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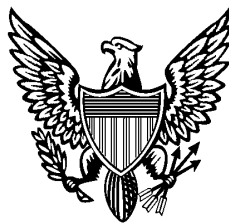
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Present Law and Analysis Relating to  
Individual Retirement Arrangements

**PRESENT LAW AND ANALYSIS  
RELATING TO  
INDIVIDUAL RETIREMENT ARRANGEMENTS**

Scheduled for a Public Hearing  
Before the  
SELECT REVENUE MEASURES SUBCOMMITTEE  
of the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on June 26, 2008

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



June 24, 2008  
JCX-53-08

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## INTRODUCTION

The House Committee on Ways and Means, Select Revenue Measures Subcommittee, has scheduled a public hearing to take place on June 26, 2008, on the role of individual retirement arrangements (“IRAs”) in our retirement system. The hearing is scheduled to focus on the recently issued report by the Government Accountability Office (GAO), entitled “Individual Retirement Accounts, Government Actions Could Encourage More Employers to Offer IRAs to Employees,” June 2008; the role of IRAs in our retirement system; and legislative proposals for automatic IRA enrollment. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, includes a description of present law and analysis relating to IRAs.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Retirement Arrangements* (JCX-53-08), June 24, 2008. This document can also be found on our website at [www.jct.gov](http://www.jct.gov).

## I. OVERVIEW

Individual retirement arrangements (“IRAs”) are tax-exempt accounts generally designed to help ensure adequate income for retirees. The IRA provisions attempt to meet this goal of retiree income assurance in two ways: (i) IRAs provide a vehicle to which employees can roll over employer-sponsored pension assets upon separation from service; and (ii) IRAs provide those without an employer-sponsored plan, or those who participate in an employer-sponsored plan that provides limited benefits, with a retirement savings opportunity. This pamphlet explores the role of IRAs as a vehicle for individual retirement savings.

IRAs play a significant role in retirement savings. For 2005, individuals contributed approximately \$57.4 billion to IRAs and rolled over \$231.3 billion into IRAs. At the end of 2005, approximately 51.5 million taxpayers held \$3.5 trillion in IRAs, based on fair market value.<sup>2</sup>

There are two basic types of IRAs under present law: traditional IRAs,<sup>3</sup> to which both deductible and nondeductible contributions may be made,<sup>4</sup> and Roth IRAs.<sup>5</sup> The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income. For a Roth IRA, all contributions are after-tax (no deduction is allowed) but, if certain requirements are satisfied, distributions are not includable in gross income. Both types of IRAs grant consumption tax treatment to retirement savings, and the two types are generally economically equivalent.

The Code does not limit an individual’s access to the funds in an IRA but generally imposes additional taxes if the individual withdraws the funds prematurely or delays withdrawal. In this way, the tax provisions are designed to funnel use of these funds toward retirement.

A number of proposals have been introduced to mandate (in some cases, to allow) automatic IRAs in the case of employers who do not sponsor retirement plans for their employees. Under such proposals, absent an election to opt out of the program, a certain percentage of an employee's compensation would be automatically deposited into that individual's IRA. Automatic IRA proposals have been advocated as means to increase retirement savings for low and middle income taxpayers.

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<sup>2</sup> These 2005 amounts are for all IRAs, including traditional IRAs, Roth IRAs, SIMPLE IRAs, and simplified employee pensions (SEPs).

<sup>3</sup> Sec. 408. Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>4</sup> Sec. 219.

<sup>5</sup> Sec. 408A.

## II. ECONOMICS OF IRAS

### IRAs and individual consumption taxation

#### In general

Tax policy experts often describe the U.S. individual income tax system as a hybrid of an income tax system and a consumption tax system. This assertion may appear counterintuitive, because an income tax and the best-known forms of consumption taxes (e.g., a sales tax or a value added tax (“VAT”)) at first glance seem to be very different. Economists, however, look to the underlying incidence (the parties on whom the burden of a tax actually comes to rest) and effect of different taxes, rather than their form. From this perspective, the substantive difference between an idealized income tax and an idealized consumption tax boils down to only one factor: an income tax, but not a consumption tax, burdens (taxes) income from savings – more specifically, the risk-free “return to waiting.”<sup>6</sup>

Because the purpose of saving is to fund future consumption, an idealized income tax imposes greater burdens on a taxpayer’s decision to defer consumption than does an idealized consumption tax. For this reason, some tax policy analysts assert that, at least in their pure form, income taxes distort the decision to invest current after-tax income rather than to spend it: current consumption bears one level of income tax, while deferred consumption bears two – current tax, only after payment of which are there savings to be invested, and tax on the time value of money (the return to waiting) while consumption is being deferred. Since by definition that time value of money is the market’s mechanism for compensating a taxpayer for his or her agreement to defer consumption, taxing the return to waiting discourages postponed consumption (*i.e.*, savings), compared to current consumption.<sup>7</sup>

IRAs, section 401(k) plans, qualified retirement plans, and other tax-advantaged forms of saving modify the tax treatment of saving that would apply in a pure income tax, by permitting taxpayers to defer income tax on substantial amounts of current income. As described below, in an income tax system, the deferral of income tax on income that is saved indirectly achieves substantially the same economic effects (that is, an exemption from tax on the normal return to

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<sup>6</sup> See Joseph Bankman and David Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 Stanford Law Review, 2005-2006. The difference between income taxes and consumption taxes can be seen by considering the classic Haig-Simons definition of income, which states that:  $\text{Income} = \text{Consumption} + \text{Change in Wealth}$ . A consumption tax, of course, imposes tax on only on the first term of the right-hand side of the equation (*i.e.*, consumption). The only difference then between a pure consumption tax and a pure income tax is the second term on the right-hand side of the equation. This term in turn comprises new investment (or withdrawals of previously-invested capital) and returns on capital, which is a way of saying that, in a pure income tax, savings come out of after-tax income (because new savings are included in the definition of “income”), and returns on those savings are taxed.

<sup>7</sup> The economics literature on the practical effect of income taxes on saving is briefly summarized later in this section.

saving) as a consumption tax.<sup>8</sup> The existence of IRAs and other tax-advantaged forms of saving is thus a principal reason why the U.S. individual income tax system is described as a hybrid of an income tax and a consumption tax.

There is voluminous literature on consumption taxation and the relative merits of consumption taxation versus income taxation.<sup>9</sup> Proponents of consumption taxation have argued its superiority to income taxation on various grounds, including that (1) it is better to tax what one takes from society (consumption) rather than one's contribution to society (income), (2) consumption is simpler to measure than income, (3) consumption is less variable than income and thus a better measure of an individual's lifetime well-being, and (4) consumption taxation does not tax the return to saving, and thus encourages saving, capital formation, and economic growth. Moving from an income tax to a consumption tax has drawbacks as well, including (1) the need for a higher nominal rate of tax to raise the same revenue (since consumption of current income usually is less than that income), (2) difficulties in making a consumption tax as progressive as an income tax, since the poor consume a larger share of their income immediately, and (3) many difficult transition issues in moving from an income tax system to a consumption tax, including whether and how to tax "old" capital that was created under an income tax system.

#### Cash flow approach to consumption taxation (deductible IRAs)

Because income equals the sum of consumption and changes to wealth, consumption represents income that is not saved. Accordingly, one way to tax consumption is to begin with income as the base but allow a full deduction for savings. This approach to consumption taxation is known as a "consumed income" tax, or a "cash-flow" tax. It is called a cash flow tax because it measures the tax base through cash-flow accounting: monetary income is included in the tax base, and monetary outflows to savings are deductible.

A cash-flow consumption tax is similar to the treatment of deductible IRAs under present law. Using deductible IRAs, taxpayers deduct contributions to qualified accounts in the year they make contributions, but upon withdrawal they include in income the entire amount withdrawn. A full cash-flow consumption tax treats all saving as if it were done in a qualified account. Furthermore, under a cash flow consumption tax there would be no requirement to hold the savings until retirement, nor any required distributions from the account in retirement. The

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<sup>8</sup> The general observation made in the text does not strictly apply to equity investments in taxable "C" corporations, because in that case there is an income tax imposed at the corporate level that is not deferred by the investor-level deferral rules for IRAs, or similar retirement plans. The extent to which the corporate income tax succeeds in taxing capital income is itself a controversial topic beyond the scope of this pamphlet.

<sup>9</sup> For an overview of some of the issues raised by consumption taxation, see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, 2<sup>nd</sup> ed., rev. Arlington VA: Tax Analysts, 1984; Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), June 5, 1995; Congressional Budget Office, *The Economic Effects of Comprehensive Tax Reform*, July 1997.

accounts would be subject to taxation whenever the account holder chose to withdraw funds for consumption for any purpose.

The effect of cash-flow treatment, as in a deductible IRA, is that the taxpayer receives a tax-free return on his savings, assuming the tax rate is the same at the time of deduction and withdrawal. Specifically, the taxpayer is able to defer consumption from one period to the next and earn the full pre-tax rate of return on the deferred consumption.

The following example illustrates how the cash-flow or deductible IRA approach (initial deduction plus inclusion of all proceeds) results in the exemption from tax of the return to saving. Assume that the marginal tax rate is 20 percent and the taxpayer saves \$1,000 of his income in a savings account. The \$1,000 of savings gives the taxpayer a \$1,000 deduction and thereby reduces the taxpayer's tax liability by \$200 (20 percent of \$1,000). Assume that the taxpayer withdraws the savings (plus interest) one year later. If the account yields a five percent rate of return, the taxpayer withdraws \$1,050. The withdrawal is included in the tax base and is taxed at the 20-percent rate, for an extra tax liability of \$210, leaving the taxpayer with net proceeds of \$840.

#### Tax prepayment approach to consumption taxation (Roth IRAs)

Another way to implement a consumption tax indirectly is to include in the base only earned income. Taxpayers claim no deduction for savings, but their returns to saving, whether in the form of interest, dividends, rents, royalties, or capital gains, are excluded from the base of the tax and thus are received tax-free. This “tax prepayment” approach<sup>10</sup> treats all savings as coming from after-tax dollars. In terms of the previous example, a taxpayer initially pays tax of \$200 on the \$1,000 he sets aside from current consumption. When he withdraws the \$840 in the following year (the \$800 he was able to put in the account plus a five-percent return), none of that is included in the tax base. This tax prepayment approach is similar to that provided under present law for Roth IRAs and to the individual portion of the of Hall-Rabushka flat tax<sup>11</sup> and the Bradford X-tax.<sup>12</sup>

#### Economic equivalence of deductible and Roth IRAs

The above examples showed the same economic result from saving in a Roth or a deductible IRA. In both examples the taxpayer was able to earn a rate of return on deferred consumption equal to the full pre-tax rate of return on saving. Specifically, in both cases \$800 of

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<sup>10</sup> This approach is sometimes described as a “yield exemption” approach.

<sup>11</sup> Robert E. Hall and Alvin Rabushka, *The Flat Tax*, Hoover Institution Press, Stanford, CA, 2<sup>nd</sup> ed. 1995.

<sup>12</sup> David F. Bradford, “A Tax System for the Twenty-First Century” in Alan J. Auerbach and Kevin A. Hassett (eds.), *Toward Fundamental Tax Reform*, AEI Press, Washington, D.C., 2005. See also David F. Bradford, *The X Tax in the World Economy*, AEI Press, Washington, D.C., 2004. See also David F. Bradford, *Untangling the Income Tax*, Harvard University Press, Cambridge, MA, 1986.

first period consumption was traded for \$840 in second period consumption. The combination of a deduction for saving and inclusion of all proceeds in the base upon withdrawal from the qualified savings account has the same result as exempting from tax the return on saving.<sup>13</sup>

Some caveats to this equivalence are warranted.<sup>14</sup> Whether a Roth IRA and a traditional IRA to which deductible contributions are made are in fact economically equivalent depends on there being no difference between the taxpayer's marginal tax rate in the year contributions are made and the marginal tax rate in the year IRA funds are withdrawn. If marginal rates were to decrease over time (because of a legislated reduction in tax rates or because taxpayers fall into lower tax brackets in retirement), a traditional IRA to which deductible contributions are made is more advantageous than a Roth IRA, because the traditional IRA permits taxpayers to defer payment of tax until rates are lower. When marginal tax rates increase over time, a Roth IRA is preferable because the income will be exempted from tax at a higher rate than the rate at which the forgone deduction would have been taken.

The economic equivalence of saving in a Roth IRA or a traditional deductible IRA does not mean that a dollar contributed to a Roth IRA is the economic equivalent of a dollar contributed to a deductible IRA. The reason is that a given dollar that is contributed to a Roth IRA represents an after-tax contribution, and therefore requires a greater reduction in current consumption (since the contribution is not deductible). As a result, an after-tax contribution (such as a Roth IRA) represents more saving than the same dollar contribution to a deductible IRA, which is made with pre-tax dollars. As the above examples showed, a taxpayer in the 20

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<sup>13</sup> This result is an analog of the "Cary Brown theorem," which holds that, assuming constant tax rates, permitting an immediate deduction for the cost of a marginal asset that ordinarily would be purchased with after-tax dollars is equivalent to exempting the yield from the asset from tax. Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen* 300 (1948). See also Joint Committee on Taxation, "*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II*", (JCX-63-07), September 4, 2007, at page 6 for a related discussion.

<sup>14</sup> In addition to the points made in the text, an after-tax contribution to a Roth IRA and a pre-tax (deductible) contribution to a traditional IRA theoretically could also produce divergent results when a taxpayer has the ability to earn systematically higher than normal returns (so-called economic rents), through possessing some unique asset or market position. In that case, the economic returns from exploiting that special situation would ultimately be taxed when the returns (above and beyond the normal returns from investment) were withdrawn from a traditional IRA, but not from a Roth IRA (because all returns from the latter are tax-exempt). This difference reflects the fact that, at least in theory, only normal returns are sheltered from tax, in the former case, while in the latter case, all returns are tax-free. This distinction is unlikely, however, to have any practical effect, because of the limitations imposed on the type of investment assets that an IRA may hold and the relatively small-scale investment that IRAs are designed to accommodate. Roth IRAs and other pre-paid forms of consumption tax, such as the Hall-Rabushka flat tax and the Bradford X-tax, which at the individual level are essentially a tax on wage income but not income from savings, all exempt above-normal returns from taxation. Point-of-sale consumption taxes, such as a national retail tax, or a value added tax like that common in much of the rest of the world, will exempt the normal return to saving from tax but capture tax on above-normal returns, similar to cash flow consumed income taxes or deductible IRAs.

percent tax bracket must reduce current consumption by \$1,000 to contribute \$1,000 to a Roth IRA, but only by \$800 to contribute \$1,000 to a deductible IRA, because the \$1,000 contribution reduces current tax liability by 20 percent of \$1,000, or \$200.

