests that the program may not have much of an incentive effect on saving. The primary incentive is probably simply to shift $2,000 per year in assets to IRAs.[30]

Proponents of IRAs would argue that these are largely transition problems. After several years the average individual's capacity to shift assets will be exhausted. For example, if X has $10,000 in liquid assets and each year transfers the $2,000 maximum to an IRA, after 5 years he will have no more assets to shift and must begin savings or forgo the IRA benefit. In most cases, however, the effect will not be so unambiguous. For example, if X had previously been saving $1,500 per year for retirement and continues to do so, it will take considerably longer to shift all of his assets (20 years or more).

Even if the individual retirement account law encourages taxpayers with accumulated savings to simply shift their assets into IRAs, this may have some effect in increasing savings. Federal law imposes an additional ten percent tax if the taxpayer withdraws his IRA assets before age 59-1/2.[31] This additional tax will reduce taxpayers' willingness to spend amounts in IRAs on their latest consumption whim. However, this effect is likely to be fairly small. As financial planners have taken great pains to explain, the tax incentives provided by IRAs fairly quickly overwhelm the additional ten percent tax on early withdrawals.[32] Thus, IRAs can be used for relatively short term savings goals.

2. Tax Arbitrage

Even if the taxpayer does not hold liquid assets that he can shift into an IRA, a permissible alternative is to borrow funds to make a contribution. Since the interest paid on the loan is deductible from his other income, the tax reduction or incentive is the same for the

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[30] See Steuerle, Tax Arbitrage, Inflation, and The Taxation of Interest Payments and Receipts, 30 Wayne L. Rev. 991 (1984); and Steuerle, Building New Wealth by Preserving Old Wealth: Savings and Investment Tax Incentives in the Postwar Era, 36 Nat. Tax J. 307, 314-17 (1983). For a contrary view that the $2,000 maximum actually increases the effectiveness of the incentive of IRAs, see Hubbard, Do IRAs and Keoghs Increase Saving? 37 Nat. Tax J. 43 (1984). Hubbard's view is apparently based on the revenue savings of the maximum--i.e., concentrating the incentive on lower income individuals is more cost effective. Id. at 46. Unlimited contributions would permit the wealthy to shift large amounts of assets to IRAs at a revenue cost and no gain in savings.

[31] I.R.C. 6 §408(f) (1984).

[32] See, e.g., Shaftner, O'Neil, & Dillaway, Using Individual Retirement Accounts as Temporary Tax Shelters, 7 Rev. of Taxation of Individuals 175 (1983). Collins, Estimating the Benefits of Individual Retirement Accounts: A Simulation Approach, 14 J. of Consumer Affairs 122, 130-35 (1980), provides a method of determining the point at which the IRA tax reduction exceeds the withdrawal penalty. This, of course, will depend upon the taxpayers' tax bracket and the rate of return on the investment.

borrower and the saver. For example, Y borrows $2,000 at 10 percent to make an IRA contribution. If the IRA earns a 10 percent or better return he is in the same position as X who made his contribution by shifting his assets. He receives a $2,000 deduction for the contribution, a $200 deduction for the interest paid on the loan, and the interest earned is exempt. If the IRA earns less than the interest paid on the loan, then there will be some cost to obtaining the contribution deduction and interest exemption, but it will be slight.[33] This practice of "arbitrage" is very common. It may take the form of directly borrowing to make an IRA contribution or more commonly the taxpayer will borrow funds to buy a car, boat, or home, while retaining sufficient liquid assets to make an IRA contribution.[34] Clearly, this ability to "arbitrage" IRA subsidies reduces the incentive provided by IRAs to increase savings.

3. Income Effects

The savings incentive provided by IRAs will additionally be reduced by what economists refer to as the "income effect" of price changes. In deciding whether to increase his savings, an individual must determine how much of his income will be used for current consumption or saved for consumption at some future time (e.g., after retirement). If the value of savings is increased by providing tax incentives such as IRAs, the amount of savings should increase because the "price" of deferring consumption has gone down. However, for persons who already are saving, the tax incentive also has the effect of increasing their income.

For example, assume that Z annually saves $3,000 for retirement. Even if Z does not change his savings behavior, the availability of IRA tax deferral provides him with additional income (the amount of his tax savings under the IRA law). Z may choose to use all or part of this additional income for current consumption. This could reduce the total amount of his savings--in effect he is using the tax savings to reduce the amount of wages or salary that he must save to meet his retirement income objectives.[35] Note the effect of the $2,000 maximum. Because of the limit, the IRA incentive provides no increased return on additional savings by Z. If Z increases his

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[33] The arbitrager will still realize a (potentially) significant tax benefit. It is only a "cost" in that the maximum benefit available to the saver will not be realized.

[34] See Steuerle, Building New Wealth by Preserving Old Wealth: Savings and Investment Incentives in the Postwar Era, supra note 30, at 315-16.

[35] Z can do this by simply spending his tax savings in the year realized. His aftertax income has risen, while his saving has remained constant (i.e., declined as a proportion of total aftertax income).

savings from $3,000 to $4,000 per year, the IRA law provides no increased return on his savings as a result of the $1,000 increase. The only benefit he derives is from putting the first $2,000 in an IRA.[36] In this circumstance, Z's original preference between current consumption and savings will govern without regard to the IRA incentive. Given this circumstance, the IRA law will probably have the effect of reducing savings (proportionately) of some individuals.[37]

C. State Considerations--Savings Incentives

Would adopting state tax treatment of IRA contributions that conforms to the federal law increase saving for retirement by Minnesotans? In order for conformance to be an effective state savings inducement, it will have to induce additional savings--i.e., savings in addition to that stimulated by the availability of the federal tax deferral. (It is interesting to note that the Department of Revenue estimates of the fiscal impact of IRA conformance do not assume any additional use of IRAs resulting from state conformance.) Secondly, it should be noted that the present state law's exemption of income earned by IRAs already provides a substantial savings incentive.

Some insight into the savings incentive provided by state conformance may be provided by quantifying the value to the saver/investor of conformance. In general the value of conformance to a saver will depend upon his marginal tax rate,[38] the rate of return earned on the investment

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[36] The income effect of the IRA incentive is present even if the individual would not save at the maximum without the incentive. For example, assume Z-2 makes $40,000 per year, is in the 30 percent tax bracket, and regularly saves 3 percent of his income or $1,200 for retirement. By contributing the $1,200 to an IRA, Z-2 will save $360 in taxes. Z-2 must now decide what to do with his tax savings. He could choose to continue his current pattern and save 3 percent of it or he could increase or decrease the proportion of his income that he saves. However, unlike Z any additional amounts saved (up to $2,000) will qualify for the higher returns provided by IRA tax deferral. This higher return may increase Z-2's preference for saving. However, he may spend the $360 in tax savings rather than save it if, for example, all he feels he needs to save is $1,200 per year.

[37] It is for this reason that it is probable that the IRA law actually reduces net savings in the economy, if one assumes that the cost of the program is financed by increasing the federal deficit.

[38] More specifically it will depend upon the marginal rate in the year the contribution was deferred and the marginal rate in the year the IRA distribution is received. These two rates may be different. For example, taxpayers generally expect to be subject to lower tax rates during retirement. Further complicating this is Minnesota's exemption of up to $11,000 of pension income for certain low and middle income taxpayers. Minn. Stat. §290.01, subd. 26 (1984). In making the calculations these complicating factors were ignored--it was assumed that the marginal tax rates remain the same at the time of contribution and distribution and that the pension income exclusion does not apply. See Appendix B for more detail.

of his contribution, and the term or length of time before the IRA assets are withdrawn. Tables 6 and 7 display matrices of "gain factors" resulting from state conformance.[39] The gain factor represents the increase in IRA assets that would result from conformance to the federal rules. Thus, a gain factor of 1.15 means that as a result of conformance with the federal rules the taxpayer's assets would increase by 1.15 times the IRA contribution (i.e., 15 percent) for the given marginal tax rate, the assumed rate of return, and the term of the investment in the account. Table 6's matrix assumes a term of 25 years and permits comparison of the effect of varying the marginal tax rate and the rate of return. Table 7 assumes an interest rate of ten percent and displays the effect of varying marginal tax rates and terms of the investments. The equations used to calculate these matrices are given in Appendix B which also includes a third matrix comparing rate of return and the term of the investment.

