Griswold v. Commissioner, 85 T. C. 869 (1985)

Borrowing against an individual retirement annuity results in immediate loss of its tax-favored status and requires inclusion of the annuity's fair market value in gross income.

Summary

In Griswold v. Commissioner, the Tax Court held that borrowing against an individual retirement annuity (IRA) leads to its disqualification as an IRA as of the first day of the taxable year in which the borrowing occurs. Kenneth Griswold borrowed against his IRA annuity, which had a fair market value of $6,866 on January 1, 1980. The court ruled that this borrowing triggered the annuity's immediate loss of IRA status and required the Griswolds to include the full value in their 1980 gross income, based on the clear language of IRC section 408(e)(3) and the legislative intent to prevent premature access to retirement funds.

Facts

Kenneth Griswold owned an annuity contract with John Hancock Mutual Life Insurance Co. , which qualified as an individual retirement annuity under IRC section 408(b). On July 1, 1980, Griswold borrowed against the loan value of the annuity. The fair market value of the annuity on January 1, 1980, was $6,866. Griswold repaid the loan by April 15, 1981, and later received the full balance of the annuity in July 1981, which he reinvested within 60 days.

Procedural History

The Commissioner determined a deficiency in the Griswolds' 1980 federal income tax, arguing that the borrowing disqualified the annuity as an IRA, requiring inclusion of its value in their gross income. The case was brought before the U. S. Tax Court, which issued its opinion on November 26, 1985.

Issue(s)

1. Whether Griswold's borrowing against the annuity contract during 1980 caused the contract to cease being an individual retirement annuity under IRC section 408(e)(3)?

2. Whether the Griswolds must include the fair market value of the annuity contract as of January 1, 1980, in their gross income for 1980?

Holding

1. Yes, because the borrowing was a disqualifying event under IRC section 408(e)(3) and its regulations, causing the annuity to lose its IRA status as of January 1, 1980.

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2. Yes, because IRC section 408(e)(3) requires the fair market value of the annuity as of the first day of the taxable year to be included in gross income when a borrowing occurs.

Court's Reasoning

The Tax Court applied the clear language of IRC section 408(e)(3) and the accompanying regulations, which state that borrowing under or by use of an individual retirement annuity disqualifies it as an IRA from the first day of the taxable year. The court noted that this rule serves the legislative purpose of preventing the premature use of retirement funds. The court rejected Griswold's reliance on a 60-day reinvestment rule under section 408(d), as it only applies to distributions from a valid IRA, not to a disqualified one. The court emphasized that the legislative history of ERISA, which introduced section 408, aimed to ensure that funds contributed to IRAs are used for retirement purposes, not accessed early through borrowing or other transactions.

Practical Implications

This decision underscores the strict prohibition against borrowing against individual retirement annuities. Tax practitioners must advise clients that any borrowing against an IRA annuity, regardless of the amount or the intent to repay, will trigger immediate taxation of the annuity's full value as of the year's start. This ruling influences how financial planners and taxpayers structure their retirement savings, emphasizing the need for alternative funding sources for short-term needs. It also affects insurance companies issuing IRA annuities, requiring them to clearly communicate the tax consequences of borrowing. Subsequent cases have consistently applied this principle, reinforcing the integrity of the IRA system as intended by Congress.

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