Present law, which caps the annual contribution to a Roth or a deductible IRA at the same amount of \$5,000 (for 2008), thus effectively sets a higher cap for the Roth IRA, thereby permitting greater amounts of tax-preferred saving to be done in the Roth IRA. For taxpayers not constrained by a cap, the proper economic comparison of the tax benefits of the two types of tax-favored saving for a taxpayer with a 20 percent marginal rate is the comparison of an 80 cent Roth IRA contribution for each dollar contribution to a deductible IRA because each requires the same reduction in current consumption.<sup>15</sup>

### **Practical effect of IRAs on saving**

Economists disagree as to whether IRAs and other tax-advantaged saving vehicles increase the level of national saving. In fact, economists disagree whether, in practice, an income tax discourages saving. At issue is the extent to which taxpayers change their saving in response to the net, after-tax return to their saving. Some studies have argued that one should expect substantial increases in saving from increases in the net return.<sup>16</sup> Other studies have argued that large behavioral responses to changes in the after-tax rate of return need not occur.<sup>17</sup> Empirical investigation of the responsiveness of personal saving to the taxation of investment earnings provides no conclusive results.<sup>18</sup> Some find personal saving responds strongly to increases in the net return to saving,<sup>19</sup> while others find little or a negative response.<sup>20</sup> Studies of

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<sup>15</sup> The equivalence is easily seen mathematically: the final after-tax value of the contribution to the deductible IRA is given by  $C * (1+r)^n * (1-t)$ , where  $C$  equals the contribution,  $r$  the annual rate of return,  $n$  the number of years the investment is held, and  $t$  the tax rate. The final after-tax value of the equivalent Roth IRA contribution is  $(1-t) * C * (1+r)^n$ . Note that  $(1-t) * C$  represents the reduced amount that can be contributed to the Roth IRA since tax must be paid first. The only difference in the two expressions is the location of the  $(1-t)$  term, and thus the expressions are mathematically equivalent when  $t$  is unchanged.

<sup>16</sup> Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, 71, September 1981.

<sup>17</sup> David A. Starrett, "Effects of Taxes on Saving," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, (Washington, D.C.: Brookings Institution), 1988.

<sup>18</sup> See Douglas W. Elmendorf, "The Effect of Interest-Rate Changes on Household Saving and Consumption: a Survey," *Finance and Economics Discussion Series*, 96-27, (Washington D.C.: Board of Governors of the Federal Reserve System), 1996.

<sup>19</sup> Michael Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, 86, April 1978.

<sup>20</sup> George von Furstenberg, "Saving," in Henry Aaron and Joseph Pechman (eds.), *How Taxes Affect Economic Behavior*, (Washington, D.C.: Brookings Institution), 1981.

retirement savings incentives follow a similar pattern, with some finding an increase in saving as a result of the incentives,<sup>21</sup> while others find little or no increase as retirement plan savings substitute for other saving.<sup>22</sup> With respect to the tax advantaged forms of saving, the revenue loss to the Federal government represents a decline in government saving, and thus must be accounted for to determine net national saving.

### **Federal tax revenue consequences of IRAs**

Just as Roth IRAs and deductible IRAs are economically identical (subject to the caveats discussed above) from the individual's perspective, so too are they economically identical (subject to the same caveats) from the perspective of the government, which is the other party to the transaction. From the government's point of view, the cash-flow approach makes it a partner in any saving done by the individual. In the examples above, the government forgoes the \$200 of tax at the time the saving is done and collects a tax of \$210 (equal to \$200 plus five-percent interest) at the time the proceeds of saving are withdrawn. The \$200 deduction for saving could be viewed as the government making a contribution to the purchase of the asset that the individual invests in. The size of the government share is equal to the marginal tax rate, in this example, 20 percent.

Because both types of IRAs are tax advantaged to the holder, both generate less revenue for the Federal government relative to income tax treatment of the same savings, and in practice exempt the same income from tax. The two types of IRAs have very different consequences, however, for the timing of Federal tax receipts. Because the Federal budget process does not rely on a measure of the present value of budget effects, but only looks at nominal changes in Federal receipts over the ten year budget window, the two types of IRAs look very different when viewed from this perspective. From the examples above, it is clear that the budget rules will overstate the present-value cost to the government of deductible IRAs, because the revenue loss of the deduction occurs immediately in the budget window, while much of the subsequent tax on withdrawals will occur outside the budget window and thus not be accounted for. In contrast, the cost of Roth IRAs will be understated, since there is no upfront deduction and much of the earnings will occur outside the budget window; the resulting exemption of those earnings from future tax will not be accounted for under the budget scorekeeping rules.

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<sup>21</sup> Daniel J. Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification", *Journal of Public Economics*, Volume 87, Issues 5-6, May 2003, pages 1259-1290; James M. Poterba, Steven F. Venti, and David A. Wise, "Do 401(k) Contributions Crowd Out Other Personal Saving?", *Journal of Public Economics*, Volume 58, Issue 1, September 1995, pages 1-32; James M. Poterba, Steven F. Venti, and David A. Wise, "How Retirement Saving Programs Increase Saving", *The Journal of Economic Perspectives*, Vol. 10, No. 4 (Autumn, 1996), pages 91-112.

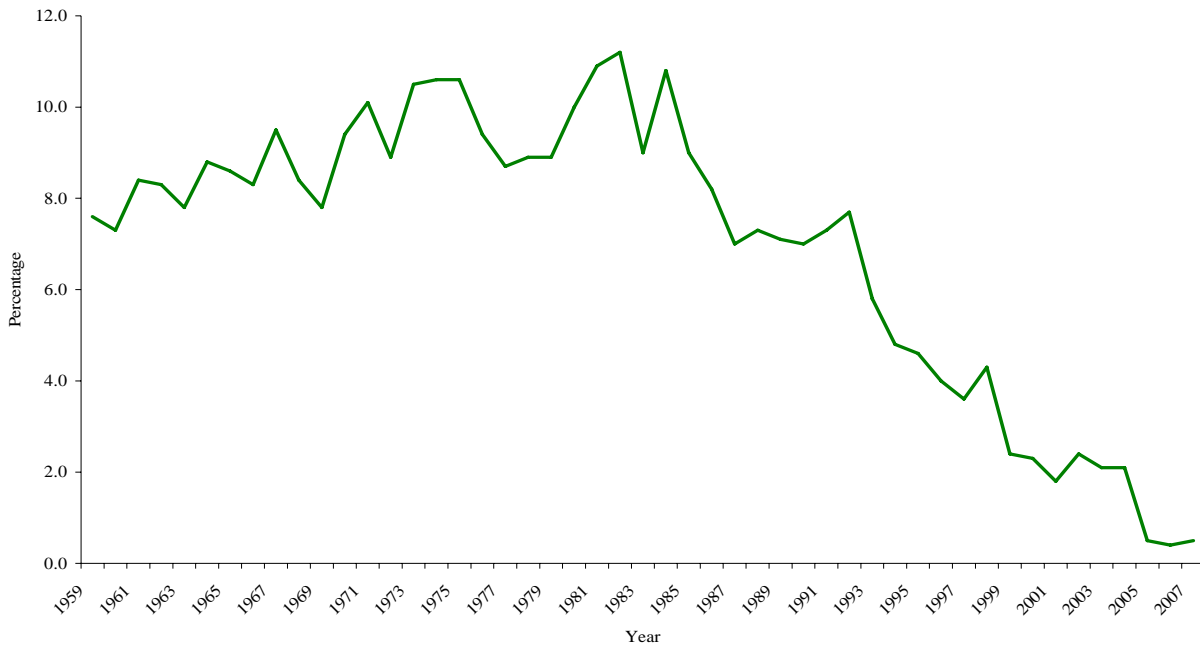
<sup>22</sup> Karen M. Pence, "401(k)s and Household Saving: New Evidence from the Survey of Consumer Finances" (December 2001), FEDS Working Paper No. 2002-06; William G. Gale and John Karl Scholz, "IRAs and Household Saving," *The American Economic Review*, Vol. 84, No. 5 (Dec., 1994), pages 1233-1260.

Thus, current budget scorekeeping rules make it easier to expand the use of Roth IRAs as compared to deductible IRAs. Furthermore, the conversion of deductible IRAs into Roth IRAs will raise revenue within the budget window, even when the Federal government’s true revenue position is unchanged when valued on a present value basis. Accordingly, tax provisions that liberalize the ability to convert existing deductible IRAs (and pay tax) to Roth IRAs are scored as raising revenue within the budget window. Such a provision was enacted in Tax Increase and Prevention Reconciliation Act of 2005, by removing the income limits for conversion of deductible IRAs to Roth IRAs for conversions occurring after December 31, 2009. The removal of the income limits for conversions from traditional to Roth IRAs also effectively removes the income limit for *contributions* to Roth IRAs, because a taxpayer can contribute to a traditional IRA, which has no maximum income limitations, and immediately convert the funds into a Roth IRA.

**Data related to saving and IRAs**

The U.S. saving rate has declined steadily over recent decades, as shown in Figure 1.<sup>23</sup> The personal savings rate averaged about nine percent during the 1960s, 1970s, and 1980s.

**Figure 1.—Personal Saving as a Percentage of Disposable Personal Income, Selected Years, 1959-2007**



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

<sup>23</sup> The personal saving rate equals personal income less current taxes and personal outlays. As such, it does not measure the change in asset values as either income or saving. During periods of rising asset values, a broader measure of saving would show higher savings rates.

Beginning in the early 1990s, the personal savings rate began a steady decline. Since 2005, the personal savings rate has averaged only one-half of one percent.

IRAs and other retirement saving vehicles are an important element of U.S. personal savings. Table 1, below, shows annual contributions and rollover data for recent years. In 2005, \$15.8 billion was contributed to traditional IRAs, and \$18.6 was contributed to Roth IRAs.<sup>24</sup> Amounts rolled over from previously saved funds in employer plans – over \$231.3 billion in 2005 – dwarf the annual contributions to IRAs. Tables 2 and 3 show the distribution of taxpayer contributions to traditional and Roth IRAs by income class and by age. Table 4 shows the contributions to IRAs by taxpayer filing status. Though there are only about 54 percent more married taxpayers than single and head of household taxpayers, they contribute about 159 percent more than the single and head of household filers. Some of this differential likely reflects the greater average age of married filers as well as their higher average income.

**Table 1.—Annual Contributions and Rollover Data**  
(Billions of Dollars)

Tax Year	Contributions				Roth Conversions	Rollover Contributions
	Traditional IRAs	Roth IRAs	SEP Plans	SIMPLE Plans		
2001	9.2	11.0	10.1	5.5	3.1	187.8
2002	12.4	13.2	10.3	6.3	3.3	204.4
2003	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
2004	12.6	14.7	13.8	7.6	2.8	214.9
2005	15.6	18.6	14.6	8.6	2.6	231.3

Source: Statistics of Income Bulletin (2001-2004) and Joint Committee on Taxation staff calculations (2005).

<sup>24</sup> An additional \$14.6 billion was contributed to SEP plans and \$8.6 billion to SIMPLE plans.

**Table 2.—Contributions to Traditional and Roth IRAs for Primary  
and Secondary Taxpayers by AGI, Tax Year 2005**  
(Millions of Dollars)

<b>Adjustment Gross Income</b>	<b>Traditional IRAs</b>		<b>Roth IRAs</b>	
	<b>Number</b>	<b>Amount</b>	<b>Number</b>	<b>Amount</b>
Less than Zero.....	35	84	48	118
\$0 to \$10,000 .....	126	253	312	712
\$10,000 to \$20,000 .....	304	710	357	747
\$20,000 to \$30,000 .....	441	1,019	432	918
\$30,000 to \$40,000 .....	465	1,879	487	1,094
\$40,000 to \$50,000 .....	518	1,389	609	1,485
\$50,000 to \$75,000 .....	984	2,679	1,448	3,819
\$75,000 to \$100,000 .....	669	1,942	1,340	3,859
\$100,000 to \$200,000 .....	1,079	3,522	1,651	5,067
\$200,000 and over.....	713	2,707	97	299
<b>Total .....</b>	<b>5,334</b>	<b>15,495</b>	<b>6,783</b>	<b>18,120</b>

Source: Joint Committee on Taxation staff calculations.

**Table 3.—Contributions to Traditional and Roth IRAs for Primary  
and Secondary Taxpayers by Age, Tax Year 2005**  
(Millions of Dollars)

Age of Contributor	Traditional IRAs		Roth IRAs	
	Number	Amount	Number	Amount
Less than Age 30.....	272	524	1,171	2,588
Age 30 to 39.....	710	1,771	1,603	3,714
Age 40 to 49.....	1,357	3,605	1,690	4,228
Age 50 to 54.....	927	2,806	922	2,876
Age 55 to 59.....	898	2,902	781	2,622
Age 60 to 64.....	732	2,450	375	1,284
Age 65 and Above .....	429	1,407	218	771
Not Available .....	9	29	11	38
<b>Total .....</b>	<b>5,334</b>	<b>15,495</b>	<b>6,783</b>	<b>18,120</b>

Source: Joint Committee on Taxation staff calculations.

At the end of 2005, over \$3 trillion was held in traditional IRAs in 40.4 million accounts; \$157 billion was held in Roth IRAs in 13.8 million accounts. While contributions to Roth IRAs have outpaced those of traditional IRAs in recent years, the larger balances in traditional IRAs reflect their longer period of existence as well as the effect of rollovers from employer plans. Tables 5 and 6 show the total 2005 fair market value of IRAs, SEP, and SIMPLE plans, by income class and age.

Statistics such as those shown in Table 2 and Table 5 are often cited by critics of tax-favored savings arrangements.<sup>25</sup> These critics also observe that IRAs are used primarily by higher income taxpayers who would save for retirement with or without a tax subsidy and that these taxpayers may be simply moving existing savings into tax favored accounts. IRS data show that participation rates for those eligible to contribute to IRAs is close to 30 percent for taxpayers with AGI in excess of \$200,000, while it is below 10 percent for those with AGI less

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<sup>25</sup> See, for example, William G. Gale, Mark Iwry, and Peter Orszag, “Improving Tax Incentives for Low-Income Savers: The Savings Credit,” Urban Institute Discussion Paper No 22, page 1 (June 2005).

than \$40,000.<sup>26</sup> As a result of these observations, some believe that IRAs have not been very effective in increasing retirement savings by low income taxpayers.