The gain factors displayed in Tables 6 and 7 and Appendix B provide a measure of the magnitude of the savings incentive provided by conformance. These incentives increase with higher marginal tax rates, longer investment terms, and higher rates of return. For example, a taxpayer subject to the top marginal rate of 16 percent would realize an increase in his assets equal to 18 percent of the contribution for a 25 year investment providing a return of 12 percent. To put this increase into perspective, it represents roughly a 0.7 percent annual increase in the return on the contribution--significant, but not dramatic.

State conformance on IRAs as a method of stimulating retirement savings would also be subject to the limitations pointed out above applicable to the federal law. For the reasons detailed above--the encouragement of asset shifting, tax arbitrage, and the income effects of the tax reductions--the link between state conformance and increased savings is probably too tenuous to justify the high revenue cost of conformance. On balance, state conformance probably should not be justified on the grounds that it will increase retirement savings.[40] The justification for conformance must be found in other tax policy considerations.

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[39] Computation of the gain factors was made using a modification of the approach contained in Collins, supra note 32. See Appendix B for additional details.

[40] An additional factor occasionally advanced as support for IRAs and other savings and investment incentives--i.e., the need to increase the general level of savings and investment in economy to spur productivity growth--probably does not apply to state tax policy considerations. Since capital flows readily across state borders, any effect of increasing overall savings by Minnesotans is likely to benefit the national economy generally rather than Minnesota. As such, it properly should be a responsibility of the federal government, rather than individual states.

TABLE 6
GAIN FACTORS FOR STATE IRA CONFORMANCE
MARGINAL TAX RATE--INTEREST RATE ON IRA

State Marginal Tax Rate	Interest Rate*					
	4%	6%	8%	10%	12%	14%
1.6%	1.01	1.01	1.01	1.01	1.02	1.02
2.2%	1.01	1.02	1.02	1.02	1.02	1.02
3.5%	1.02	1.03	1.03	1.03	1.03	1.04
5.8%	1.04	1.05	1.05	1.06	1.06	1.06
7.3%	1.05	1.06	1.07	1.07	1.07	1.08
8.8%	1.06	1.07	1.08	1.09	1.09	1.09
10.2%	1.07	1.09	1.10	1.10	1.11	1.11
11.5%	1.08	1.10	1.11	1.12	1.12	1.13
12.8%	1.09	1.11	1.12	1.13	1.14	1.14
14.0%	1.10	1.12	1.14	1.15	1.15	1.16
15.0%	1.10	1.13	1.15	1.16	1.17	1.17
16.0%	1.11	1.14	1.16	1.17	1.18	1.18

*Compounded continuously; assumes 25 year term.

TABLE 7
GAIN FACTORS FOR STATE IRA CONFORMANCE
MARGINAL TAX RATE--TERM OF IRA

State Marginal Tax Rate	Term (Years)						
	2	5	10	15	20	25	30
1.6%	1.00	1.01	1.01	1.01	1.01	1.01	1.02
2.2%	1.00	1.01	1.01	1.02	1.02	1.02	1.02
3.5%	1.01	1.01	1.02	1.03	1.03	1.03	1.03
5.8%	1.01	1.02	1.04	1.05	1.05	1.06	1.06
7.3%	1.01	1.03	1.05	1.06	1.07	1.07	1.07
8.8%	1.02	1.04	1.06	1.07	1.08	1.09	1.09
10.2%	1.02	1.04	1.07	1.09	1.10	1.10	1.11
11.5%	1.02	1.05	1.08	1.10	1.11	1.12	1.12
12.8%	1.02	1.05	1.09	1.11	1.12	1.13	1.14
14.0%	1.03	1.06	1.10	1.12	1.14	1.15	1.15
15.0%	1.03	1.06	1.10	1.13	1.15	1.16	1.17
16.0%	1.03	1.07	1.11	1.14	1.16	1.17	1.18

Assumes 10% interest rate, continuously compounded.

II. SIMPLICITY

One of the commonly recognized goals of any tax system is simplicity. Simplicity is particularly important to a tax, such as the individual income tax, which relies upon taxpayer self-assessment. A simple tax system increases taxpayer and citizen understanding and thereby fosters political accountability. A simple tax system reduces the cost of taxpayer compliance and the state's cost of administration and collection.

A. Contributions

Minnesota's method of taxing contributions to individual retirement accounts can only be described as complex and confusing. In order to comply with the law, a taxpayer who makes an IRA contribution must first determine whether during the taxable year he was a participant in a qualified pension plan, government pension, or tax sheltered annuity plan within the meaning of the federal law in effect for tax year 1981. Evidence indicates that many taxpayers do not know whether they are covered by a plan and furthermore, there are a number of legal ambiguities involved in applying the 1981 federal statute.[41] If the taxpayer determines he is not covered by a pension plan, then he must further determine whether his contribution exceeds (1) $1,500 ($1,750 for a spousal IRA) or (2) 15 percent of his "compensation," determined again under the federal rules. If the contribution exceeds either or both amounts, he must add back the greater amount. Thus, calculating the taxable amount will involve a multiple step process that requires application of ambiguous and now obsolete federal law.

The special rules enacted by the 1984 Legislature for employees who are covered by tax credit employee stock ownership programs (ESOPs) rise to even higher levels of complexity and confusion in the taxation of IRA contributions. Since an ESOP is a qualified plan, a participant in an ESOP would be disqualified from making deductible IRA contributions under the 1981 federal law.[42] As a result, the full amount of the contribution would need to be added to federal adjusted gross income in computing Minnesota gross income. However, the 1984 amendments provide that in special circumstances for ESOP participants, their IRA contributions or a portion of them need not be added back in computing Minnesota gross income. In

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[41] For example, assume a taxpayer is employed by an employer with a qualified plan, but the employee is not vested under the plan. He terminates his employment and takes a second position with an employer that does not have a qualified plan. May he make a deductible IRA contribution for the taxable year in which he was employed in both positions? Compare Foulkes v. Commissioner, 638 F.2d 1105 (7th Cir. 1981) (IRA deduction permitted) with Chapman v. Commissioner, 77 T.C. 497 (1981) (no deduction permitted, taxpayer retained "break-in" service rights under pension plan).

[42] I.R.C. §409A(a)(1).

order to qualify, the employee must not be covered by a qualified plan other than the ESOP and the total ESOP contributions for the taxable year may not exceed $300.[43] If the employee qualifies under these rules, the amount of the contribution which must be added back is determined as described above for taxpayers who are not covered by a qualified plan (i.e., the excess over the lesser of $1,500 or 15 percent of compensation), except that the maximum contribution is further reduced by the amount of the ESOP contributions for the taxable year. The additional complexity created by this provision is obvious.

B. Distributions

The method of taxing IRA distributions is only slightly simpler and additionally requires the foresight to maintain good state tax records over the life of the account. For federal tax purposes an IRA distribution which is not "rolled over" into another IRA is taxable. In order to determine the state taxability of an IRA distribution the taxpayer must go through a three step process. First, the taxpayer must determine the total amount of contributions which were added to compute Minnesota gross income, i.e., the contributions that he has already paid state tax on. Secondly, this amount must be reduced by any distributions which were subtracted from gross income in prior tax years. Finally, the resulting amount is compared with the distribution and the smaller amount is subtracted from gross income.

Obviously, in order to comply with these requirements the taxpayer will need to retain his state tax records over the life of the account.[44] Relatively young taxpayers (in their 20s and 30s) are making IRA contributions from which distributions will be made 30 or 40 years later.

