Griswold v. Commissioner, T.C. Memo. 1984-8 (1984)

Borrowing against an individual retirement annuity, even if the loan is repaid, causes the annuity to lose its status as an IRA as of the first day of the taxable year, triggering immediate taxation of the annuity's fair market value.

Summary

Kenneth Griswold borrowed against his individual retirement annuity (IRA) contract, relying on advice that repayment would negate tax consequences. The Tax Court held that under Internal Revenue Code (IRC) Section 408(e)(3), any borrowing against an IRA annuity causes it to cease being an IRA from the first day of the taxable year. Consequently, Griswold was required to include the annuity's fair market value in his gross income for the year of the borrowing, regardless of subsequent repayment or reinvestment. This case underscores the strict statutory prohibition against borrowing from IRA annuities.

Facts

Petitioner Kenneth Griswold owned an annuity contract with John Hancock Mutual Life Insurance Co. that qualified as an individual retirement annuity (IRA) under IRC Section 408(b). On July 1, 1980, Griswold borrowed against the loan value of this annuity, based on advice from a John Hancock representative that repayment would eliminate any tax consequences. He fully repaid the loan before April 15, 1981. In late June or early July 1981, Griswold received the entire balance of the annuity and reinvested it within 60 days. The IRS determined a deficiency, arguing that the borrowing in 1980 caused the annuity to cease being an IRA, making its fair market value taxable income for 1980.

Procedural History

The Commissioner of Internal Revenue determined a tax deficiency against petitioners Kenneth and Florine Griswold for the 1980 tax year. The Griswolds petitioned the Tax Court to contest this deficiency. The sole issue remaining after concessions was whether the borrowing against the annuity contract triggered tax consequences under Section 408(e)(3).

Issue(s)

1. Whether, under IRC Section 408(e)(3), petitioner's borrowing against his annuity contract in 1980 caused the contract to cease being an individual retirement annuity.
2. If the borrowing caused the annuity to cease being an IRA, whether the fair market value of the annuity as of January 1, 1980, must be included in petitioners' gross income for 1980.

Holding

1. Yes, because Section 408(e)(3) clearly states that if the owner of an IRA annuity borrows against it, “the contract ceases to be an individual retirement annuity as of the first day of such taxable year.”
2. Yes, because Section 408(e)(3) further mandates that the owner “shall include in gross income for such year an amount equal to the fair market value of such contract as of such first day.”

Court’s Reasoning

The Tax Court relied on the plain language of IRC Section 408(e)(3) and Treasury Regulation Section 1.408-3(c), which explicitly state that borrowing against an IRA annuity causes it to lose its IRA status from the first day of the taxable year and triggers immediate taxation. The court emphasized that the statute’s language is unambiguous and leaves no room for exceptions based on repayment or intent. The court quoted the House Ways and Means Committee report, stating, “If any prohibited borrowing occurs, (regardless of the amount involved) the contract is to lose its qualification as an individual retirement annuity as of the first day of the taxable year of the contract owner in which the borrowing occurs. In this case, the owner is to include in income for that year the fair market value…of the contract as of the first day of that year.”

The court further noted the legislative intent behind ERISA and Section 408, which was to encourage retirement savings and discourage transactions that circumvent this purpose. Borrowing against an IRA annuity, even temporarily, was identified as such a prohibited transaction because it allows pre-retirement access to retirement funds, undermining the statutory goal. The court dismissed the petitioner’s reliance on the annuity proceeds’ reinvestment, stating that once the borrowing occurred, the contract ceased to be an IRA as of January 1, 1980, and subsequent IRA-related provisions like rollovers were inapplicable.

Practical Implications

Griswold v. Commissioner establishes a strict rule: any borrowing against an IRA annuity, regardless of amount, duration, or intent to repay, will disqualify the annuity as an IRA from the first day of the taxable year of the borrowing. This decision serves as a stark warning to taxpayers and legal practitioners. It highlights the importance of understanding the specific prohibitions within retirement savings regulations. Legal advice concerning IRAs must unequivocally state that borrowing against an annuity will trigger immediate income tax consequences on the annuity’s full fair market value. This case is routinely cited by the IRS and in subsequent tax cases to enforce the no-borrowing rule for IRA annuities, reinforcing the principle that tax law in this area is strictly construed, even if based on erroneous advice from financial institutions.