**Table 4.—Contributions to Traditional and Roth IRAs for Primary and Secondary Taxpayers by Filing Status, Tax Year 2005**

Filing Status	Total Number of Primary and Secondary Taxpayers	Traditional IRAs		Roth IRAs	
		Number	Amount	Number	Amount
Single .....	49,656	1,156	3,079	1,974	5,201
Married.....	107,559	3,919	11,909	4,506	12,330
Head of Household .....	19,985	258	508	302	588
<b>Total .....</b>	<b>177,199</b>	<b>5,334</b>	<b>15,495</b>	<b>6,783</b>	<b>18,120</b>

Source: Joint Committee on Taxation staff calculations. Excludes dependent filers.

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<sup>26</sup> Victoria Bryant, "Accumulation and Distribution of Individual Retirement Arrangements, 2004," Statistics of Income Bulletin, Spring 2008.

**Table 5.—Fair Market Value of Selected Retirement Accounts  
for Primary and Secondary End of Year 2005**

Adjustment Gross Income, 2005	Traditional IRAs		Roth IRAs		SEP		SIMPLE	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Less than Zero.....	388	23,923	126	2,615	56	3,174	23	642
\$0 to \$10,000 .....	1,632	64,891	599	4,616	106	1,964	66	616
\$10,000 to \$20,000 .....	3,204	163,664	748	6,401	167	4,011	173	1,185
\$20,000 to \$30,000 .....	3,267	166,545	911	8,854	192	5,031	280	2,126
\$30,000 to \$40,000 .....	3,221	164,326	969	8,534	233	6,751	280	3,854
\$40,000 to \$50,000 .....	3,203	180,255	1,180	11,004	252	8,278	288	3,236
\$50,000 to \$75,000 .....	7,618	482,502	2,841	31,884	629	20,097	615	8,450
\$75,000 to \$100,000 .....	5,817	457,516	2,425	30,044	585	25,713	429	7,839
\$100,000 to \$200,000 .....	8,254	753,446	3,443	44,351	968	64,293	522	14,962
\$200,000 and Over.....	3,751	625,955	573	8,730	597	93,149	247	11,719
<b>Total .....</b>	<b>40,355</b>	<b>3,083,024</b>	<b>13,814</b>	<b>157,032</b>	<b>3,787</b>	<b>232,460</b>	<b>2,924</b>	<b>54,630</b>

Source: Joint Committee on Taxation staff calculations.

**Table 6.—Fair Market Value of Traditional and Roth IRAs for Primary  
and Secondary Taxpayers by Age, End of Year 2005**

<b>Age of Contributor</b>	<b>Traditional IRAs</b>		<b>Roth IRAs</b>	
	<b>Number</b>	<b>Amount</b>	<b>Number</b>	<b>Amount</b>
Less than Age 30.....	956	6,405	1,813	10,414
Age 30 to 39.....	4,317	80,895	3,144	25,201
Age 40 to 49.....	8,548	345,375	3,532	37,059
Age 50 to 54.....	5,361	322,086	1,784	22,349
Age 55 to 59.....	5,494	475,928	1,669	21,403
Age 60 to 64.....	4,808	539,700	996	16,422
Age 65 and Above .....	10,813	1,310,432	852	23,996
Not Available .....	58	2,203	23	188
<b>Total .....</b>	<b>40,355</b>	<b>3,083,024</b>	<b>13,814</b>	<b>157,032</b>

Source: Joint Committee on Taxation staff calculations.

### III. PRESENT LAW AND ADDITIONAL ISSUES

#### A. Individual Retirement Arrangements

##### 1. Tax treatment of contributions

###### Limits

###### In general

The annual contribution limits for IRAs constrain the level of savings in IRAs, and therefore the amount of savings for which a taxpayer can use this vehicle to opt into consumption tax treatment. The contribution limits for IRAs are coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth IRAs) for a taxable year is the lesser of a certain dollar amount (\$5,000 for 2008) or the individual's compensation.<sup>27</sup> As described earlier, the economic effect of imposing the same contribution limits on traditional and Roth IRAs actually is to offer Roth IRA participants a higher limit than traditional IRAs offer. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by \$1,000. Thus for example, if an individual over age 50 contributes \$6,000 to a Roth IRA for 2008 (\$5,000 plus \$1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for the year. In addition, deductible contributions to traditional IRAs and after tax contributions to Roth IRAs generally are subject to adjusted gross income limits as well. IRA contributions generally must be made in cash.

###### Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. In the case of an individual who is an active participant in an employer-sponsored plan, the adjusted gross income phase-out ranges for 2008 are: (1) for single taxpayers, \$53,000 to \$63,000; (2) for married taxpayers filing joint returns, \$85,000 to \$105,000; and (3) for married taxpayers filing separate returns, \$0 to \$10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with adjusted gross income for 2008 between \$159,000 and \$169,000.

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<sup>27</sup> The dollar limit is indexed.

To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible contributions to a traditional IRA, subject to the same limits as deductible contributions, including catch-up contributions. An individual who has attained age 70-½ prior to the close of a year is not permitted to make contributions to a traditional IRA.

### Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. The adjusted gross income phaseout ranges for 2008 are: (1) for single taxpayers, \$101,000 to \$116,000; (2) for married taxpayers filing joint returns, \$159,000 to \$169,000; and (3) for married taxpayers filing separate returns, \$0 to \$10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70-½.

### Separation of traditional and Roth IRA accounts

Contributions to traditional IRAs and to Roth IRAs must be kept in completely separate IRAs, meaning arrangements with a separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a recharacterization or a conversion, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers (except for married taxpayers filing separate returns) with modified adjusted gross income of \$100,000 or less generally may convert a traditional IRA into a Roth IRA. Under the Tax Increase Prevention and Reconciliation Act of 2005,<sup>28</sup> the \$100,000 limit is repealed for taxable years beginning after December 31, 2009. This change will effectively eliminate the gross income limits for Roth IRA contributions. Any taxpayer will be able to make a nondeductible contribution to a traditional IRA and then immediately convert that amount to a Roth contribution.

The amount converted is includible in income as if a withdrawal had been made,<sup>29</sup> except that the early distributions tax (discussed later) does not apply. However, the early distribution tax is recouped if the taxpayer withdraws the amount within five years of the conversion.

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (in a trustee-to-trustee transfer) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date for the individual's income tax return for that year.<sup>30</sup> In that case, the contribution will be treated

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<sup>28</sup> Pub. L. No. 109-222.

<sup>29</sup> A special rule is provided in the case of a rollover in 2010. In such case, unless the taxpayer elects otherwise, the amount includible in income as a result of the conversion is included in income ratably in 2011 and 2012.

<sup>30</sup> Sec. 408A(d)(6).

as having been made to the transferee plan (and not the transferor plan). The amount transferred must be accompanied by any net income allocable to the contribution and no deduction is allowed with respect to the contribution to the transferor plan. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA. However, Treasury regulations limit the number of times a contribution for a taxable year may be recharacterized.<sup>31</sup>

### **Excise tax on excess contributions**

To the extent that contributions to an IRA exceed the contribution limits, the individual is subject to an excise tax equal to six percent of the excess amount.<sup>32</sup> This excise tax generally applies each year until the excess amount is distributed. Any amount contributed for a taxable year that is distributed with allocable income by the due date for the taxpayer's return for the year will be treated as though not contributed for the year. In order to receive this treatment, the taxpayer must not have claimed a deduction for the amount of the distributed contribution.

### **Rollovers**

The largest source of contributions to IRAs is tax-free rollover contributions from employer sponsored retirement plans.<sup>33</sup> Under present law, a distribution from a tax qualified retirement plan, an employee retirement annuity ("section 403(a) annuity"), a tax-sheltered annuity ("section 403(b) annuity"), an eligible deferred compensation plan of a State or local government employer (a "governmental section 457(b) plan"), or an IRA generally is included in income for the year distributed. However, eligible rollover distributions may be rolled over tax free to another plan, annuity, or IRA. This is accomplished by a direct rollover (direct payment to the other plan, annuity, or IRA) or by contributing the amount within 60 days.<sup>34</sup>

In general, an eligible rollover distribution includes any distribution to the plan participant or IRA owner other than certain periodic distributions, minimum required distributions, and distributions made on account of hardship.<sup>35</sup> Distributions to a participant from a qualified retirement plan, an employee retirement annuity, a tax-sheltered annuity, or a

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<sup>31</sup> Treas. Reg. sec. 1.408A-6.

<sup>32</sup> Sec. 4973(b) and (f).

<sup>33</sup> See Table 1.

<sup>34</sup> The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual. Sec. 402(c)(3)(B).

<sup>35</sup> Sec. 402(c)(4). Certain other distributions also are not eligible rollover distributions, e.g., corrective distributions of elective deferrals in excess of the elective deferral limits and loans that are treated as deemed distributions.

governmental section 457(b) plan generally can be rolled over to any of such plans or an IRA.<sup>36</sup> Similarly, distributions from an IRA to the IRA owner generally are permitted to be rolled over into a qualified retirement plan, an employee retirement annuity, a tax-sheltered annuity, a governmental section 457(b) plan, or another IRA.

Similar rollovers are permitted in the case of a distribution to the surviving spouse of the plan participant or IRA owner. Nonspouse beneficiaries are only permitted to make a tax-free rollover contribution by a direct rollover to an IRA.<sup>37</sup>

## **2. Investment, regulation and protection of IRA funds**

### **In general**

An IRA can be a trust, a custodial account, or an annuity contract. The rules for trusts and custodial accounts are slightly different from the rules for annuity contracts. Unless maintained in connection with an employer-sponsored retirement plan,<sup>38</sup> an IRA is not an employee pension benefit plan subject to the Employee Retirement Income Security Act of 1974 (“ERISA”).<sup>39</sup> Thus, an IRA holder generally does not have ERISA protection in the case of fiduciary misconduct<sup>40</sup> but, because ERISA preemption does not apply, an IRA is subject to any state law protections that may apply.<sup>41</sup> The Code does provide some rules for IRA trustees (and custodians) and annuity issuers, and provides some rules regarding the investment of IRAs, that

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<sup>36</sup> Some restrictions or special rules may apply to certain distributions. For example, after-tax amounts distributed from a plan can be rolled over only to a plan of the same type or to an IRA.

<sup>37</sup> Sec. 402(c)(11).

<sup>38</sup> SEPs and Simple IRA plans are types of tax qualified employer retirement plans where contributions are made to IRAs.

<sup>39</sup> Labor Reg. sec. 2510.3-2(d).

<sup>40</sup> ERISA contains general fiduciary duty standards for fiduciaries of ERISA pension plans that apply to all fiduciary actions, including investment decisions, and imposes personal liability on the fiduciary to make the plan whole for any breach. ERISA requires that a plan fiduciary generally must discharge its duties solely in the interests of participants and beneficiaries and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. ERISA provides a special rule in the case of a defined contribution plan that permits participants to exercise control over the assets in their individual accounts. Under the special rule, if a participant exercises control over the assets in his or her account (as determined under regulations), the participant is not deemed to be a fiduciary by reason of such exercise and no person who is otherwise a fiduciary is liable for any loss, or by reason of any breach, that results from the participant’s exercise of control.

<sup>41</sup> Subject to several exceptions, section 514 of ERISA provides that the provisions of ERISA supersede any and all State laws that relate to any employee benefit plan that is subject to ERISA. As noted in the text, an IRA is generally not treated as an employee benefit plan for purposes of ERISA.

are designed to protect IRA holders. Under these rules, an IRA trust instrument, custodial account, or annuity contract must provide that the individual's interest in the IRA is nonforfeitable. Additionally, the Code requires that the trustee or custodian of an IRA must be a bank (which is generally subject to Federal or State supervision) or an IRS approved nonbank trustee, and an annuity contract must be issued by an insurance company (which is subject to State supervision). Furthermore, IRAs are subject to the Code's prohibited transaction rules (described below).

The remaining rules applicable to IRA investments are designed less for the protection of investors and more to prevent misuse of the accounts by IRA owners. For example, to prevent the IRA owner from investing in personal items, such as art work, an IRA is not permitted to invest in coins or other collectibles.<sup>42</sup> In addition, an IRA trust or custodial account cannot be used as security for a loan,<sup>43</sup> and an IRA annuity contract holder cannot borrow from the contract.<sup>44</sup> Finally, if an IRA owner engages in a prohibited transaction with respect to the IRA, the account or annuity ceases to be an IRA.

### **Rules for approved nonbank trustees**

In order for a trustee or custodian that is not a bank to be an IRA trustee or custodian, the entity must apply to the IRS for approval. The Treasury Regulations list a number of factors that are taken into account in approving an applicant to be a nonbank trustee.<sup>45</sup> The applicant must demonstrate fiduciary ability (ability to act within accepted rules of fiduciary conduct including continuity and diversity of ownership), capacity to account (experience and competence with other activities normally associated with handling of retirement funds), and ability to satisfy other rules of fiduciary conduct which includes a net worth requirement. Because it is an objective requirement that may be difficult for some applicants to satisfy, the net worth requirement is the most significant of the requirements for nonbank trustees.

To be approved, the entity must have a net worth of at least \$250,000 at the time of the application. There is a maintenance rule that varies depending on whether the trustee is an active trustee or a passive trustee and that includes minimum dollar amounts and minimum amounts as a percentage of assets held in fiduciary accounts. A special rule is provided for nonbank trustees that are members of the Security Investor Protection Corporation (SIPC).

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<sup>42</sup> Sec. 408(m).

<sup>43</sup> Sec. 408(e)(4).

<sup>44</sup> Sec. 408(e)(3).

<sup>45</sup> Treas. Reg. sec. 1.408-2(e).

## **Prohibited transactions**

The Code prohibits certain transactions between certain tax-preferred retirement plans and a disqualified person.<sup>46</sup> Traditional and Roth IRAs are subject to these prohibited transaction rules.<sup>47</sup>

Prohibited transactions include certain direct or indirect transactions between a plan and a disqualified person:<sup>48</sup> (1) the sale, exchange, or leasing of property; (2) the lending of money or other extension of credit; and (3) the furnishing of goods, services or facilities. Prohibited transactions also include any direct or indirect: (1) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the plan; (2) in the case of a fiduciary, an act that deals with the plan's income or assets for the fiduciary's own interest or account; and (3) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Under the Code, if a prohibited transaction occurs, the disqualified person generally is subject to a two-tier excise tax.<sup>49</sup> The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved. The term "amount involved" generally means the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received.<sup>50</sup> A special rule applies, however, to IRAs, under which the IRA owner and beneficiaries are exempt from the two tiered tax. Instead, if these individuals engage in a prohibited transaction, the accounts cease to be an IRA and the entire account is treated as distributed.<sup>51</sup>

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<sup>46</sup> Sec. 4975.