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[43] Minn. Stat. §290.01(20a)(20) (1984). Contributions to ESOPs are made in common stock. The law does not specify how this stock will be valued for purposes of the $300 limitation. The terminology of the state law--"worth less than $300"--is not directly identical with the terminology used in the Internal Revenue Code--"value." I.R.C. §48(n)(6)(B). Therefore, it is not clear whether the Internal Revenue Code's specific procedure for valuing stock traded on an exchange (average of the stock's price for 20 consecutive days preceding the contribution) would apply or what valuation rules would apply for stock that is not traded on an exchange. Furthermore, no requirement is placed on the employer to disclose this amount to the employee, so implicitly the question is left to the taxpayer-employee.

[44] The language of the subtraction is phrased in terms of contributions to and distributions from "an account." Minn. Stat. §290.01(20b)(19) (1983 Supp.) [emphasis added]. However, given the likelihood that taxpayers will maintain multiple IRA accounts to diversify investment portfolios or for other reasons, it seems reasonable that the exclusion will be applied to the aggregate of all accounts. Given the ability to transfer assets from one account to another and to make tax free rollovers of distributions, it would seem an impossible complexity to require accounting of the recovery of contributions on an account-by-account basis.

It probably is unreasonable to expect that these taxpayers will retain such long term tax records. Under similar circumstances, the tax law increases compliance by placing the burden of such record keeping on the financial intermediary. For example, in the analogous provisions for recovery of a pension plan participant's aftertax contributions the burden of record keeping is placed on the plan administrator or trustee which, in turn, reports the amounts to the Internal Revenue Service and the state tax administrator. The state's complex system of taxing IRA distributions is likely to cause significant compliance problems in the future as distributions increase.

The pension income exclusion presents an additional complexity problem for the taxation of IRA distributions. Minnesota law permits recipients of pension income, including IRA distributions, to subtract up to $11,000 of pension income in computing Minnesota gross income. The amount of pension income which may be subtracted is reduced, dollar for dollar, by the lesser of (1) federal adjusted gross income, excluding the includible portion of social security and railroad retirement benefits, in excess of $17,000 or (2) the sum of federal adjusted gross income, social security, and railroad retirement benefits in excess of $23,000.[45]

The law does not specify how this exclusion will be integrated with the subtraction for the recovery of previously taxed IRA distributions. Two questions may be posed in this regard. First, will IRA distributions which are nontaxable under the recovery of contributions rule qualify for inclusion in the pension income amounts?[46] If so, inclusion of already nontaxable amounts would permit taxpayers a double subtraction in certain circumstances, thereby reducing the tax liability on other income of the taxpayer. Secondly, will the amount of federal adjusted gross income used to calculate the income offset be reduced by the taxpayer's nontaxable IRA distributions?[47] If not, the affected taxpayer groups are likely to argue that these distributions are no more income than the money in the taxpayer's bank account and thus have no place in the income offset. If the pension exclusion is modified to integrate the subtraction of IRA distributions, it will add a further complexity to the already very complex pension income exclusion.

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[45] Minn. Stat. §290.08, subd. 26 (1984). The alternative income offset provision is effective for tax year 1985. L. 1984, chap. 502, art. 2 §§7, 18.

[46] The plain language of the law implies that the distributions would qualify for the exclusion. Minn. Stat. §290.08, subd. 26(b)(3) provides that "'Pension income' means to the extent included in the taxpayer's federal adjusted gross income the amount received by the taxpayer * * * (B) as a retirement or survivor's benefit made from a plan qualifying under section * * * 408 * * * of the Internal Revenue Code." Section 408 governs the operation of individual retirement accounts.

[47] The plain language of the law implies that FAGI will not be reduced by nontaxable distributions. The only stated adjustment in the definition of federal adjusted gross income is that for includible social security and railroad retirement benefits. Minn. Stat. §290.08, subd. 26(a)(1).

C. Compliance

Given the complexity of the state's IRA provisions and the lack of general public understanding of the rules, one would expect compliance rates to be poor. Available evidence for tax year 1982 indicates that this was the case. In 1982, IRA deductions were claimed on approximately 243,000 federal income tax returns by Minnesota state income taxpayers. The Revenue Department issued audit notices for failure to add back IRA contributions for 26,800 returns.[48] This constitutes an 11 percent noncompliance rate relative to those who claim IRA deductions on the federal return, not all of whom will be subject to the state addition. The total estimated deficiency is $6.3 million. The average deficiency per return was $260. (The former estimate assumes that some of the taxpayers will be able to demonstrate to the department that failure to add-back all or part of the contribution was appropriate.)

The department's IRA audit compliance project for tax year 1982 involved a three step process. First, the identity of taxpayers who claimed federal IRA deductions and failed to add back equivalent amounts on their state returns was determined, using computer matching techniques. Secondly, the employers of these taxpayers were identified from W-2 forms and an effort was made to determine whether each employer provided a qualified pension plan(s) for its employees. This information was gathered from Department of Labor lists or, if necessary, by contacting the employer directly. Finally, based on this information audit notices were sent to taxpayers. Direct contact with the taxpayer may show that he was in compliance with the law. For example, the taxpayer may be employed by a firm with a qualified pension plan, but his particular job classification may not be covered.

The audit project seems likely to have identified most, if not all, of the taxpayers who did not comply with the law. However, it also required substantial department resources--an average of 5 to 6 examiner positions as well as significant computer time, clerical costs, and so forth. Increased experience and expanded use of computers may reduce these costs somewhat in the future.

According to department staff, the largest source of noncompliance is taxpayers who are covered by pension plans but who fail to add back contributions. According to anecdotal evidence gathered from tax preparers, many taxpayers are simply not aware whether they are covered by a pension or annuity plan and, as a result, obtaining accurate information in this regard is difficult. Under the old federal law, employers were required to include a check in a box on the W-2 form if

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48 All the data listed in this section on compliance is based on phone conversations with Don Trimble of the Discrepancy Verification Unit, Income Tax Division of the Department of Revenue.

the employee was a participant in a plan. This provided a convenient notice to the taxpayer, tax preparer, and tax administrator of whether the taxpayer qualified to make a deductible IRA contribution. With the enactment of universal IRAs, the IRS discontinued the requirement that this information be included on the W-2 form. The state could require employers to continue providing this information to increase compliance and simplify auditing. However, this would impose additional complications. The state currently uses a W-2 form identical to the federal form. Deviating from that form would require employers either to fill out a separate form or to provide a separate notification to their employees. Depending upon the trend of future compliance rates, this step may be worth considering, if the Legislature determines to continue a system of IRA taxation which depends upon the taxpayer's participation in a qualified plan, government pension or tax sheltered annuity plan.

Given the state's auditing efforts and taxpayers' increased experience with the IRA law, one may expect that the compliance rates will improve. However, a second compliance problem looms in the more distant future regarding the subtraction from gross income for the recovery of previously taxed IRA contributions. It seems likely that taxpayers will fail to keep the detailed long term state tax records that are necessary to accurately compute this subtraction. Since taxpayers probably tend to resolve ambiguities in their favor, this likely will result in undertaxation of IRA distributions. Many cautious taxpayers who do not have adequate records, however, will undoubtedly overpay. Furthermore, the department's record keeping and computing costs may be strained to the limit, if it must keep running records of all taxpayers with IRA contribution additions to gross income for the life of their accounts (30 to 40 years potentially). If the department does not keep these sorts of records, it will have some difficulty auditing the IRA distribution subtractions of taxpayers.

III. EQUITY

Equity provides a second important benchmark for evaluating a tax or tax provision. The concept of equity is generally considered to be composed of two elements--horizontal and vertical equity. Horizontal equity demands that equals be treated equally. For example, taxpayers with equal incomes should each be subject to an equal amount of income tax. Vertical equity deals with the taxation of persons or things which are not equal. For example, questions of how progressive (if at all) an income tax structure should be is a question of vertical equity.

For obvious reasons, vertical equity is a somewhat more illusive concept than horizontal equity and conclusions will depend more upon the political and moral values of the observer. Rather than join these discussions, considerations of vertical equity can perhaps be dispatched with two observations. First, as was described in section III above, state conformity to the post-1981 IRA rules would have the effect of shifting the relative state income tax burden toward lower income taxpayers on average. In this sense conformity would make the overall state tax structure "less progressive" if no other changes were made. Secondly, if the Legislature wishes to conform to the federal IRA rules but also does not wish to make the tax system "less progressive," it may make other changes that offset or counterbalance the effect of conformity. For example, it could adopt the federal IRA rules and concurrently restructure the rate schedule and personal credit amount to preserve the current distribution of income tax burdens across different income levels.

In an ideal income tax system--i.e., an income tax levied on a comprehensive definition of all income without exception--a subtraction for IRA contributions and an exemption of the earnings of IRA accounts would violate horizontal equity.[49] Two taxpayers with equal incomes--one of whom makes an IRA contribution and one who does not--would be taxed differentially. Equals would not be treated equally. However, IRA conformity is not being considered in the context of an ideal income tax, but rather for inclusion in a tax which has a tax base that is a patchwork quilt of exceptions to a comprehensive definition of income. As a result, IRA conformity must be considered in this context and proponents can make a number of arguments that the IRA law enhances (or at least does not reduce) the equity of the income tax.

First, it might be argued that IRAs somewhat equalize the availability of tax preferences for retirement savings. The federal and state income taxes provide numerous opportunities for tax deferred retirement savings for employees. The most common and widespread of these are pension plans. Someone who is not covered by a pension plan, however, is at a comparative disadvantage. All of his income is subject to taxation and because of all the exceptions for the retirement savings of others, he is taxed at higher rates. As described in Part One, section II-A above, the original 1974 IRA law was designed to ameliorate this inequity by permitting those not covered by pension plans to open IRAs. With the expansion of IRA availability to pension plan participants, the program ceased to serve as directly in equalizing the availability of tax deferred retirement savings. However, IRAs still, to a certain extent, serve this function, since those most likely to use IRAs are persons not covered by pension plans, all other things being equal.

The state could continue to view the IRA law as primarily a device to counterbalance the advantageous tax treatment of employees covered by pension plans. For example, the increases in the contribution limits ($2,000 versus $1,500 and 100 percent versus 15 percent of compensation) could be adopted, but not the expansion to those already covered by pensions. IRA conformance

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[49] This presumes that income is the appropriate base for taxation. An alternative, frequently advanced recently, is to tax personal consumption (income, less savings, plus dissavings and borrowing), rather than income. See, e.g., Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974). IRAs are, in effect, a personal consumption tax feature grafted onto an income tax.

would seem to be an ineffective mechanism for equalizing the tax advantages of participants in a pension plan. For example, the maximum annual contribution to a defined contribution pension plan is $30,000 as contrasted with the $2,000 IRA maximum.[50] However, under certain circumstances an IRA may be more advantageous. For example, an employer's contributions to a pension plan on the employee's behalf may be less than $2,000 in any given year or on average over his years of covered employment. The employee's interest in the pension may not be vested and may never vest if he terminates his employment.[51]

In addition to the IRA law, the federal income tax provides opportunities for voluntary, tax deferred saving for retirement. Given the state's adoption of these voluntary, tax deferred retirement savings programs one could argue that equal treatment suggests that similar treatment be given to IRA contributions. For example, state and local employees under section 457 deferred compensation plans are permitted to defer up to one-third of their compensation or $7,500 per year, whichever is less.[52] Minnesota's income tax conforms to the federal tax treatment of these plans and Minnesota law further provides for establishment and administration of a qualifying deferred compensation plan for the employees of the state and political subdivisions.[53] Similarly, federal and state law permits employees of corporations which have established deferred compensation plans to receive deferred tax treatment of a portion of their salary under 401(k) plans.[54] In contrast to these plans, IRAs have the advantage of being

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[50] I.R.C. §§415(c); 219(b)(1)(A). There are policy reasons for providing more generous tax treatment of pension plans as compared with voluntary employee savings programs such as the IRA law. Pension plan benefits must be provided on a nondiscriminatory basis to all employees (with certain exceptions). This will increase the extent of coverage of such plans as compared with purely voluntary plans such as IRAs. As described above, under voluntary programs taxpayers with higher marginal tax rates, the greater capacity to shift assets, and so forth are more likely to participate. Therefore, it seems likely that pension plans will be more successful in stimulating additional retirement savings, especially among lower income individuals, than voluntary programs such as IRAs.

[51] Specifically addressing these considerations in a state IRA law would likely come at a high price in terms of complexity, if they can be addressed at all. For example, the vesting problem seems virtually insoluble short of a complex system involving recapture. Most pension plans require five to ten years of service before any rights to benefits vest. Of the plan's current nonvested participants, some, but not all, will eventually become vested. However, it will likely be impossible to establish a simple, administrable rule that predicts which participants will ultimately receive vested rights.

[52] I.R.C. §457.

[53] Minn. Stat. §352.96 (1982). As of the end of fiscal year 1984, there were 13,693 employees participating in the deferred compensation plan and the plan had $111 million in total assets. Assets (contributions plus income less distributions and administrative costs) in the deferred compensation plan have increased at a rate of 40% per year over the last five years.

[54] I.R.C. §401(k). Interestingly, distributions from 401(k) plans qualify under the pension income exclusion, while distributions of 457 deferred compensation plans do not. See Minn. Stat. §290.08(26)(b)(3)(B) (1984).

available to all employees even if their employers have not established a 401(k) or 457 plan.

A second equity argument might be made that IRAs will partly equalize the differential treatment of nonbusiness borrowers and savers. Because of the itemized deduction for nonbusiness interest payments, the federal and state income taxes favor those who borrow to finance consumption as compared with those who save to do so. If A saves money over several years to purchase, for example, a car, the interest earned on his savings is taxed in the interim. Conversely, if B borrows money to purchase a car, the interest he pays is deductible, thereby reducing the tax on his other income. IRAs by reducing the relative tax burden on savers may be argued to serve as a partial antidote to this differential treatment of savers.[55] Some have argued that the IRA law is one of many small steps that is gradually moving the U.S. income tax toward becoming a personal consumption tax.[56] If this is so, IRAs may be justified as a transition phase to a personal consumption tax base in the future which satisfies horizontal equity criteria.

A third equity argument may be made on the basis of interstate integration of the taxation of IRAs. Minnesota is one of only six states that do not conform fully with the federal IRA rules.[57] Thus, if a taxpayer makes IRA contributions that are subject to Minnesota taxation, later moves to another state, and receives distributions from the IRA while in that state, the amounts would be subject to state income taxation twice--once when contributed in Minnesota and again when distributed in the second state. While it may not be apparent which of the two states' systems is more fair, fairness would seem to demand in a society with a highly mobile population that they be consistent. However, this desirable goal of consistency and uniformity, in general, is not one that a state may carry out since it is dependent upon the actions of many states. Each state would seem justified in insisting that the other state(s) conform to its practice. However, in a circumstance where the overwhelming majority of states and the federal government have adopted one rule, perhaps this may create a presumption that the few states, such as Minnesota, that deviate should conform.

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[55] The proponents of a personal consumption tax base rely primarily upon efficiency arguments, rather than equity considerations. The concern is that the income tax distorts the choice between consumption and savings. See, Minarck, "Conference Discussion," What Should Be Taxed: Income or Expenditures?, 302ff (Brookings Institution, 1980). Note that the tax penalty for saving under an income tax goes beyond the deductibility of interest paid and the includability of interest and other capital income earned. A tax which is neutral as between current versus future consumption requires both the deduction of savings and exemption of capital income until consumed. This, of course, is the mechanism employed under the IRA law. However, because of the opportunities for tax arbitrage as described in the text in section IV, it is not clear in the existing tax that IRAs move any closer to neutrality than alternatives that move closer to true comprehensive income taxation (e.g., disallowing the itemized deduction for interest paid).

[56] See, e.g., Bradford, The Possibilities for an Expenditure Tax, 35 Nat. Tax J. 243 (1983).

[57] See Appendix D.

PART THREE:

LEGISLATIVE OPTIONS

This section discusses options that the Legislature may wish to consider for the taxation of individual retirement accounts. The discussion attempts to list the major advantages and disadvantages of each alternative. The treatment of Keogh Plans and simplified employee pensions (SEPs) can, and perhaps should, be considered a separate issue from IRAs. These plans are discussed in Appendix C. Given the uncertainty of the effect of IRAs on savings behavior as discussed above in Part Two, section I, the listing of advantages and disadvantages does not include any consideration of the effect of alternatives on individual savings for retirement.