<sup>47</sup> The prohibited transaction rules under the Code also apply to other tax-favored savings vehicles, including qualified retirement plans, health savings accounts (sec. 223), medical savings accounts (sec. 220), and Coverdell education savings accounts (sec. 530). Under ERISA, similar prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. In general, IRAs are not subject to ERISA. The prohibited transaction rules under the Code and ERISA do not apply to governmental plans or church plans.

<sup>48</sup> In general, "disqualified person" includes: (1) a fiduciary; and (2) a person providing services to the plan. An IRA owner with authority to control the investment of the assets in the IRA (a "self-directed IRA") is a fiduciary, and therefore, a disqualified person under the prohibited transactions rules.

<sup>49</sup> Sec. 4975(a)-(b).

<sup>50</sup> Sec. 4975(f)(4).

<sup>51</sup> Sec. 4975(b)(3) and sec. 408(e)(2).

## **Claims of creditors and treatment of IRAs in bankruptcy**

In general, Federal law provides little protection for an IRA owner with respect to judgment creditors of the owner. This is in contrast to the protections that are provided in the case of an employer sponsored retirement plan that is subject to ERISA. Section 206(d) of ERISA provides broad protection for employer sponsored retirement plans by providing that the benefits provided under the plan generally may not be assigned or alienated. The U.S. Bankruptcy Code provides some relief in the case of a debtor who owns an IRA in that the IRA may be exempted from inclusion in the debtor's bankruptcy estate.<sup>52</sup> The exemption is generally subject to an indexed dollar limit (\$1,095,000 for cases commencing on or after April 1, 2007).<sup>53</sup>

### **3. Tax treatment of distributions**

#### **Rules for determining amount includible in gross income**

##### Traditional IRAs

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent that the withdrawal is a return of the individual's basis in contract in the form of nondeductible contributions or rolled over after tax employee contributions. All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs. The portion of the individual's basis that is recovered with any distribution is the same ratio as the amount of the aggregate basis in all the individual's traditional accounts to the amount of the individual's aggregate account balances in all traditional IRAs.

##### Roth IRAs

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-½, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. All Roth IRAs are treated as a single contract for purposes of determining the amount that is a return of contributions. To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions; (2) conversion contributions (on a first in, first out basis); and (3) earnings. To the extent a distribution is treated as made from a

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<sup>52</sup> See 11 U.S.C. sec. 522.

<sup>53</sup> 11 U.S.C. sec. 522(n). In applying the limit to a debtor's IRA, amounts attributable to rollover contributions from employer sponsored qualified retirement plans are disregarded. In addition, IRAs that are attributable to SEPs and SIMPLE plans are also disregarded. The Bankruptcy Code provides that the exemption limit for IRAs may be increased if the "interests of justice so require." 11 U.S.C. sec. 522(n).

conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion.

## **Early and late distribution taxes**

### **In general**

Unlike section 401(k) plans and other employer-provided tax deferred savings,<sup>54</sup> there are no limitations under the Code on an individual's access to IRA funds before retirement. Absent any contractual agreement with the financial institution holding the IRA assets limiting access or a lack of liquidity in the IRA assets, an IRA owner can withdraw from the IRA at any time. This pre-retirement access contrasts with the policy for the special tax treatment for IRAs, which is to prevent retirement savings from being burdened by income tax before the funds are used for retirement. The Code contains an early distribution tax and required minimum distribution rules that seek to ensure that IRA assets are used for retirement.

### **Early distribution tax**

Early withdrawals from an IRA generally are subject to an additional tax.<sup>55</sup> This additional tax applies to distributions from both traditional and Roth IRAs. The tax is calculated by reference to the amount of the distribution that is includable in adjusted gross income. Includable amounts withdrawn prior to attainment of age 59-½ are subject to an additional 10-percent tax unless another exception applies. There are other exceptions for withdrawals that are: due to death or disability; made in the form of certain periodic payments; used to pay medical expenses in excess of 7.5 percent of adjusted gross income; used to purchase health insurance of certain unemployed individuals; used for higher education expenses; used for first-time homebuyer expenses of up to \$10,000; or made to a member of a reserve unit called to active duty for 180 days or longer.

Although distributions from a Roth IRA are subject to the early distribution tax, it may not be a very effective tool for limiting use of Roth IRA savings before age 59-½. Distributions from a Roth IRA are treated first as a recovery of contributions. As a result, the basis in a Roth IRA, meaning the amount of the contributions, can be withdrawn tax free at any time.<sup>56</sup> Thus, generally, the only consequence of the withdrawal is the loss of the potential for future tax-free earnings. These contributions may be viewed as a ready source of funds before retirement. On the other hand, knowing that the amount of contributions can be withdrawn tax free at any time

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<sup>54</sup> See discussion infra at III.B. Employer Provided and Assisted Retirement Savings.

<sup>55</sup> Sec. 72(t).

<sup>56</sup> Because the distribution of basis is not includable in income, it is automatically exempt from the early distribution tax. As discussed earlier, the only distributions of Roth IRA contributions that are subject to the early distributions tax are conversion contributions distributed within five years of the conversion.

may encourage a higher rate of savings (within the IRA contribution limits). This is because the individual knows that the contributions will remain available before retirement, as needed.

Even within the framework of the early distribution tax, there is room for significant distributions that are not used for retirement. First, there is no additional tax on use of funds after age 59-½. However, this age may be long before a realistic retirement age for most healthy individuals. Any significant consumption of retirement savings before age 65 without careful planning may leave many individuals who experience significant longevity without adequate resources toward the end of life. Second, there are a number of exceptions to the early distribution tax for use of the funds for specified purchases (e.g. higher education expenses or first-time home purchases) that may encourage taxpayers to use these savings for purposes other than retirement.

### Required minimum distributions

Distributions from traditional IRAs generally are required to begin by the April 1 of the year following the year in which the IRA owner attains age 70-½. To the extent that the required minimum amount for a year is not distributed, the distributee is subject to an excise tax equal to 50 percent of the difference between the amount distributed for the year and the amount that was required to be distributed.<sup>57</sup> Distributions are required to be made (in accordance with regulations) over the life or life expectancy of the IRA owner, or over the joint lives or joint life expectancy of the IRA owner and a designated beneficiary.<sup>58</sup> The regulations implement this provision by providing generally that the required minimum distribution is determined by dividing the IRA account balance as of the end of the prior year by a distribution period,<sup>59</sup> generally a number in the uniform lifetime table.<sup>60</sup> This table is based on joint life expectancies of the individual and a hypothetical beneficiary 10 years younger. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple's joint life expectancy is greater than the uniform life time table), the joint life expectancy of the couple is used. There are special rules in the case of annuity payments from an insurance contract.

If an IRA owner dies after minimum required distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. The regulations interpret this as allowing payments using a distribution period equal to the remaining years for the beneficiary's life or, if there is no

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<sup>57</sup> Sec. 4974.

<sup>58</sup> Treas. Reg. sec. 1.408-8 provides rules for required minimum distributions from IRAs. Generally those rules incorporate by reference the rules in Treas. Reg. sec. 1.401(a)(9)-1 through -9.

<sup>59</sup> Treas. Reg. sec. 1.401(a)(9)-5.

<sup>60</sup> Treas. Reg. sec. 1.401(a)(9)-9.

designated beneficiary, a distribution period equal to the remaining years of the IRA owner's life, as of the year of death.<sup>61</sup>

If the IRA owner dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the IRA owner's death. The five-year rule does not apply if distributions begin within one year of the IRA owner's death and are payable (in accordance with regulations) over the life or life expectancy of a designated beneficiary. For payments over life expectancy, the required minimum distribution for a year is calculated using a distribution period that is determined by reference to the beneficiary's life expectancy.<sup>62</sup> Special rules apply if the beneficiary of the IRA is the surviving spouse.

Roth IRAs are not subject to the minimum distribution rules during the IRA owner's lifetime. However, Roth IRAs are subject to the post-death minimum distribution rules that apply to traditional IRAs. Arguably, this allows a Roth IRA to be used primarily as an estate planning device rather than a retirement savings vehicle in certain cases. Others argue that this feature allows larger amounts to be retained in tax free savings until needed. Thus, larger amounts can be saved for higher late-in-life expenses, such as long term care.

#### Statistics on early withdrawals

Based on tabulations of tax return data, in 2005, there were about 2.2 million returns with primary and secondary taxpayers age 59 and younger who had taxable IRA distributions. These taxpayers had taxable IRA and pension distributions of about \$30 billion. About 1.2 million of these returns were subject to the additional 10-percent tax on over \$13.2 billion of early distributions. Stated differently, about 56 percent of the number of taxable IRA and pension distributions received by taxpayers 59 and younger with a taxable IRA distribution appear to have qualified for an exception from the additional early withdrawal tax.

#### **4. Deemed IRAs**

Certain types of employer-sponsored retirement plans are essentially allowed to provide IRAs to employees as a part of the employer-sponsored retirement plan. This option is available to tax qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans. The Code permits these plans to allow employees to elect to make contributions to a separate account or annuity under the plan that are treated as contributions to a traditional IRA or a Roth IRA. To receive this treatment, under the terms of the plan, the account or annuity must satisfy the requirements of the Code for being a traditional IRA or a Roth IRA.<sup>63</sup>

Implementing the basic provision that the account satisfy the requirements to be an IRA, the Treasury regulations under section 408(q) require that the trustee with respect to the account

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<sup>61</sup> Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).

<sup>62</sup> Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

<sup>63</sup> Sec. 408(q).

be a bank or a nonbank trustee approved by the IRS.<sup>64</sup> These requirements include the net worth requirements described previously for nonbank trustees.

However, the Treasury regulations provide that a governmental unit that maintains a qualified retirement plan need not demonstrate that all of these requirements will be met with respect to any individual retirement accounts maintained by that governmental unit pursuant to section 408(q).<sup>65</sup> For example, a governmental unit need not demonstrate that it satisfies the net worth requirements if it demonstrates instead that it possesses taxing authority under applicable law. The regulations specifically provide that the Commissioner, in his discretion, may exempt a governmental unit from certain other requirements upon a showing that the governmental unit is able to administer the deemed IRAs in the best interest of the participants. Moreover, in determining whether a governmental unit satisfies the other requirements for nonbank trustees, the Commissioner may apply the requirements in a manner that is consistent with the applicant's status as a governmental unit.

An employer might choose to offer a deemed IRA option to provide its employees one place for all their retirement savings. Offering a deemed IRA option would allow employees to choose to make payroll deduction contributions to an IRA in addition to being a plan participant, and allow employees to make rollover contributions from the employer's retirement plan, or another retirement plan or IRA, into the deemed IRA. However, deemed IRAs do not facilitate the development of payroll deduction IRA programs by employers that do not offer a retirement plan, because, by definition, only employers that maintain a retirement plan can offer employees the opportunity to contribute to a deemed IRA.

## **5. Payroll deduction IRAs**

### **In general**

Only about one-half of all private sector workers, ages 25 to 64, employed full-time, participate in an employer sponsored retirement plan.<sup>66</sup> Only about 10 percent of taxpayers eligible to make IRA contributions, which include employees not covered by an employer sponsored plan, make contributions to an IRA.<sup>67</sup> One approach for employers who do not offer a retirement plan to nevertheless facilitate retirement savings by their employees is to permit employees to contribute to traditional or Roth IRAs by direct deposit through payroll deduction.

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<sup>64</sup> Treas. Reg. sec. 1.408(q)-1.

<sup>65</sup> Treas. Reg. sec. 1.408-2(e)(8).

<sup>66</sup> Patrick Purcell, "Pension Sponsorship and Participation: Summary of Recent Trends," *CRS Report for Congress* (Sept. 6, 2007). Table 3 shows that, in 2007, 49.2 percent of private sector wage and salary workers ages 25 to 64, employed year around, participated in an employer sponsored retirement plan.

<sup>67</sup> Victoria L. Bryant, "Accumulation and Distribution of Individual Retirement Arrangements, 2004," *Statistics of Income Bulletin*, Spring 2008, at 92 (Figure B).

The employer establishes a program under which each employee can elect to have the employer withhold an amount each pay period and contribute the amount to an IRA established by the employee. In the Conference report to the Taxpayer Relief Act of 1997,<sup>68</sup> Congress indicated that “employers that chose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs.” Congress encouraged the Secretary of the Treasury to “continue his efforts to publicize the availability of these payroll deduction IRAs.”<sup>69</sup> In response to that directive, the IRS published Announcement 99-2,<sup>70</sup> which reminds employers of the availability of this option for their employees.

One main concern of an employer offering an IRA payroll deduction program is inadvertently becoming liable under ERISA for establishing an employee pension benefit plan subject to title I of ERISA. As early as 1975, the Department of Labor (“DOL”) issued a regulation describing circumstances under which the use of an employer payroll deduction program for forwarding employee monies to an IRA will not constitute an employee pension benefit plan subject to ERISA.<sup>71</sup> Interpretive Bulletin 99-1<sup>72</sup> restated and updated the DOL’s positions on these programs. Under the DOL guidance, the general rule is that, in order for an IRA payroll program not to be a pension plan subject to ERISA, the employer must not endorse the program. To avoid endorsing the program the employer must maintain neutrality with respect to an IRA sponsor in its communication to its employees.<sup>73</sup>

An employer is not endorsing the program merely because it encourages its employees to save for retirement by providing general information on the IRA payroll deduction program and other educational materials that explain the advisability of retirement savings, including the advantages of contributing to an IRA and distributing materials written by the IRA sponsor describing its programs. The employer must make clear, however, that its involvement in the program is limited to collecting the deducted amounts and remitting them promptly to the IRA sponsor and that it does not provide any additional benefit or promise any particular investment return on the employee’s savings.<sup>74</sup>

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<sup>68</sup> Pub. L. No. 105-34.

<sup>69</sup> H. Rep. No. 102-220, at 775 (1997).

<sup>70</sup> 1999-1 C.B. 305. The IRS also includes information on its website concerning the rules for this option and the pros and cons for an employer adopting a payroll deduction IRA program.

<sup>71</sup> Labor Reg. sec. 2510.3-2(d).

<sup>72</sup> 64 F.R. 32999, June 18, 1999; Labor Reg. sec. 2509.99-1.

<sup>73</sup> Labor Reg. sec. 2509.99-1.

<sup>74</sup> Labor Reg. sec. 2509.99-1(b).

Recognizing that the cost of a payroll deduction program may be significantly reduced by limiting the number of IRA sponsors to which contributions are remitted, the DOL indicates in Interpretive Bulletin 99-1 that an IRA payroll deduction plan will not be subject to ERISA merely because the employer elects an IRA sponsor as the designated recipient of payroll deduction contributions, or otherwise limits the IRA sponsors to which contributions will be remitted, provided that any limitations on, or cost associated with an employee's ability to transfer or roll over IRA contributions to another IRA sponsor is fully disclosed in advance of the employee's decision to participate in the program. If the employer negotiates any special terms and conditions for its employees not available to other IRA contributors or the employer exercises any influence over the investments made or permitted by the IRA sponsor, then the employer may not be considered neutral.

An employer can pay any fee the IRA sponsor imposes on employers for services the sponsor provides in connection with establishment and maintenance of the payroll deduction process itself, and still remain neutral. The employer may also assume the internal cost of implementing and maintaining the payroll deduction program, but if an employer pays, in connection with operating an IRA payroll deduction program, any administrative, investment management, or other fee that the IRA sponsor would require employees to pay for establishing or maintaining the IRA, the employer may be considered to have established a pension plan under ERISA for its employees.<sup>75</sup>

### **Employer attitudes toward payroll deduction IRAs**

Despite the efforts of Congress, IRS, and DOL to publicize and facilitate payroll deduction IRAs, it has been noted that relatively few employers offer this option to employees.<sup>76</sup> One of the reasons an employer may be hesitant to provide this option to employees is the administrative expense of maintaining this arrangement. Further, because employees can set up an IRA on their own at any time, they may not value this as a benefit that the employer is providing. Finally, employees can achieve the benefit of payroll deduction on their own by an arrangement with their bank to make regular transfers into their IRAs.

## **6. Incentives for Roth IRA contributions**

### **Lower income taxpayers**

Individuals who currently have low income may get little or no benefit from a current deduction for a contribution to a traditional IRA, but later may be subject to income tax when they take distributions. For those taxpayers, a contribution to a Roth IRA is likely to produce a better long term tax result. In addition to the tax-free withdrawal of qualified distributions, basis can be recovered tax-free even if the distribution is not a qualified distribution. Thus, as

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<sup>75</sup> Labor Reg. sec. 2509.99-1(e).

<sup>76</sup> Peter Orszag, J. Mark Iwry, and William G. Gale, *Aging Gracefully: Ideas to Improve Retirement Security in America*, The Century Foundation Press, New York (2006), Ch. 4 (J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs") at 47.

discussed earlier, the taxpayer can have access to funds contributed without being subject to the early distribution tax. Even for individuals who benefit from the deduction, a contribution to a Roth IRA of the maximum amount nevertheless will produce more income at retirement because, as discussed in Part 1 of this pamphlet, a dollar contributed to a Roth account represents greater after-tax saving than a dollar contributed to a traditional deductible IRA, because the former is contributed on an after-tax basis while the latter is contributed on a pre-tax basis.

### **Abuse incentives**

Some taxpayers have sought to take advantage of the fact that Roth IRAs permit tax-free distributions by transferring value into a Roth IRA that is not a legitimate return on investment for the assets held by the Roth IRA, but instead is a disguised additional contribution.<sup>77</sup> In some cases, a conversion from a traditional IRA to a Roth IRA is structured to avoid including the full fair market value of the amount converted into gross income.<sup>78</sup> The incentive in a traditional IRA for abuse is much more limited because the distributions from the account are includible in gross income as ordinary income.

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<sup>77</sup> Notice 2004-8, 2004-1 CB 333, describes certain abusive Roth transactions that involve this type of transfer of value and identifies the transactions as “listed transactions.” In Notice 2004-8, the Treasury Department announced that certain transactions involving Roth IRAs are tax avoidance transactions and identified these transactions (“Roth IRA shelters”) as listed transactions for purposes of the tax return reporting requirements of section 6706A.

<sup>78</sup> The preamble to TD 9220, Converting an IRA Annuity to a Roth IRA, 70 F.R. 48868, published August 22, 2005, describes transactions in which taxpayers have attempted to structure conversions of a traditional IRA annuity to a Roth IRA annuity to permit including in gross income less than the fair market value of the traditional IRA annuity on the date of the conversion.

## B. Employer Provided and Assisted Retirement Savings

### 1. Overview of employer sponsored qualified retirement plans

Although IRAs hold more assets than any other type of tax-favored retirement vehicle, it appears that most of the funds in IRAs are attributable to rollover contributions from employer sponsored retirement plans rather than regular IRA contributions.<sup>79</sup> However, only about half of the U.S. working population is covered by an employer sponsored qualified retirement plan.<sup>80</sup> For low income taxpayers, the percentage of employees not participating in an employer sponsored retirement plan is much higher.<sup>81</sup> Other than the retirement savings element inherent in Social Security benefits, the only tax qualified retirement savings vehicle for these employees is IRAs. However, the rate of regular IRA contributions (traditional or Roth) by low income taxpayers is very low.<sup>82</sup>

For employers, the decision as to whether to maintain an employer sponsored retirement plan is voluntary. For employers who decide to maintain an employer sponsored retirement plan, the Code provides parameters as to the amount of benefits, the timing of benefit distributions, and the deductibility. The Code and ERISA provide parameters as to protections that must be afforded to employees and their spouses to ensure that they receive the benefit promised under the plan. However, within these parameters, an employer who chooses to maintain an employer sponsored retirement plan has a great deal of flexibility in deciding the structure of the plan and the level of benefits.

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<sup>79</sup> GAO, “Individual Retirement Accounts, Government Actions Could Encourage More Employers of Offer IRAs to Employees,” GAO-08-590 (June 2008).

<sup>80</sup> Patrick Purcell, “Pension Sponsorship and Participation: Summary of Recent Trends,” *CRS Report for Congress* (Sept. 6, 2007). Table 3 shows that, in 2007, 49.2 percent of private sector wage and salary workers ages 25 to 64, employed year around, full-time participated in an employer sponsored retirement plan. See also, Mary M. Schmitt and Judy Xanthopoulos, “Automatic IRAs: Are They Administratively Feasible, What are the Costs to Employers and the Federal Government, and Will They Increase Retirement Savings,” Preliminary Report Prepared for AARP, Optimal Strategies, LLC, (March 8, 2007), 15. The report points out that, since the 1980s, the portion of workers participating in employer sponsored qualified retirement plan has remained stable at approximately 50 percent.

<sup>81</sup> Elizabeth Bell, Adam Carasso, and C. Eugene Seurle, “Strengthening Private Sources of Retirement Savings of Low-Income Families,” the Urban Institute (Sept. 2005), points out that in 2003, among full-time workers - including those with or without access to pension plans- nearly 72 percent of the bottom income quartile failed to participate in a pension plan, compared to 28 percent in the top fourth.

<sup>82</sup> Victoria Bryant, “Accumulation and Distribution of Individual Retirement Arrangements, 2004,” *Statistics of Income Bulletin* (Spring 2008). Figure B shows the percentages of eligible taxpayers who made IRA contributions with the adjusted gross incomes of \$1 to \$10,000, \$10,000 to \$20,000, and \$20,000 to \$30,000 are 2.2 percent, 3.8 percent and 7.1 percent respectively.

An employer has a great deal of flexibility in designing the structure of its plan. One element is whether the employer offers it as a unilateral benefit that the employee accepts implicitly by accepting employment with, or remaining employed by, the employer. Alternatively the employer may allow a year-by-year choice by the employee whether to accept current compensation, or make contributions to the plan. Employers may structure plans as a retention tool so that only employees who work for a certain number of years become vested in the benefits accrued under the plan.

An employer may have a variety of motivations in deciding whether to offer a retirement plan. The motivations to offer a plan may be different for a large public company that is broadly owned by its stockholders than for an owner-operated company where the plan is providing retirement benefits for both the owners and their employees. For a large public company that is competing for employees with other employers that offer retirement plans, the motivation may be primarily recruitment and retention of employees. For an owner-operated company, a key motivation may be providing for the owner's retirement. Providing benefits to employees as well may be viewed as part of the cost for the tax deferral for the owner. For some employers, the decision to offer a plan may be subject to collective bargaining negotiations.

A key element in an employer's decision is the value that employees place on being provided benefits under a retirement plan versus receiving current compensation. A basic reason for employees to value the benefits of an employer sponsored retirement plan is the tax deferral inherent in these plans. In addition to the amount of employer nonelective contributions permitted, an employer sponsored retirement plan has higher contribution limits for employee elective deferrals than the limits for deductible contributions to IRAs. Finally, the employer may separately make nonelective or matching contributions.

An employer has a number of options from which to choose if it decides to offer a qualified retirement plan. The options include: (1) plans qualified under section 401(a), which are commonly referred to as "tax qualified plans" or "tax qualified retirement plans," and which may include qualified cash or deferral arrangements (so called "section 401(k) plans") and which offers an employer the most flexibility in designing a retirement program for its employees; (2) plans described in section 403(a), which are commonly referred to as "section 403(a) annuities" and are subject to some of the requirement applicable to tax qualified retirement plans; (3) SIMPLE IRAs<sup>83</sup> and simplified employee pensions ("SEPs"),<sup>84</sup> that are funded through direct contributions by the employer to IRAs established for each employee; (4) section 403(b) tax-deferred annuities, which may only be sponsored by certain types of tax-exempt employers; and (5) section 457(b) plans sponsored by State and local governments ("governmental section 457(b) plans"), which are sometimes offered by a governmental employer in lieu of a section 401(k) plan.

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<sup>83</sup> Sec. 408(p). There is a parallel safe harbor simple plan design for qualified section 401(k) plans for small employers in section 401(k)(11).

<sup>84</sup> Sec. 408(k).

## 2. Tax qualified retirement plans

### In general

A plan of deferred compensation that meets the qualification standards of section 401(a) of the Code (a tax qualified retirement plan) is accorded special tax treatment under present law. Employees do not include contributions in gross income until amounts are distributed, even though the arrangement is funded and even if benefits are nonforfeitable. In the case of a taxable employer, the employer is entitled to a current deduction (within limits) for contributions even though the contributions are not currently included in an employee's income. Contributions to a tax qualified retirement plan, and earnings thereon, are held in a tax-exempt trust.

Tax qualified retirement plans are broadly classified into two categories, defined benefit pension plans and defined contribution plans, based on the nature of the benefits provided. Under a defined benefit pension plan, benefits are determined under a plan formula, which is generally based on compensation and years of service. Benefits under defined contribution plans are based solely on the contributions, and earnings thereon, allocated to separate accounts maintained for plan participants. Historically, defined benefit plans were the more common form of employer sponsored retirement plan but in recent years the trend has shifted toward defined contributions plans.<sup>85</sup> The trend also has shifted towards section 401(k) plans, plans funded with elective deferrals made by employees through payroll deduction.<sup>86</sup>

Tax qualified retirement plans may permit both employees and employers to make contributions to the plan. Under a qualified cash or deferred arrangement (i.e., a "section 401(k)" plan), employees may elect to make pretax contributions to a plan. Such contributions are referred to as elective deferrals. Employees may also make after-tax contributions to a tax qualified retirement plan. Employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes pretax or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes contributions.

Present law imposes a number of requirements on tax qualified retirement plans that must be satisfied in order for favorable tax treatment to apply. These requirements include vesting requirements, limits on contributions, and nondiscrimination requirements that are intended to ensure that the tax qualified retirement plan covers a broad group of employees. Certain of these rules are discussed in more detail below.

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<sup>85</sup> GAO, "Private Pensions: Low Defined Contribution Plan Savings May Pose Challenges to Retirement Security, Especially for Many Low-Income Workers," GAO-08-8 (Nov. 2007) at 7.

<sup>86</sup> *Id.* at 8.

## **Vesting requirements**

The Code provides minimum vesting rules under which a participant's right to the participant's normal retirement benefit must be nonforfeitable (i.e., vested) upon the participant's attainment of normal retirement age.<sup>87</sup> In defining normal retirement age, a plan may not specify a normal retirement age that is later than either age 65 or the fifth anniversary of the time the participant commenced plan participation.<sup>88</sup>

In the case of a defined contribution plan, the plan must also satisfy two alternative vesting schedules.<sup>89</sup> Under the first vesting schedule, a participant must be fully vested in the participant's accrued benefit derived from employer contributions upon completion of three years of service (often referred to as “three year cliff vesting”). Under the second vesting schedule (referred to as “graduated vesting”), a participant must be vested in a specified percentage of the participant's accrued benefit derived from employer contributions at the time the participant completes various specified amounts of service with the sponsoring employer: With two years of service, the specified percentage is 20 percent; with three years, 40 percent; with four years, 60 percent; with five years, 80 percent; and with six years, 100 percent. A plan is permitted to provide a more generous vesting schedule than the two required schedules (e.g., 100 percent vesting upon completion of one year of service). Employee after-tax contributions must be nonforfeitable at all times,<sup>90</sup> and special rules apply in the case of elective deferrals under a section 401(k) plan and employer matching contributions with respect to such deferrals (described in more detail below).

## **Limits on contributions to tax qualified defined contribution plans**

The annual additions under a defined contribution plan with respect to each plan participant cannot exceed the lesser of (1) 100 percent of the participant's compensation or (2) a dollar amount, indexed for inflation (\$46,000 for 2008). Annual additions are the sum of employer contributions,<sup>91</sup> employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.

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<sup>87</sup> Sec. 411(a).

<sup>88</sup> Sec. 411(a)(9).

<sup>89</sup> Under section 411, additional vesting rules apply in the case of a defined benefit plan. In general, a plan may condition the vesting of a participant's accrued benefit on years of service with the employer, but the vesting schedule must at least provide 100 percent vesting with five years of service or 100 percent vesting over a three to seven year graduated vesting schedule. There are also rules to prevent back-loaded rates of accrual.

<sup>90</sup> Sec. 411(a)(1).

<sup>91</sup> Elective deferrals are treated as employer contributions for this purpose.