I. RETENTION OF THE STATUS QUO

A first alternative is to retain the status quo. Under present law, if the taxpayer is a participant in a government pension plan, qualified plan, or tax sheltered annuity, the full contribution is taxed when made. If the taxpayer is not a participant in a plan, contributions are taxed to the extent they exceed the lesser of 15 percent of his compensation or $1,500. All income earned by the IRA is exempt until distributed. Distributions are exempt from state tax to the extent they represented a recovery of previously taxed contributions.

Advantages

Taxpayers have operated under this system for two full tax years. Understanding of and adjustment to the system seem likely to increase as time passes. An old adage of tax policy is that the best tax is an old tax. Retention of the status quo avoids the necessity for the Legislature to face the issues connected with the restructuring of the tax base and redistribution of tax burdens that will occur with full IRA conformity. No revenue losses will result which must be made up with tax rate or base increases or expenditure reductions.

Disadvantages

The overarching disadvantage of retention of the status quo is the series of complexity and compliance problems with the existing system. These problems seem likely to become worse, rather than better. This is particularly so when more taxpayers begin receiving distributions from IRAs and must determine how much of each constitutes recovery of previously taxed contributions. Furthermore, the $1,500 and 15 percent limitations add a substantial complication and likely lead to confusion of taxpayers. If the Legislature desires to limit IRAs to their original purpose--i.e., equalizing the availability of tax deferred retirement savings to those not covered by pension plans--the retention of the $1,500 and 15 percent limits would seem to be unnecessary and undesirable. Furthermore, the revenue cost of eliminating these restrictions is relatively small.

II. FULL CONFORMITY WITH FEDERAL LAW

A second alternative is to conform fully with the federal law--increasing the maximum contribution to $2,000 or 100 percent of compensation and permitting all persons with compensation to make deductible contributions. This alternative would, without other changes, reduce annual income tax revenues by approximately $74 million in calendar year 1985. A variation on this alternative would restructure the rate schedule in order to recoup the reduced revenue and to preserve the approximate current distribution of tax burdens across income levels.

Advantages

The major advantage of this approach is simplicity and understandability. It avoids the compliance problems associated with requiring taxpayers to add to adjusted gross income some or all of their IRA contributions. The Revenue Department's costs of administering and enforcing the IRA provisions would decline. The state's law and tax base would conform more closely to that of most other states (35 out of 41), minimizing the inequities imposed on interstate migrants. Furthermore, it would avoid the difficulties that are likely to arise with the exemption of a portion of IRA distributions--e.g., determining the exempt portion and coordinating this with the pension income exclusion.

Disadvantages

The major disadvantage of this approach is the substantial revenue cost and the narrowing of the tax base, requiring significantly higher tax rates to raise equivalent amounts of revenue. Through the exclusion of pension income, Minnesota largely exempts pension income from state taxation. Further expansions of the opportunities for tax deferred retirement savings--in effect the ability to convert current taxable income to future exempt pension income--has the potential to create a gaping hole in the tax base.[58] As the baby boom generation approaches the phase of the life cycle of peak savings and subsequently begins retiring, this may reach crisis proportions.

If compensating adjustments are not made in the rate schedule or other features, full conformity would shift the tax burden toward taxpayers with

[58] Note that, as discussed above in Part One, section II, the state has already relinquished a proportionately larger share of its future tax base by exempting the current income earned on individual retirement accounts.

relatively lower incomes.[59] This effect could be mitigated or eliminated by enacting compensating rate changes. Designing these changes will not be easy and inevitably the compensation will only be approximate and "on average." Rate restructuring can maintain the approximate distribution of tax burden across different income classes, but, of course, individual burdens will be shifted among taxpayers within each income class. Furthermore, compensating adjustments would need to be made at regular intervals in the future since the value or "cost" of IRA conformance is dynamic and will increase and the distribution of the benefit may shift as time passes. Some unintended consequences are likely to occur.

III. PARTIAL CONFORMITY--EXTEND NEW MAXIMUMS TO TAXPAYERS NOT COVERED BY PENSION PLANS

An alternative midway between preserving the status quo and full conformity would be to adopt the new federal maximum limits (the greater of $2,000 or 100 percent of compensation), but to continue requiring taxpayers covered by pension plans to add back their contributions. This approach would have a relatively modest revenue impact as compared with full conformity. In 1983, the Revenue Department estimated that this would reduce revenues by approximately $3 million annually.[60] The overall increase in estimated IRA participation rates since 1983 probably would increase this estimate to on the order of $5 to $6 million per year.

Advantages

This approach has the advantage of providing some simplification at a relatively low cost. Furthermore, it would increase the tax deferred savings opportunities for those who receive the fewest tax benefits under current law--i.e., those not covered by pension plans. This approach would also avoid the redistribution of tax burdens and the narrowing of the tax base that are inevitable under a full conformity approach.

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[59] Even if the legislature wishes to reduce annual income tax revenues by $74 million in adopting full IRA conformity, it will be necessary to restructure the tax, unless the the legislature wishes to shift the relative share of the tax burden toward lower income taxpayers. This restructuring could be done in a two step process. First, the rates could be increased and/or brackets restructured to recoup the revenue lost as a result of full conformity from approximately the same income levels that benefited from conformity. The second step would be to provide a proportional rate reduction in an amount sufficient to reduce revenues by $74 million annually.

[60] Research Office, Dep't. of Revenue, "Analysis of Proposal to update to the Federal Treatment of IRA's [sic] for Taxpayers Having No Other Pension Plan," (Ap. 29, 1983).

Disadvantages

This approach does not deal with the principal compliance and complexity problem with current law--i.e., the difficulties associated with (the taxpayer, tax preparer or Revenue Department) determining whether the taxpayer is a participant in a qualified plan, government pension or tax sheltered annuity. Furthermore, it does nothing to address or reduce future compliance and complexity problems that are likely to arise in the taxation of IRA distributions.

Other efforts to fine tune or equalize the availability of state qualified IRA contributions to participants in pension plans seem doomed to add high degrees of complexity. For example, it has been suggested that state qualifying IRA contributions be permitted to the extent that pension contributions on behalf of the employee were less than the IRA maximum. This is essentially a more liberalized version of that applicable to ESOPs described above in Part Two, section I-A. It is interesting to note that in 1978 the U.S. Senate considered and rejected a similar proposal because it would "necessarily result in substantial complexity and administrative problems for employers, employees, and the Internal Revenue Service."[61] Of course, implementation at the federal level would involve substantially less complexity than an equivalent state provision that deviates from the federal treatment. These same considerations support repeal of the special provision enacted in 1984 for ESOP participants.

IV. COMPLETE DECOUPLING WITH THE FEDERAL IRA LAW

A final alternative would be to divorce the state tax base from the federal IRA law completely--i.e., to require all IRA contributions to be added back to compute Minnesota gross income. This alternative could include the full current taxation of all income earned by IRA assets, as well as IRA contributions.

Advantages

This alternative has the advantage of preserving the tax base and permitting lower tax rates. It avoids the serious tax base gap problem of exempting additional forms of retirement savings in combination with the exemption of pension income.

Other than the option of full conformity, it comes the closest to satisfying the simplicity and understandability criterion. Taxpayers would know that all IRA contributions must be added back in computing Minnesota gross income. If the current income of IRA accounts is also taxed, this will greatly simplify the

[61] S. Rep. No. 1263, 95th Cong. 2d Sess. 88-89, reprinted in 1978 U.S.C.C.A.N. 6761, 6852-53.

taxation of IRA distributions since they could be simply exempted in total. If one's standard of equity is a comprehensive income tax base, this alternative also comes the closest of any of the alternatives of satisfying the equity criterion.