## **Nondiscrimination requirements**

The nondiscrimination requirements are designed to ensure that tax qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees.<sup>92</sup> Under a general nondiscrimination requirement, the contributions or benefits provided under a tax qualified retirement plan must not discriminate in favor of highly compensated employees.<sup>93</sup> Treasury regulations provide detailed and exclusive rules for determining whether a plan satisfies the general nondiscrimination rules. Under the regulations, the amount of contributions or benefits provided under the plan, and the benefits, rights and features offered under the plan, must be tested.<sup>94</sup>

Treasury regulations provide three general approaches to testing the amount of nonelective contributions provided under a defined contribution plan: (1) design-based safe harbors; (2) a general test; and (3) cross-testing.<sup>95</sup> Elective deferrals, matching contributions, and after-tax employee contributions are subject to separate testing as described below.

## **Limitation on in-service distributions**

A defined contribution plan that is classified as a profit sharing plan or as a stock bonus plan is permitted to provide for in-service distribution of benefits prior to a participant's attainment of normal retirement age.<sup>96</sup> More restrictive rules apply to pension plans, which include defined benefit plans and certain types of defined contribution plans. Under these rules, in-service distribution of benefits generally is not permitted until the participant has attained the

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<sup>92</sup> Sections 401(a)(3) and 410(b) provide a test for determining if the group of employees covered under a qualified plan is too heavily weighted in favor of highly compensated employees. The test generally compares the percentage of highly compensated employees of the employer covered under the plan to the percentage of nonhighly compensated employees of the employer covered under the plan. For purposes of this coverage test and other nondiscrimination requirements, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of \$105,000 (for 2008) or (b) at the election of the employer had compensation for the preceding year in excess of \$105,000 (for 2008) and was in the top 20 percent of employees by compensation for such year (sec. 414(q)). A nonhighly compensated employee is an employee other than a highly compensated employee.

<sup>93</sup> Sec. 401(a)(4). A qualified retirement plan of a governmental employer is not subject to the nondiscrimination requirements.

<sup>94</sup> See Treas. Reg. sec. 1.401(a)(4)-1.

<sup>95</sup> See Treas. Reg. sec. 1.401(a)(4)-2(b) and (c) and sec. 1.401(a)(4)-8(b).

<sup>96</sup> Treas. Reg. sec. 1.401-1(b)(1)(ii). The plan is required to provide a definite predetermined formula for distributing benefits under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance from employment.

earlier of normal retirement age or age 62.<sup>97</sup> Special rules apply in the case of a section 401(k) plan (discussed below).

### **Special rules for elective deferrals under section 401(k) plans, after-tax contributions, and matching contributions**

#### **In general**

Section 401(k) plans are subject to the rules generally applicable to tax qualified defined contribution plans.<sup>98</sup> In addition, special rules apply.

As described above, an employee may make elective deferrals to a section 401(k) plan. The maximum annual amount of elective deferrals that can be made by an individual is \$15,500 (for 2008). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan. As a result, the dollar limit on elective deferrals is increased for an individual who has attained age 50 by \$5,000 (for 2008). An employee's elective deferrals must be fully vested.

Elective contributions, and attributable earnings, cannot be distributed from the plan before the earlier of the employee's attainment of age 59½, death, disability, or severance from employment. Elective contributions, but not associated earnings, can be distributed for hardship. A plan also can permit an employee to borrow the funds prior to these events within certain limits.<sup>99</sup>

#### **Special nondiscrimination tests**

A special annual nondiscrimination test, called the actual deferral percentage test (the "ADP" test) applies to elective deferrals under a section 401(k) plan.<sup>100</sup> Generally, this is an objective mathematical test that compares the average rate of deferral for highly compensated employees to all other employees. This test generally allows the average deferral rate for highly compensated employees to exceed the average deferral rate for other employees but not by more than a calculated percentage. The permissible deviation is the greater of (1) 125 percent, or (2) the lesser of (i) two percentage points or (ii) double the average rate, of the average deferral rate of other employees. Employer matching contributions and after-tax employee contributions are subject to a similar special annual nondiscrimination test (the actual contribution percentage test

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<sup>97</sup> Sec. 401(a)(36); Treas. Reg. secs. 1.401-1(b)(1)(i) and 1.401(a)-1(b)(1).

<sup>98</sup> Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

<sup>99</sup> Sec. 72(p).

<sup>100</sup> Sec. 401(k)(3).

or “ACP test”) which compares the average rate of matching and after tax contributions to the plan of the two groups.<sup>101</sup>

### Effect of ADP and ACP test on employer behavior

Both the ADP and ACP tests include room for a higher rate of contribution for highly compensated employees because the rates are generally the result of employee elections over which the employer’s control is limited. Generally, a large portion of an employer’s highly compensated employees want to make the maximum elective contribution to the 401(k) plan (\$15,500 for 2008).<sup>102</sup> These employees will also want the maximum benefit of any matching contributions provided under the plan. In addition to insuring that the tax benefits for these contributions do not go primarily to highly compensated employees, the tests motivate employers to educate nonhighly compensated employees on the benefits of retirement savings and encourage them to elect to make contributions under the plan. Employers may also use matching contributions as an incentive for employees to defer. However, the matching contribution feature must be structured so it is not just an incentive for highly compensated employees, and does not cause the plan to fail the ACP test.

If either test is not satisfied, a mechanism is provided under the Code for the employer to make additional contributions to nonhighly compensated employees or to distribute deferrals of highly compensated employees to such employees so that the tests are satisfied. Employers generally are motivated to encourage nonhighly compensated employee participation to avoid making corrective distributions to highly compensated employees, or being required to make additional contributions to the plan.

### Safe harbor plan design

The Small Business Job Protection Act of 1996<sup>103</sup> added a safe harbor method of satisfying the ADP and ACP tests because these tests were considered complex and administratively difficult for some employers to apply.<sup>104</sup> There was also a concern that, because satisfying the tests was dependent on the election decisions of employees, the results might not always be predictable. Under a safe harbor added by the Act, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement (a “safe harbor” section 401(k) plan).<sup>105</sup> A plan satisfies the contribution requirement under the safe harbor rule if the employer either

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<sup>101</sup> Sec. 401(m)(2).

<sup>102</sup> Highly compensated employees over age 50 will also want to make catch up contributions but those contributions are not required to be distributed to satisfy the ADP test.

<sup>103</sup> Pub. L. No. 104-188.

<sup>104</sup> H. Rep. No. 104-586 (1996) at 101. Conf. Rep. No. 104-737 (1996) at 235.

<sup>105</sup> Sec. 401(k)(12).

(1) satisfies a matching contribution requirement (100 percent of elective contributions of the employee for contributions not in excess of 3 percent of compensation, and 50 percent of elective contributions for contributions that exceed 3 percent of compensation but do not exceed 5 percent) or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement. The required matching contributions and the three percent nonelective contribution must be immediately nonforfeitable (i.e., 100 percent vested) when made. The plan satisfies the notice requirement if, within a reasonable time before the beginning of the plan year, the plan provides written notice to each eligible employee of the employee's rights and obligations under the plan.

#### Effect of safe harbor design on employer behavior

The safe harbor plan design is based on the concept that the promised matching contributions or nonelective contributions when combined with elective contributions by nonhighly compensated employees can be expected to produce rates of deferral by nonhighly compensated employees that will guarantee satisfaction of the ADP test. However, the automatic satisfaction of the ADP and ACP test may reverse the incentive for some employers to educate nonhighly compensated employees about the need to save for retirement and encourage plan participation. As long as the employer provides the minimum notice required and provides the minimum contributions required, the plan is deemed to satisfy the ADP and ACP tests even if no nonhighly compensated employees make elective contributions under the plan.

#### Designated Roth contributions

A section 401(k) plan is permitted to include a "qualified Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates (at such time and in such manner as the Secretary may prescribe) as not excludable from the participant's gross income. The annual dollar limit on a participant's designated Roth contributions is the same as the limit on elective deferrals, reduced by the participant's elective deferrals that the participant does not designate as designated Roth contributions. Designated Roth contributions are treated as any other elective deferral for certain purposes, including the nondiscrimination requirements applicable to section 401(k) plans.

A qualified distribution from a participant's designated Roth contributions account is not includible in the participant's gross income. A qualified distribution is a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59-1/2, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.

### **3. Employee retirement annuities**

Under section 403(a) of the Code, an employee retirement annuity is treated in a similar manner as a tax qualified retirement plan for tax purposes (i.e., contributions on behalf of employee participants are not currently includible in the employees' gross income, and the

employer is permitted an immediate deduction for such contributions). An employee retirement annuity is subject to many of the same rules as a tax qualified retirement plan, such as the contribution limits and nondiscrimination rules described above.<sup>106</sup>

#### **4. Employer retirement plans using IRAs**

##### **Simple IRA plan**

Under present law, a small business that employs fewer than 100 employees can establish a simplified retirement plan, which is called the savings incentive match plan for employees (“SIMPLE”) retirement plan. A SIMPLE retirement plan is generally a plan under which contributions are made to an individual retirement arrangement for each employee (a “SIMPLE IRA”).<sup>107</sup> A SIMPLE retirement plan allows employees to make elective deferrals, subject to a limit of \$10,500 (for 2008). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SIMPLE retirement plan up to a limit of \$2,500 (for 2008).

In the case of a SIMPLE IRA, the group of eligible employees generally must include any employee who has received at least \$5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive \$5,000 in the current year. A SIMPLE IRA is not subject to the nondiscrimination rules generally applicable to tax qualified retirement plans.

Employer contributions to a SIMPLE IRA must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to three percent of the employee’s compensation. The employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee’s compensation). In addition, a lower percentage cannot be elected for more than two years out of any five year period.<sup>108</sup> Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a two percent of compensation nonelective contribution on behalf of each eligible employee with at least \$5,000 in compensation for such year, whether or not the employee makes an elective contribution.

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<sup>106</sup> Sec. 404(a)(2).

<sup>107</sup> There is also an option to provide a SIMPLE plan as part of a section 401(k) plan (a “SIMPLE section 401(k)” plan). In the case of a SIMPLE section 401(k) plan, the group of employees eligible to participate must satisfy the minimum coverage requirements generally applicable to qualified retirement plans under section 410(b). A SIMPLE section 401(k) plan does not have to satisfy the ADP or ACP test and is not subject to the top-heavy rules. The other qualified retirement plan rules generally apply.

<sup>108</sup> This option is not available for SIMPLE section 401(k) plans.

The employer must provide each employee a 60-day election period before the beginning of the calendar year and a notice at the beginning of the 60-day period explaining the employee's choices under the plan.<sup>109</sup>

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE plan, and the employer may not maintain any other qualified retirement plan.

#### Simplified employee pensions (SEP)

A simplified employee pension ("SEP") is an IRA to which employers may make contributions up to the limits applicable to tax qualified defined contribution plans (\$46,000 for 2008). All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee has (1) attained age 21, (2) performed services for the employer during at least three of the immediately preceding five years, and (3) received at least \$500 (for 2008) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a SARSEP (i.e., a salary reduction SEP) under which employees could make elective deferrals. The SARSEP rules were generally repealed with the adoption of SIMPLE plans. However, contributions may continue to be made to SARSEPs that were established before 1997. Salary reduction contributions to a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan (\$15,500 for 2008). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SARSEP up to a limit of \$5,000 (for 2008).

### **5. Special plans for governmental and tax exempt employers**

#### **Tax-sheltered annuities (section 403(b) plans)**

Section 403(b) plans are another form of employer sponsored qualified retirement plan that provide the same tax benefits as qualified retirement plans. Employers may contribute to such plans on behalf of their employees, and employees may make elective deferrals. Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of State or local governments (including public schools). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans.

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the special limits for elective deferrals and catch-up contributions under a section 401(k) plan. If elective deferral and catch-up contributions are made to both a qualified defined contribution plan and a section 403(b) plan for the same employee, a single limit applies to the elective deferral contributions under both

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<sup>109</sup> Notice 98-4, 1998-1 C.B. 269.

plans. Special contribution limits apply to certain employees under a section 403(b) plan maintained by a church. In addition, additional elective deferrals are permitted under a plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches in the case of employees who have completed 15 years of service.

Section 403(b) plans are generally subject to the minimum coverage and general nondiscrimination rules that apply to qualified defined contribution plans. In addition, employer matching contributions and after-tax employee contributions are subject to the ACP test.<sup>110</sup> However, pretax contributions made by an employee under a salary reduction agreement (i.e., elective deferrals) are not subject to nondiscrimination rules similar to those applicable to elective deferrals under section 401(k) plans. Instead, all employees generally must be eligible to make salary reduction contributions. Certain employees may be disregarded for purposes of this rule.

### **Governmental section 457(b) plans**

Section 457 provides special rules with respect to the deferred compensation arrangements of States and local government and tax-exempt employers. Deferred compensation for this purpose does not include contributions and benefits under the previously discussed employer sponsored qualified retirement plans. In the case of a State and local government employer, section 457(b) permits the plan participant to defer inclusion in gross income of amounts that are actually contributed to the trust that funds the plan until the time of actual distribution of plan benefits, provided certain requirements are satisfied, including limitations on the amount that may be deferred under the plan. The maximum annual deferral under such a plan generally is the lesser of (1) \$15,500 (for 2008) or (2) 100 percent of compensation. A special, higher limit applies for the last three years before a participant reaches normal retirement age (the “section 457 catch-up limit”). In the case of a section 457(b) plan of a governmental employer, a participant who has attained age 50 before the end of the taxable year may also make catch-up contributions up to a limit of \$5,000 (for 2008), unless a higher section 457 catch-up limit applies. Only contributions to section 457(b) plans are taken into account in applying these limits; contributions made to a qualified retirement plan or section 403(b) plan for an employee do not affect the amount that may be contributed to a section 457(b) plan for that employee. Thus, for example, a State or local government employee covered by both a section 457(b) plan and a section 401(k) or 403(b) plan can contribute up to \$15,500 (for 2008) to each plan for a total of \$31,000.

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<sup>110</sup> As in the case of a qualified retirement plan, a governmental section 403(b) plan is not subject to the nondiscrimination rules.

## C. Other Savings Vehicles

### 1. Education savings

Present law provides tax-exempt status to Coverdell education savings accounts, which are certain trusts or custodial accounts that are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary.<sup>111</sup> The aggregate annual contributions that can be made by all contributors to Coverdell education savings accounts for the same beneficiary is \$2,000 per year. In the case of contributors who are individuals, the maximum contribution limit is reduced for individuals with adjusted gross income between \$95,000 and \$110,000 (\$190,000 to \$220,000 in the case of married taxpayers filing a joint return).<sup>112</sup> Contributions to a Coverdell education savings account are not deductible. Distributions from a Coverdell education savings account are not includible in the distributee's income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. Note that the tax treatment of the Coverdell education savings account, as well as for the qualified tuition programs discussed below, is the same as that provided for Roth IRAs when the funds are withdrawn for qualified use.