Disadvantages

This alternative involves some inevitable complexity problems. How will the income earned by IRA accounts be taxed? For example, will long term capital gains qualify for a 60 percent exclusion? Will dividends qualify for the $100/$200 exclusion if the taxpayer has not otherwise exhausted it? If the alternative does not provide for the taxation of the current income of IRA assets, the complexity and compliance problems that are likely to result from Minnesota's current system of taxing IRA distributions will remain. This alternative is likely to be very unpopular given the widespread use of IRAs. Also, it may be viewed as taking away the IRA benefit under current law of those who have the fewest retirement savings alternatives--employees who are not participants in pension plans. This alternative also exacerbates the problem of Minnesota deviating from the norm of IRA taxation in other states. It increases the potential for double taxation of the IRAs of interstate migrants.

CONCLUSION

With the 1981 expansion of IRAs Congress presented state tax policymakers with a classic dilemma: either (a) conform to federal law and accept a substantial narrowing of the state tax base to provide an economic incentive of dubious worth or (b) impose substantial additional complexity on state taxpayers and administrators. On the one hand, a narrower tax base implicitly leads to higher tax rates and greater variability of tax liabilities among taxpayers with comparable incomes. On the other hand, complexity results in higher costs of compliance, potentially lower compliance rates, less understanding and accountability, and greater inefficiency.

In 1982 the Legislature exempted the income earned by the new IRAs from state taxation, while refusing to adopt the new federal rules expanding the deduction for IRA contributions. This refusal was largely intended to avoid the large revenue loss (or the need to increase tax rates) as a result of conforming with the new contribution rules. In the near term, the exemption of income earned by IRA assets had a relatively small fiscal impact. However, in the long run this exemption constitutes a much larger loss of state tax base than the deductibility of contributions. The failure to conform to the new federal contribution rules resulted in substantial additional complexity for taxpayers making IRA contributions. Taxpayer compliance rates in 1982 were, as a result, low and the Department of Revenue needed to undertake a substantial enforcement/audit effort to insure that the state collected its legally owed tax revenues.

Congressional enactment of universal IRAs was justified as a means of stimulating increased retirement savings by individuals. As enacted, IRAs are, at best, a very blunt instrument for achieving this purpose--a flawed savings incentive grafted onto a tax structure that otherwise provides incentives for consumption, rather than saving. The IRA law provides tax reductions for substantial numbers of taxpayers who receive no incentive to increase their savings for retirement as a result: taxpayers who have the capacity to shift existing assets into IRAs, who use the IRA law to engage in tax arbitrage, and who already were annually saving amounts equal to or greater than the IRA maximum contribution. Insofar as state tax policy is concerned, the Legislature probably should not adopt the new federal IRA rules if its goal is to stimulate additional retirement savings.

However, a strong argument for partial or full adoption of the new federal IRA rules can be made on the grounds of simplicity. At best, the current rules are needlessly complex. At worst, failure to conform to federal law promises to present ever growing complexity and compliance problems as taxpayers receive IRA distributions which constitute a recovery of previously taxed contributions.

Adoption of the new federal IRA contribution rules would shift the relative state income tax burden toward lower income taxpayers generally. If the Legislature provides for conformance with the federal law, it should also modify the rate schedule or other features of the tax to offset this shift unless it wishes to effect such a redistribution of the relative tax burden. The adoption in 1982 of the exemption of IRA income without compensating changes had the effect of shifting the relative shares of the tax burden toward lower income taxpayers.

APPENDIX A

FILERS MAKING 1983 IRA CONTRIBUTIONS

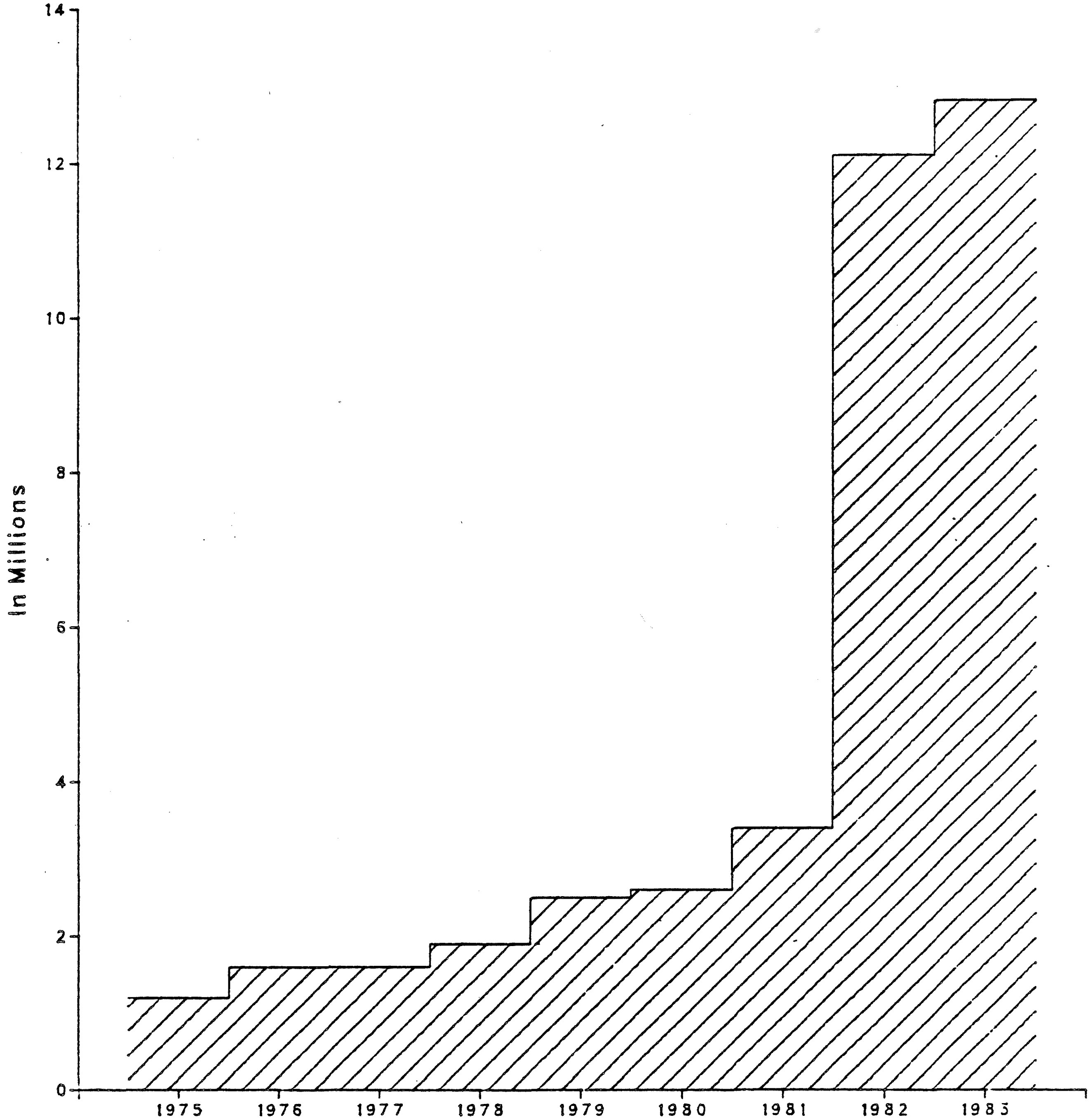
AGI Range	All Filers: Number*	All Filers: Pct. of Total	Filers Making IRA Contributions: Number*	Filers Making IRA Contributions: Pct. of Total	Filers Making IRA Contributions: Pct. of Filers**
Under $5,000	15,718	17.4%	200	1.6%	1.3%
$5,000 under $10,000	15,955	17.6	389	3.0	2.4
$10,000 under $15,000	13,046	14.4	786	6.1	6.0
$15,000 under $20,000	10,444	11.6	1,346	10.5	12.9
$20,000 under $30,000	16,284	18.0	2,753	21.5	16.9
$30,000 under $50,000	14,848	16.4	4,903	38.3	33.0
$50,000 under 100,000	3,457	4.8	2,035	15.9	58.9
$100,000 or more	657	0.7	390	3.0	59.4
TOTAL	90,407	100.0	12,802	100.0	14.2

*Expressed in thousands.