Present law provides tax-exempt status to a qualified tuition program, defined as a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions.<sup>113</sup> Under a qualified tuition program, a person may purchase tuition credits or certificates on behalf of a designated beneficiary, or in the case of a State program, may make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. Contributions to a qualified tuition program must be made in cash, and the program must have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions to a qualified tuition program are not deductible. Contributions to a qualified tuition program generally are treated as a completed gift eligible for the gift tax annual exclusion. Distributions from a qualified tuition program are not includible in the distributee's gross income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made.

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<sup>111</sup> Sec. 530.

<sup>112</sup> Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the present-law contribution limit and the adjusted gross income levels do not apply for years beginning after December 31, 2010. Thus, for example, the limit on annual contributions to a Coverdell education savings account is \$500 after 2010.

<sup>113</sup> Sec. 529.

## 2. Health savings

A health savings account (“HSA”) is a trust or custodial account used to accumulate funds on a tax-preferred basis to pay for qualified medical expenses.<sup>114</sup> Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Contributions to an HSA are excludable from income and not subject to employment taxes if made by the individual’s employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional 10-percent tax unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65). Note that allowing a deduction for contributions as well as an exclusion for withdrawals provides tax treatment far more advantageous than consumption tax treatment. If a taxpayer is in the 25 percent marginal rate bracket, and the normal return to saving is five percent annually, a \$100 contribution to an HSA will cost the taxpayer only \$75 to make on account of the deduction for the contribution. The \$100 will grow to \$105 in the following year. If it is withdrawn for eligible health care consumption in that year, the taxpayer’s \$75 investment will have returned \$105 after one year, for an after-tax return of 40 percent.

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan. The maximum aggregate annual contribution that can be made to an HSA in 2008 is \$2,900 in the case of self-only coverage and \$5,800 in the case of family coverage.<sup>115</sup>

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<sup>114</sup> Sec. 223.

<sup>115</sup> The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by \$900 in 2008, and \$1,000 in 2009 and thereafter.

## D. Saver's Credit

### 1. In general

Present law provides a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions (referred to as the "saver's credit").<sup>116</sup> The saver's credit was enacted as an additional tax incentive for low- and middle-income individuals to save for retirement. It was enacted in response to a concern that the rate of private savings in the United States is low; in particular many low- and middle-income individuals have inadequate savings or no savings at all.<sup>117</sup> A key reason cited for these low levels of saving is that lower-income families are likely to be more budget constrained with competing expenses such as food, clothing, shelter, and medical care that take a larger portion of their income.<sup>118</sup>

The credit is available with respect to contributions to various types of retirement savings arrangements, including contributions to a traditional or Roth IRA and elective deferrals to a section 401(k) plan, section 403(b) plan, or a governmental 457(b) plan. The maximum annual contribution eligible for the credit is \$2,000. The credit rate depends on the adjusted gross income of the taxpayer. For 2008, married taxpayers filing joint returns with adjusted gross income of \$53,000 or less, head of household taxpayers with adjusted gross income of \$39,750 or less, and single taxpayers with adjusted gross income of \$26,500 or less are eligible for the credit. The adjusted gross income limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are age 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The credit rates based on AGI for 2008 are as follows.

<i>Joint Filers</i>	<i>Heads of Households</i>	<i>Single Filers</i>	<i>Credit Rate</i>
\$0-\$32,000	\$0-\$24,000	\$0-\$16,000	50 percent
\$32,000-\$32,500	\$24,000-\$25,875	\$16,001-\$17,250	20 percent
\$34,500-\$53,000	\$25,876-\$39,750	\$17,251-\$26,500	10 percent
Over \$53,000	Over \$39,750	Over \$26,500	0 percent

The amount of any contribution eligible for the credit is reduced by taxable distributions received by the taxpayer and his or her spouse from any savings arrangement described above or any other qualified retirement plan during the taxable year for which the credit is claimed, the two taxable years prior to the year the credit is claimed, and during the period after the end of the

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<sup>116</sup> Sec. 25B.

<sup>117</sup> S. Rep. No. 106-411 (2000).

<sup>118</sup> *Id.*

taxable year and prior to the due date for filing the taxpayer's return for the year. In the case of a distribution from a Roth IRA, this rule applies to any such distributions, whether or not taxable.

## **2. Tax credit as an incentive for low income taxpayers**

One significant limitation on this credit as an incentive for low income taxpayers to make IRA contributions is that it is not a refundable credit. That is, the credit cannot be claimed if the taxpayer's regular tax liability is zero. Given the relatively low AGI limitations for claiming the credit, many taxpayers in the relevant AGI ranges may not have regular tax liability. This will be particularly true for taxpayers with children who are eligible for the dependent exemption and child credit. For this reason, many of the lowest income taxpayers – those eligible for the 50 percent credit— are not able to receive the full benefit of the credit, or even any credit.<sup>119</sup> For example, a head of household filer in 2008 with \$20,000 of AGI would appear to be eligible for a 50 percent credit on a \$1,000 contribution to an IRA. However, if that taxpayer has two dependent children, he is already unable to claim the full value of the child credit, and thus any additional credits are of no value.

There are additional reasons why a tax credit, even a refundable one, might be limited in its ability to encourage saving. A primary reason would be the simple budget constraints mentioned above—that is, many low income taxpayers are faced with current needs too great for them to contemplate saving any of their income. Additionally, given the complexity of the Code, many taxpayers are likely to be unaware of the tax credit and their eligibility for it, thus limiting its ability to act as an incentive to save.<sup>120</sup>

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<sup>119</sup> Gary Koenig and Robert Harvey, “Utilization of the Saver’s Credit: An Analysis of the First Year” (Forum: Federal Income Tax Credits for Low-Income Families), *National Tax Journal* (Dec. 2005) at 787-806. They find that 11.5 percent of all those claiming the saver’s credit in 2002 had their credit limited by their tax liability. For those eligible at the 50 percent rate, the comparable figure is 43 percent.

<sup>120</sup> *Id.*

## E. Auto-Enrollment

### 1. In general

As discussed above, under a section 401(k) plan, employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash. Contributions made to the plan at the election of the employee are referred to as “elective deferrals” or “elective contributions.” A section 401(k) plan may be designed so that the employee will receive cash compensation unless the employee affirmatively elects to make contributions to the section 401(k) plan. Alternatively, a plan may provide that elective contributions are made at a specified rate (when the employee become eligible to participate) unless the employee elects otherwise (i.e., elects not to make contributions or to make contributions at a different rate). Arrangements that operate in this manner are sometimes referred to as “automatic enrollment” plans. In these plans, the employee must have an effective opportunity to elect to receive cash in lieu of contributions. Treasury regulations provide that whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.<sup>121</sup>

By capitalizing on employee inertia and minimizing the decisions that an employee is forced to make, automatic enrollment has been shown to increase rank and file participation in section 401(k) plans.<sup>122</sup> One of the initial attractions of automatic enrollment for section 401(k) plans to employers was the increased in participation by nonhighly compensated employees which helped the plan to satisfy the ADP test. Some employers, however, had reservations about automatic enrollment. Some employers in some states were concerned that automatic enrollment might violate State law, while others were concerned that any default investment under the plan might not be subject to the fiduciary relief under ERISA section 404(c) for employee directed investments.<sup>123</sup> Another concern was that any default contributions under an auto-enrollment feature immediately became subject to the rules precluding in-service distribution of elective deferrals from section 401(k) plans, section 403(b) plans, and governmental section 457(b) plans.

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<sup>121</sup> Treas. Reg. sec. 1.401(k)-1(e)(2). Similar rules apply to elective deferrals under section 403(b) plans and section 457(b) plans.

<sup>122</sup> Barbara O’Neil, “Overcoming Inertia: Do Automatic Saving and Investing Work?” *Journal Family Economic Issue* (2007) 28:321-335.

<sup>123</sup> The concern was that, because the employee has not explicitly chosen the default investment, the special ERISA rule for participant directed investments might not apply (under which no person who is otherwise a fiduciary under the plan is liable for any loss, or by reason of any breach, that results from the participant’s exercise of control).

## 2. Pension Protection Act of 2006

### In general

The Pension Protection Act of 2006 (“PPA”)<sup>124</sup> provides a number of special rules to the Code and ERISA to facilitate and encourage automatic enrollment in section 401(k) plans as well as section 403(b) plans and section 457(b) plans. Use of any of the special rules is predicated on a default contribution that is a stated percentage of compensation which applies uniformly to all participants. In addition, a notice must be provided to participants of the choice between making or not making contributions and the default contribution rate and investment, and each participant must be given a reasonable period of time after receipt of the notice to make an election with respect to contributions and investments.

PPA added a mechanism for employers to allow employees to unwind the automatic enrollment in the first 90 days after the first elective contribution is made for the employee under the arrangement. Thus, an employee who failed to act (despite notice and opportunity to elect out of automatic enrollment) could withdraw any automatic elective contributions within 90 days without having those contributions be subject to the rule precluding in-service distribution of elective contributions from a section 401(k) plan, section 403(b) plan, or a governmental section 457(b) plan before age 59-½.

PPA also made changes to ERISA to permit the DOL to provide a safe harbor default investment option and to preempt State laws if certain requirements are satisfied. Specifically, PPA amended ERISA to provide that a participant in an individual account plan with automatic enrollment is treated as exercising control over the assets which in the absence of an investment election are invested in accordance with regulations prescribed by the Secretary of Labor.

Under those regulations, which were issued October 24, 2007, the default investment option for those automatically enrolled must be a qualified default investment alternative (QDIA).<sup>125</sup> The choices for a QDIA include a product with a mix of investments that takes into account the individual’s age or retirement date (an example of such a product could be a life-cycle or targeted-retirement-date fund); an investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual’s age or retirement date (an example of such a service could be a professionally-managed account); a product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund); and a capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax). In addition, a QDIA must either be managed by an investment manager, plan trustee, plan sponsor or a committee comprised primarily of employees of the plan sponsor that is a named fiduciary, or be an investment company registered

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<sup>124</sup> Pub. L. No. 109-280.

<sup>125</sup> Labor Reg. sec. 2550.404c-5.

under the Investment Company Act of 1940. Further, a QDIA generally may not invest participant contributions in employer securities.

### **ADP safe harbor**

PPA also added a new safe harbor method of satisfying the ADP test. Recognizing that automatic enrollment alone is likely to generate higher participation rates, the auto enrollment safe harbor requires the following lower rate of matching contribution than is required for the pre-existing section 401(k) ADP safe harbor: (1) 100 percent of the employee's elective deferrals up to one percent of compensation and (2) 50 percent of the employee's elective deferrals from two to six percent of compensation. The nonelective alternative is the same three percent of compensation but, the matching and nonelective contributions are only required to be vested after the completion of two years of service rather than being immediately nonforfeitable.

Under the safe harbor, the automatic enrollment feature must provide that, unless an employee elects otherwise, the employee is treated as making an election to make elective deferrals equal to a stated percentage of compensation not in excess of 10 percent and at least equal to three percent of compensation through the first year that begins after the deemed election first applies to the participant. The minimum contribution rate increases by one percent for the next three years and then remains at six percent. The stated percentage must be applied uniformly to all eligible employees. Eligible employees mean all employees eligible to participate in the arrangement, other than employees eligible to participate in the arrangement immediately before the date on which the arrangement became a qualified automatic contribution arrangement with an election in effect (either to participate at a certain percentage or not to participate).

### **Effect of automatic enrollment safe harbor on employer and employee behavior**

Similar to the original section 401(k) safe harbor, the assumption is that the automatic enrollment coupled with matching contributions (albeit lower than the matching contributions under the original safe harbor) will produce elective contribution rates by nonhighly compensated employees that would allow the plan to pass the ADP and ACP tests. However, as under the original safe harbor, some employers may not be motivated to do more than the minimum required to satisfy the Code requirements to use the automatic enrollment safe harbor. Thus, it may not have the same effect on the elective contribution rate for these employees. Some employers using the safe harbor even might be motivated to encourage nonhighly compensated employees to elect not to contribute to the extent permitted in the statutory framework. This might be true if the employer does not view employees as valuing the benefit sufficiently to justify the employer's added cost. Further, the employer might have chosen the new auto-enrollment safe harbor specifically because it contains a lower match and might see it as an opportunity to lower plan costs with respect to these employees.

## IV. AUTOMATIC IRA PROPOSALS

### A. Proposals Relating to Automatic Enrollment in Payroll Deduction IRAs

#### **H.R. 2167; S. 1141, the “Automatic IRA Act of 2007”**<sup>126</sup>

Bills have been introduced in the House and Senate to mandate automatic IRAs. Automatic IRA proposals have been advocated as a means to increase savings for retirement by low- and middle-income taxpayers.<sup>127</sup> Under H.R. 2167 and S. 1141, employers that do not sponsor a retirement plan for their employees would be required to offer a payroll deduction IRA program to their employees. The proposal includes a default for any employee who fails to make an election under which payroll deduction contributions for the employee automatically begin to be made to an IRA established for the employee. The proposal contemplates that the automatic enrollment contribution rate for employees who fail to make an affirmative election would be at three percent of compensation (but not more than the IRA dollar limit for the year). The proposal also requires employers who maintain a retirement plan to offer a payroll deduction program to employees not covered under the plan with certain exceptions. The proposal allows a newly created Thrift Savings Plan (“TSP”) board (the “TSP II Board”) that would have authority to provide for annual increases but not to a percentage that exceeds eight percent of compensation.<sup>128</sup>

Under H.R. 2167 and S. 1141, exceptions to the mandate are provided for certain small employers and for new employers as well as exceptions for employees of governmental entities and churches. The proposal provides that the TSP II Board is to provide for the maintenance and establishment of automatic IRAs. The bills also provide an option under which payroll deduction contributions under automatic IRAs to TSP accounts can be made by the employers with their payroll taxes.

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<sup>126</sup> The “Automatic IRA Act of 2007,” H.R. 2167 sponsored by Mr. Neal (and Mr. English, Mr. Emanuel, Mr. Larson, and Ms. Schwartz), and S. 1141 sponsored by Mr. Bingaman (and Mr. Smith, Mr. Kerry, Ms. Snowe, and Mr. Harkin). The provisions of H.R. 2167 and S. 1141 are also included in the “Women’s Retirement Security Act of 2008,” H.R. 5543 sponsored by Mr. Allen (and Mr. English and Ms. Berkley) and S. 1288 sponsored by Mr. Smith (and Mr. Conrad, Mr. Kerry, Mr. Bingaman, and Ms. Snowe). That bill includes other pension proposals as well.