**Percentage of all filers within the AGI range with IRA contributions.

Source: Department of Treasury, Statistics of Income Bulletin (Summer, 1984).

FIGURE D
Taxpayers Making IRA Contributions



Data: Dept. of Treasury
<u>Statistics of Income Individual Income Tax Returns</u> (1975–83)
Graphics: Minnesota House of Representatives Research Department

APPENDIX B

GAIN FACTORS FOR IRA STATE CONFORMANCE

Interest Rate*	Term in Years: 2	5	10	15	20	25	30
4	1.03	1.04	1.06	1.07	1.08	1.10	1.10
6	1.03	1.05	1.07	1.09	1.10	1.11	1.12
8	1.03	1.06	1.08	1.10	1.12	1.13	1.13
10	1.04	1.06	1.10	1.11	1.13	1.13	1.14
12	1.04	1.07	1.10	1.12	1.13	1.14	1.14
14	1.05	1.08	1.11	1.13	1.14	1.14	1.14

*Assumes marginal state tax rate of 12.8%.

The gain factors in the table above and in Tables 6 and 7 contained in the text were calculated using the following formula:

$$(1) \qquad \frac{e^{in}}{(1-t)e^{in} + t}$$

where i is the interest rate earned on the account, n is the term of the investment in years, and t is the marginal state tax rate. The formula was derived, following an article by Robert Collins. R. Collins, Estimating the Benefits of Individual Retirement Accounts: A Simulation Approach, 14 J. of Consumer Affairs 122 (1980). As Collins points out the value of an IRA account, A_b, at the end of a term of investment before the tax on the distribution is:

$$(2) \qquad A_b = Xe^{in}$$

where the contribution was X. Id. at 123. (The antilog of the interest rate multiplied by the term calculates the interest on a continuous compounding basis. Gain factors would be smaller if interest is earned on a simple interest basis or compounded less frequently such as annually or semi-annually.)

The tax, T, on distribution of the IRA account (assuming a lump sum distribution fully subject to tax) is

(3) $$T = t_2Xe^{in}$$

where t_2 is the marginal rate at the time of distribution. Id. at 123-24. Thus the value of the account with full federal conformity after tax, A_a, is A_b less T or

(4) $$A_a = Xe^{in} - t_2Xe^{in}$$

or simplifying this expression algebraically

(5) $$A_a = (1-t_2)Xe^{in}.$$

The value of an IRA contribution which qualified under federal law, but not under state law, would be reduced by the state income tax that must be paid on the contribution at the time it is made. Thus, the value before the tax on the distribution, B_b, is

(6) $$B_b = (1 - t_1)Xe^{in}$$

where t_1 is the state marginal tax rate at the time the contribution is made. The tax, T, on the distribution would be

(7) $$T = t_2((1-t_1)Xe^{in} - (1-t_1)X)$$

where t_2 is the marginal tax rate at the time of distribution. The contributions originally made, $(1-t_1)X$, must be subtracted because originally taxed contributions are recovered tax free under state law. Thus the value of the account after the tax on the distribution (i.e., the interest component of the distribution), B_a, is

(8) $$B_a = (1-t_1)Xe^{in} - t_2((1-t_1)Xe^{in} - (1-t_1)X).$$

Following Collins, the gain factor is computed as the ratio of the A_a to B_a or

(9) $$\frac{(1-t_2)Xe^{in}}{(1-t_1)Xe^{in} - t_2((1-t_1)Xe^{in} - (1-t_1)X)}.$$

For purposes of computing the values in the tables, it was assumed that the marginal tax rate will be the same for contributions and distributions (i.e., $t_1 = t_2$). (Note that this may not be a reasonable assumption. It is commonly thought that retired persons have lower incomes and are thus subject to lower tax rates than during their working years. More importantly, under Minnesota law the exclusion or subtraction has an important effect. IRA distributions qualify for this subtraction and thus a distribution may be subject to tax at a marginal rate of 0. This would obviously increase the gain factor. However, the pension income exclusion is offset by adjusted gross income over $17,000 or by combined social security, railroad retirement, and adjusted gross income over $23,000, whichever is less. Thus, by deferring more current income to retirement, the taxpayer may be reducing the amount of his pension income that is excluded. This could yield effective marginal rates more than double the statutory rates, because an IRA distribution could (under certain circumstances) be fully subject to tax and result in an equivalent amount of other pension income being fully subject to tax which otherwise would have qualified under the pension exclusion.* For obvious reasons of simplicity, all of these complications were ignored and it was assumed that marginal rates did not change.)

Thus, by setting t_1 and t_2 equal the previous expression (9) can algebraically be simplified to yield the formula (1) used to calculate the gain factors contained in the tables.

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*Note that the federal income taxation of social security benefits will have a similar effect. Deferring income to retirement may result in the taxpayer paying tax on a larger portion of his social security benefits in some cases. This effect will not feed back into the state pension income exclusion, however, since all social security benefits are excluded in computing AGI.

APPENDIX C

SIMPLIFIED EMPLOYEE PENSIONS AND KEOGH (HR 10) PLANS

In addition to expanding the individual retirement account law in 1981, Congress increased the amount of deductible contributions to simplified employee pension plans (SEPs), a specialized form of IRAs, and Keogh or HR 10 plans. Although these two retirement programs are distinct from and serve somewhat different purposes than IRAs, the Legislature did not adopt conforming changes to state law. Instead, along with IRAs, it required SEP and Keogh contributions which did not qualify under prior federal law to be added to adjusted gross income in computing Minnesota gross income.[1] In 1982 Congress adopted additional changes to SEPs and Keogh Plans as part of the Tax Equity and Fiscal Responsibility Act of 1982, widening the extent of nonconformity between federal and state law.[2]

The reason for the Legislature's refusal to adopt the SEP and Keogh Plan amendments is not clear. In the past the Legislature has consistently conformed to the federal law adopting and modifying the Keogh and SEP plans' laws.[3] Unlike universal IRAs, the changes would have had only a relatively modest impact on state revenues--approximately $2 million per year according to Revenue Department estimates.[4] Thus, the refusal to conform would not seem to have been motivated by the overwhelming revenue considerations involved with the 1981 IRA changes, although any revenue loss is difficult to accept during times of tight budgets such as 1982.

This Appendix briefly outlines how the Keogh and SEP plans work, as well as the 1981 and 1982 federal changes in the law and their rationale. Secondly, it examines to what extent conforming to these federal changes involves different state tax policy questions from those involved with universal IRAs.

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[1] 1982 Minn. Laws, chap. 523, art. 40 §1, codified at Minn. Stat. §290.01(20a)(23) (1982).

[2] Tax Equity and Fiscal Responsibility Act of 1982, Pub.L. No. 97-248 §238, 96 Stat. 513 (1982).

[3] One exception to this was a one year delay in the effective date of state conformance to the increase in the contribution limits for Keogh Plans under ERISA. Compare Employment Retirement Security Act of 1974, Pub.L. No. 93-406 §2001(a) and (i) with 1975 Minn. Laws, chap. 349 §4 (effective for taxable years beginning after 12/31/74, while the federal increases were effective for tax year 1974). See Comm'r. of Revenue v. Richardson, 302 N.W.2d 23 (Minn. 1981). This may have been motivated by a desire to avoid requiring the filing of amended returns for tax year 1974, since the update legislation was not passed until 1975.

[4] Research Office, Minn. Dep't. of Revenue, Revenue Analysis Summary--Income Tax IRA Contributions (Ap. 13, 1983) (mimeo).

Keogh Plans

Keogh Plans are the form of qualified pension plan permitted to self-employed individuals. The plans may be structured as either defined contribution (the participant is entitled to the contributions made on his behalf and their investment earnings) or defined benefit plans (the participant is entitled to benefits calculated under a formula based on past compensation and time of service). Participation in and benefits under Keogh plans are subject to nondiscrimination rules. In other words, a self-employed person may not make Keogh contributions on his own behalf and not on behalf of his employees. (Certain minimum service and age requirements may be imposed, though.) Similarly, he may not contribute to the plan for himself or highly compensated employees at a higher percentage rate of his total compensation than for other employees. By contrast, contributions to IRAs are purely voluntary and are made by the employee.