<sup>127</sup> Automatic IRAs have also been advocated by the Retirement Security Project which is a project of Georgetown University’s Public Policy Institute and the Brookings Institute to promote solutions to improve retirement security. The Retirement Security Project proposal for automatic IRAs is described in detail in Peter Orszag, J. Mark Iwry, and William G. Gale, *Aging Gracefully: Ideas to Improve Retirement Security in America*, The Century Foundation Press, New York (2006), Chapters 4 and 5.

<sup>128</sup> Some have suggested that the mandate include a required escalation of contributions similar to the escalation provisions in the automatic ADP safe harbor for section 401(k) plans. Thus, for example, contributions would begin at x percent and then increase by one percent for a specified number of years for any employee who fails to make an affirmative election.

The proposal provides specified default investments which include a life cycle fund similar to the life cycle funds offered under the TSP or such default investments as the TSP II Board specifies for automatic IRAs in regulations. The proposal directs the new TSP II Board to take into account the DOL regulations for default investment under qualified employer plans with automatic enrollment. The proposal also provides that the exception from the ERISA fiduciary requirements for participant directed investments applies within seven days after the individual receives notice that an automatic IRA has been established for the individual. Finally the proposal provides that any State laws that conflict with the provision for automatic IRAs are preempted.

H.R. 2167 and S. 1141 provide that the default may be either a traditional IRA or a Roth IRA. The proposal also specifies a number of administrative requirements that must be satisfied, including a mandated notice of the right to opt out or contribute a different amount, an election period, and specific timing requirements for the employer to make contributions. An excise tax applies on the failure of any employer to satisfy the automatic IRA requirements for any year equal to \$100 for each participant to whom the failure relates.

The proposal also provides for a tax credit for small employers for the first two years in which the employer maintains an automatic IRA program equal to \$25 multiplied by the number of applicable employees for whom contributions are made but not to exceed \$250 for the year.<sup>129</sup>

#### **H.R. 5160, the “Small Businesses Add Value for Employees Act of 2008”<sup>130</sup>**

H.R. 5160 provides that an employer may implement an automatic IRA arrangement. Under the proposal, there is no mandate to implement such a program. Under H.R. 5160, automatic contributions between three and 10 percent may be made. Similar to the previous proposal, participants are provided an opportunity to opt out of participation.

The proposal increases the present law credit for small employer pension plan startup costs to 50 percent of the startup costs plus \$25 per newly covered participant.

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<sup>129</sup> Present law provides for a tax credit under section 45E for small employer plan pension start-up costs for the first three years of the plan which is limited to the lesser of \$500 per year or 50 percent of the start-up costs. The credit for the establishment of automatic IRAs is designed to be less than the credit provided under present law.

<sup>130</sup> The “Small Businesses Add Value for Employees Act of 2008,” H.R. 5160, sponsored by Mr. Kind and Mr. Hulshof. The bill also includes other pension proposals as well.

## B. State Government-Sponsored Investment Opportunities

Various state legislatures are considering methods of expanding retirement savings through the use of IRAs. For example, the California State Assembly recently passed a bill that would authorize the California Public Employees' Retirement System to offer IRAs to eligible employees of eligible employers.<sup>131</sup> An eligible employer is defined under the bill as generally any employer that satisfies the requirements to establish either a SIMPLE plan or a payroll deposit IRA arrangement, and an eligible employee is defined as any employee of an eligible employer. The bill conditions the establishment of the IRA program by the Public Employees' Retirement System upon the system obtaining any necessary Federal approval or authorization, including necessary approvals and authorizations from the DOL, Internal Revenue Service, and the Securities and Exchange Commission. Reports in the media indicate that the Public Employees' Retirement System is currently evaluating the legal and regulatory hurdles that may underlie the proposal.<sup>132</sup> Among the possible hurdles underlying the proposal is approval of the system as an IRA trustee by the Department of Treasury. Other state legislatures, including those of Maryland and Washington, are considering proposed legislation that is similar to the California proposal.<sup>133</sup>

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<sup>131</sup> AB 2940, which passed the California State Assembly on May 29, 2008, is currently pending in the California State Senate.

<sup>132</sup> Marc Lifsher, "An IRA for the rest of us," *The Los Angeles Times*, April 4, 2008, page D1; John Hill and Mark Glover, "California Assembly panel passes state-run IRA proposal," *The Sacramento Bee*, April 10, 2008, page D1.

<sup>133</sup> Maryland House Bill 1228 (creating the Maryland voluntary retirement account program); Washington House Bill 2044 (creating the Washington voluntary retirement account program).

## C. Discussion of Issues

### **In general**

Advocates of an employer mandate for automatic IRAs claim that automatic IRA programs will involve little cost to employers because the employer is merely a conduit of the IRA contribution.<sup>134</sup> However, others view the cost as being potentially significant.<sup>135</sup> While the cost may be less significant than the associated cost with qualified employer plans, administrative costs and issues will be relevant in the establishment of an automatic IRA program. An employer will need to take action to establish a program. The employer will need to have a procedure for establishing default IRAs for employees and may need to decide whether the default should be a traditional or a Roth IRA. Employers must institute notice procedures to inform employees that automatic enrollment will occur absent their affirmative election. In addition, the employer must have resources to field employee concerns and questions about the program.

While administrative concerns are relevant, automatic enrollment in payroll deduction IRAs raises fewer administrative concerns than those associated with automatic enrollment in section 401(k) plans. For example, contributions to an IRA for a year are permitted to be withdrawn from an IRA (with allocable income) without tax consequence until the individual's due date for the income tax return for the year. Even after that the deadline, amounts can be withdrawn, but the early distribution tax may apply for distributions before age 59-½. In addition, unlike section 401(k) plan contributions, a payroll deduction IRA contribution is deductible without regard to the timing of the election to make the contribution.

### **Potential employee behavior**

Proponents assume that automatic IRAs will produce a comparable increase in participation as that associated with automatic enrollment in section 401(k) plans. They believe that mandatory automatic IRAs can be expected to increase contributions to IRAs by low and middle income employees. The theory is that to the extent that these employees are not saving for retirement due to inertia (simple failure to take initiative), that same failure to take initiative may prevent them from electing out of the contributions. By requiring an affirmative decision to not save in order to stop the contributions, the proposal would force employees to think about retirement savings. In the case of employees who can and want to save for retirement, the

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<sup>134</sup> Peter Orszag, J. Mark Iwry, and William G. Gale, *Aging Gracefully: Ideas to Improve Retirement Security in America*, The Century Foundation Press, New York (2006), Ch. 4 (J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs") at 49.

<sup>135</sup> Mary M. Schmitt and Judy Xanthopoulos, "Automatic IRAs: Are They Administratively Feasible, What are the Costs to Employers and the Federal Government, and Will They Increase Retirement Savings," Preliminary Report Prepared for AARP, Optimal Strategies, LLC, (March 8, 2007), 13. The report indicates that, in addition to cost to employers, costs associated with automatic IRAs to individual participants may erode the accounts significantly.

proposal will assist them in that effort. Proponents believe that once these employees actually begin the “habit” of retirement savings they are likely to continue to make contributions.

Nevertheless, some employees do not save for retirement because they need all their current income to meet their basic needs. Other employees may choose to spend their current income to finance a lifestyle that they wish to maintain. An automatic IRA may not change their behavior especially since it is fairly easy for an individual to opt out of participation (i.e., the proposal only requires a one time election by these employees to stop the contributions). Opting out may be likely in the case of individuals who are already in a negative savings position.

The ultimate success of an automatic IRA program is not only how much money employees contribute to IRAs through the program, but how much is retained as savings for use in retirement. There may be social benefits from pure savings; individuals can be prepared for unanticipated expenses or changes in their financial situation, such as a job loss. However, savings alone does not provide for a secure retirement if the savings are not retained for consumption during retirement. Historically, there have been significant withdrawals over time from IRAs as reflected in the distributions made that are subject to the early distribution tax. These withdrawals do not include distributions made pursuant to an exception to the tax. However, any further tax burden on withdrawals may limit the willingness of individuals to make contributions.

### **Potential employer behavior**

The success of the program will depend on whether it is embraced by the employer community. The employers that would be required to establish an automatic IRA program are generally employers who do not sponsor any retirement plan for their employees. This group may be opposed to such a mandate.

For some employers, the failure to offer a plan may be the result of the same inertia that causes employees to fail to set up an IRA. Other employers may desire to establish a plan, but do not because of administrative, cost, or potential liability issues. For these employers, a mandated program may facilitate action that they already wanted to take. Proponents are optimistic that such participation may introduce these employers to retirement plan service providers who may in turn induce them to set up an employer-sponsored retirement plan, such as a SIMPLE IRA plan or a section 401(k) plan.

The success of the program will depend on streamlining compliance requirements for employers so that the cost of compliance is relatively low. The IRS (or any other agency administering the program) will need to provide safe harbor notices and election forms to employers with instructions on how to administer the program. Guidance on establishing IRAs and selecting default investments will also need to be available.

There may be some risk that, if automatic IRA programs become very simple, risk-free, and low cost for employers, some employers who already maintain an employer sponsored retirement plan might drop their plan and instead adopt an automatic IRA program. They may view this as a less expensive alternative to an employer sponsored plan. This may be particularly true, for example, in the case of a small sole proprietor who does not believe that the value of the

plan to employees justifies the cost and who personally cannot afford to contribute more than the maximum IRA contribution. Still, such employers can drop their employer sponsored plan absent the proposal.

Further, some employers may have made a conscious decision not to maintain an employer sponsored retirement plan for their employees. Other than withholding and paying payroll taxes to fund social security benefits, sponsorship of a retirement plan by an employer is voluntary. The low level of voluntary establishment of payroll deduction IRA programs by employers who do not sponsor qualified retirement plans is not entirely due to inertia. Some employers may have considered and rejected the idea of establishing a payroll deduction IRA program. They might have made a judgment that further payroll deductions of any kind, let alone an automatic program, is not a program that their employees, particularly minimum wage employees, would value. The employer might assume that these employees will not be able to afford any further reduction in take home pay, and be concerned that such a reduction will generate employee dissatisfaction.

The mandatory element itself might generate resentment by some employers and resistance to embracing the program as a benefit for their employees. The level of compliance will depend on whether the employer sees the threat of penalty for noncompliance as real or illusory. An employer could present the option to employees in a way that is more likely to generate an election not to contribute than an election to make contributions.

### **Financial institutions**

In the case of a proposal that does not mandate that a Federal or State program be available to accommodate the new small IRAs that will be established, the financial community would need to embrace the program to make it feasible. Many of the employees who elect, or default into, participation will have no preexisting IRAs. For low and middle income employees, the initial contributions will be very small. Three percent of weekly pay of \$500 is only \$15. Most financial institutions charge small annual fees for IRA maintenance.<sup>136</sup> Many require minimum contributions to establish an IRA. For a default IRA for low or even middle income taxpayers, this may be a complete barrier. Thus, providing options under TSP or a State government sponsored IRA may be a critical element in a successful program.

### **Protection of employees against employer retaining deducted contributions**

The DOL has found numerous instances where employers have deducted amounts from an employee's pay for contribution to a section 401(k) plan but not contributed the amount to the plan.<sup>137</sup> The employee may not be aware that the contributions are not being made until the

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<sup>136</sup> *Id.* at 44. The report discusses the problem of small automatic IRA contributions including current minimum monthly contributions and annual administrative fees. The report suggests pooling of automatic contributions to reduce administrative fees with respect to automatic accounts.

<sup>137</sup> On November 28, 1995, Secretary of Labor Reich issued a news release warning of 401(k) fraud. The news release indicated that more than 300 companies nationwide were being investigated for potential violations, both civil and criminal. The news release indicated that since the effort had begun

employee receives his or her account statement. It is important that any proposal include sufficient protections for employees against these potential abuses by employers. One approach would be to mandate that all default contributions be made to a government sponsored IRA and all employees have a government sponsored IRA as an investment option. A mechanism could be established for regularly monitoring whether contributions were being made timely.

### **Traditional or Roth IRA as the default**

In the case of a proposal that provides that the default may be either a traditional IRA or a Roth IRA, employers would have to determine what option would be advantageous for its employees. In the case of a higher-paid workforce, the traditional IRA might appear to be the better option, because in the case of nondeductible contributions, there is no income limitation. For deductible contributions, there is no income limit if the taxpayer (or, if married both taxpayer and spouse) do not participate in an employer sponsored plan. However, for many taxpayers, a traditional IRA may not be the best choice. As discussed earlier, low-income individuals get little or no benefit from a current tax deduction, but later may be subject to income tax when they receive distributions. For individuals who benefit from the deduction, a contribution to a Roth IRA of the maximum amount (to the extent allowed by the income limits) will produce more income at retirement because, as discussed in the first section of this pamphlet, a dollar contributed to a Roth account represents greater after-tax saving than a dollar contributed to a traditional deductible IRA, because the former is contributed on an after-tax basis while the latter is contributed on a pre-tax basis. Still, higher-income employees may be unable to make Roth contributions because of the income limits.

### **Saver's credit**

Some have recommended that the saver's credit be increased and expanded in conjunction with mandating automatic IRAs.<sup>138</sup> They believe that an automatic payroll deduction IRA program alone may not be sufficient to make significant increases in IRA participation by low and middle income tax payers. Some have proposed that the saver's credit be made refundable. The current nonrefundable credit is effectively not available to taxpayers with no income tax liability. Thus, proponents argue that it does not serve as an incentive for those employees.

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earlier that year, more than 100 other cases had been closed, resulting in the recovery of more than \$3.2 million for more than 2,800 workers. It included 10 warning signs for employees that their employer might not be making their contributions to the plan. The warnings signs included signs that the employee's account statement does not include the contributions and that the employer is in financial distress.

<sup>138</sup> For example, in addition to an automatic IRA proposal, the "Women's Retirement Security Act of 2008," H.R. 5543 sponsored by Mr. Allen (and Mr. English and Ms. Berkley) and S. 1288 sponsored by Mr. Smith (and Mr. Conrad, Mr. Kerry, Mr. Bingaman, and Ms. Snowe) include provisions to expand the saver's credit and to make it refundable.