Keogh Plans were initially authorized in 1962 under the Self-Employed Individuals Retirement Act of 1962. The contribution limits were 10 percent of earned income or $2,500. In 1974 ERISA increased the contribution limits to $7,500 and 15 percent of compensation. The maximum contribution was further increased to $15,000 in the Economic Recovery Tax Act of 1981 (ERTA). Finally, in 1982 with the passage of the Tax Equity and Fiscal Responsibility Act (TEFRA) the limits were increased to $30,000 and 25 percent of compensation. The increases enacted in 1982, however, were not effective until tax year 1984.

Simplified Employee Pension Plans

SEPs were authorized in the Revenue Act of 1978 as a mechanism for employers to provide pension benefits for their employees without the complexity of establishing and maintaining a regular qualified pension plan.[5] Under a SEP the employer makes contributions to an employee's IRA account. These contributions are included in the employee's gross income and are reported on the W-2 form, but the employee is permitted an IRA deduction in the amount of the contribution. The contribution limits are the same as those applicable to Keogh Plans. In 1978, contributions were authorized at 15 percent of earned income with a maximum of $7,500. In 1981, ERTA increased this to $15,000 and permitted the employee to make up to an additional regular $2,000 IRA contribution. In TEFRA, the maximums were increased to 25 percent and $30,000 (effective tax year 1984).

Since they use the mechanisms established under the IRA law, SEPs are closer in concept to IRAs than Keogh Plans are. For example, SEP contributions are made to the employee's IRA and SEP plans are defined contribution plans with

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[5] S. Rep. No. 1263, 95th Cong., 2d Sess., at 92, reprinted in 1978 U.S.C.C.A.N. 6761, at 6855.

immediate vesting of the rights of participants. However, in other more fundamental ways SEPs are more like an employer provided pension plan than an IRA. The contributions are not voluntary employee contributions like those made to an IRA, but rather are employer contributions. Nondiscrimination rules are imposed on participation in SEPs. All employees who are 25 years of age and have performed services for the employer in three out of the previous five calendar years must be included in the plan. I.R.C. §408(k)(2). Contributions may not discriminate in favor of shareholders, officers or highly compensated employees and must be a uniform percentage of compensation for all participants (but excluding annual compensation in excess of $200,000). I.R.C. §408(k)(3).

The 1981 and 1982 Federal Amendments and State Taxation of Keogh and SEP Plans

Prior to passage of the 1981 and especially the 1982 federal tax acts, the treatment of corporate pension plans was more favorable than that of the plans available to self-employed persons, S corporations, or employers using the SEP law. For example, in 1982 the maximum annual contribution to a corporate, defined benefit pension plan was 25 percent of compensation or $45,475, whichever was less. By contrast, Keogh and SEP plans were subject to 15 percent and $15,000 limits ($7,500 prior to passage of ERTA in 1981). Furthermore, the corporate maximum of $45,475 was indexed for inflation. In order both to raise additional revenue and to equalize this disparity, TEFRA made three major changes: (1) the corporate maximum was lowered to $30,000, (2) the Keogh and SEP maximum contributions were raised to 25 percent and $30,000, and (3) indexing of the maximums was stopped until 1986 and then applied uniformly to the maximums for all types of plans.

The 1982 state law which required the addition of IRA contributions permitted by the 1981 federal law in computing Minnesota gross income also provided similar treatment for expanded Keogh and SEP plan contributions. Minn. Stat. §290.01(20a)(25) (1982). The 1983 federal update legislation made a similar provision for TEFRA's expansion of the SEP and Keogh plan contribution limits. Minn. Stat. §290.01(20a)(19) (1983 Supp.).

Are the tax policy issues concerned with SEP and Keogh plans distinguishable and separate from those associated with universal IRAs? Several considerations suggest that they are and that the legislature should seriously consider adopting the new federal rules for these plans even if it determines not to conform to the federal IRA rules.

First of all, Keogh and SEP plans are similar to other types of qualified pension plans. The contributions are made by employers and the participation of employees in the plan and the contribution amounts are limited by anti-discrimination rules. Thus, unlike IRAs as discussed in the text of the paper, expanded Keogh and SEP contributions would seem to have greater potential for generating new retirement savings. The requirement of uniform participation by all employees reduces the potential for disproportionate participation by individuals who are already saving at or near the maximum or who have the capacity to shift assets. Furthermore, the anti-discrimination rules would seem to limit the problem that predominantly higher income employees will participate as with IRAs. Note, however, that both of these problems will exist to some extent with Keoghs and SEPs since they are plans of self-employed persons and small businesses with small numbers of employees (usually) for whom the nondiscrimination rules present a less significant restraint.

Secondly, the federal amendments were motivated, in large part, by the goal of establishing parity in the taxation of corporate pensions and those of self-employed individuals, S corporations or small employers who did not wish to or were unable to bear the cost and complexity of regular qualified plans. Under federal law and current Minnesota law, these employers or self-employed individuals could obtain equivalent (or more generous) tax benefits by incorporating. By the failure to adopt the new federal rules, the state maintains an incentive for these businesses to operate in the corporate form. There seems to be little value in encouraging employers to incorporate as a condition for obtaining more generous tax treatment of their pensions. Indeed, this would seem to be counterproductive since it requires businesses to spend additional sums on legal fees, accountants' services, and so forth, while it is not clear that there is any social value in having more businesses operate as corporations.

Aside from the incentive to operate in the corporate form, the complexity/simplicity considerations involved with SEP and Keogh plans are very similar to those involved with IRAs and need not be repeated.

One might argue that the federal changes in the contribution rules primarily benefit higher income individuals and should be rejected because they therefore will reduce the progressivity of the state tax. This is true of the 1981 change which raised the maximum and did not change the percentage rate. (As a result, only employees with annual compensation in excess of $50,000 would benefit.) However, the 1982 changes also increased the percentage rate from 15 to 25 percent and thus could affect the contributions made on behalf of lower income employees. The increase in the maximum contribution from $15,000 and the contribution base from $100,000 to $200,000 will benefit only taxpayers with annual wages or other compensations of more than $100,000. Two arguments could be made to mitigate this concern. First, the businesses could provide similar benefits by incorporating and if that is a concern the state should reassess the much more significant problem of the taxation of corporate pensions. Secondly, the higher benefits of establishing an SEP or Keogh Plan may induce some employers to establish plans for the first time and they will be required to provide benefits to all their employees, including those with lower wages, on a nondiscriminatory (proportionate) basis.

In conclusion, the Legislature should view the taxation of SEP and Keogh Plans as a matter similar to the issues involved with the taxation of qualified pension plans, rather than as a special type of IRA. There seems to be little, if any, justification for treating these plans differently from other types of employer provided pensions. The relatively low annual cost of $1.7 million would not seem to justify imposing significant additional complexity on the employers and participants in these plans under the current state tax treatment of these plans.

APPENDIX D

OTHER STATE'S TAX TREATMENT OF CONTRIBUTIONS TO IRAs

States Fully Conforming with Federal Law (35)

Alabama
Arizona
Arkansas
Colorado
Delaware

Hawaii
Idaho
Illinois
Indiana
Iowa

Kansas
Kentucky
Louisiana
Maine
Maryland

Michigan
Mississippi
Missouri
Montana
Nebraska

New Mexico
New York
North Carolina
North Dakota
Ohio

Oklahoma
Oregon
Rhode Island
South Carolina
Utah

Vermont
Virginia
West Virginia
Wisconsin
District of Columbia

States With No General Income Tax (10)

Alaska
Connecticut
Florida
Nevada
New Hampshire

South Dakota
Tennessee
Texas
Washington
Wyoming

States Taxing IRA Contributions Fully (3)

Massachusetts
New Jersey
Pennsylvania

States Conforming to 1981 Federal Law (3)

California
Georgia
Minnesota

Source: Survey Conducted by JoAnne Zoff Sellner, Senate Counsel and Research (November 19, 1983), supplemented and updated through the Prentice Hall All States Tax Guide.