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Individual Retirement Accounts (IRAs): Legislative Issues in the 105th Congress

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Summary

The Taxpayer Relief Act of 1997 (P.L. 105-34) included provisions for greater tax deferrals for individual retirement account (IRA) contributions, relaxed penalties on early withdrawals, and new IRAs that pay tax-free benefits funded from after-tax savings. The 5-year cost for the IRA provisions is an estimated $2.6 billion for FY1998-FY2002. The 10-year cost ($21.9 billion) is much greater because the tax benefits of the new "Roth" IRAs will be realized only when funds are withdrawn. Further changes to IRAs have been proposed. Several technical revisions in IRA rules are included in the Senate-passed version of the Internal Revenue Service Restructuring and Reform Act of 1998 (H.R. 2676). Similar provisions were passed by the House in the Tax Technical Corrections Act of 1997 (H.R. 2645).

Legislative History

In 1971, President Nixon proposed that workers be allowed to defer from taxable income an amount of earnings set aside in an IRA. This idea was included in the Employee Retirement Income Security Act (ERISA) of 1974 (P.L. 93-406), limited to workers not covered by employer pension plans. Eligible workers could make tax-deferred IRA contributions up to the lesser of $1,500 a year or 15% of earned income. In 1981, President Reagan urged that all workers be allowed to have IRAs and that the contribution limit be raised. The Economic Recovery Tax Act of 1981 (P.L. 97-34) raised the limit to the lesser of $2,000 or 100% of earnings and made all workers eligible. A total of $2,250 could be contributed by a worker and a nonworking spouse. The Tax Reform Act of 1986 (P.L. 99-514) lowered income tax rates and broadened the taxable income base. This base-broadening included a curb on tax deferrals for IRA contributions, restricting deferrals to: (1) workers with no employer-sponsored retirement plan; and (2) workers in employer plans who meet an income test. Married accountholders with no employer coverage were treated as having employer coverage if their spouses had such coverage.

Over time, pressure built to restore tax deferrals, ease early withdrawal penalties, and allow "backdoor" IRAs that receive taxable contributions and pay tax-free benefits. Three times Congress passed bills that included these provisions but were vetoed. However, the 104th Congress did enact penalty-free early withdrawals for certain health expenses (P.L. 104-191) and a higher contribution limit for nonworking spouses (P.L. 104-188).

More significant changes were realized with passage of the Taxpayer Relief Act of 1997 (P.L. 105-34). This law established a new "backdoor" IRA called a Roth IRA which accepts only after-tax contributions but provides for tax-free distributions. It also raises the income limits that determine tax deductibility for contributions to traditional IRAs by accountholders who have employer pension coverage, and it allows a married accountholder with no employer coverage to make deductible contributions independent of the spouse's coverage status. The 1997 law also established two new situations in which penalty-free early withdrawals may be made: to pay for higher education expenses; and to purchase a first home.

Rules for Tax Year 1998

Beginning in 1998, there are three types of IRAs: "deductible" IRAs, in which income tax is deferred on both contributions and investment earnings until funds are withdrawn; "nondeductible" IRAs, contributions to which are subject to current-year tax but the investment earnings of which are tax-deferred; and "Roth" IRAs, contributions to which are taxed but the investment earnings of which may be withdrawn tax free.

Anyone with earned income can contribute yearly the lesser of $2,000 or 100% of earnings to an IRA. A spouse with little or no earnings can contribute up to $2,000 also, but a couple's combined contributions cannot exceed their earnings. The $2,000 limit applies to the sum of a person's contributions if contributions are made to multiple IRAs. An IRA must be a separate trust account held by an approved financial institution. IRA funds can be moved tax-free to another IRA once a year. Lump-sum distributions from most employer plans can be transferred tax-free (rolled over) to deductible IRAs without limit. IRAs can be invested in marketable securities, interest-bearing accounts, and certain precious metals.

Contributions to a deductible IRA are subtracted from income before computing income tax liability. A full $2,000 contribution can be deferred by an employed individual only if: the worker is not covered by an employer-sponsored retirement plan; or adjusted gross income (AGI) does not exceed $30,000 (single filer) or $50,000 (joint filer). Filers may defer less than $2,000 if their AGI is less than $40,000 (single) or $60,000 (joint). A worker's nonworking spouse can defer a $2,000 contribution if joint AGI does not exceed $150,000; partial deferral is allowed up to AGI of $160,000. Up to $2,000 can be contributed to a Roth IRA by single filers with AGI of $95,000 or less and by joint filers with AGI of $150,000 or less. Roth IRA eligibility phases out at AGI of $110,000 (single) and $160,000 (joint).

Withdrawals from an IRA before age 59½ incur a 10% excise tax on any taxable amounts withdrawn, unless the withdrawal is because of: death; disability; conversion

of the asset to a lifetime annuity; medical expenses that exceed 7.5% of AGI; the need to pay health insurance premiums while unemployed; higher education expenses; or purchase of a first home. This 10% tax is in addition to income tax on the withdrawal.

Withdrawals *must* begin by April 1 of the year after the year that the accountholder attains age 70½, at a rate that will consume the IRA over the expected remaining lifespan(s) of accountholder (and beneficiary). Failure to make such withdrawals triggers a 50% excise tax on the deficiency. Mandatory withdrawals are not required from Roth IRAs.

A deductible IRA can be converted to a Roth IRA by persons with AGI no greater than $100,000 (for single or joint filers), but income tax is due on transferred amounts not already taxed. Amounts transferred in 1998 can be averaged over 4 years for tax purposes, however.

Proposals in the 105th Congress

Many bills have been introduced to change IRA rules. The Taxpayer Relief Act of 1997 incorporated some of these proposals. The following discussion comments on issues yet to be addressed. **Table 1** arrays *all* introduced bills by type of change proposed. “P.L. 105-34" is shown in boldface type under “House bill no.” for proposals included in that law.)

Eligibility for IRA Tax Deferrals

Initially, IRA eligibility was quite limited. Participation rose quickly when all workers became eligible in 1981 but fell sharply after deferrals were curbed in 1986. In 1995, 4.2% of tax filers with wage and salary income made tax-deferred contributions, down from 18.6% in 1985. Contributions totalled $7.6 billion, down 80% from 1985. However, IRA assets continued to grow as IRA investment earnings and rollovers from employer retirement plans exceeded accountholders’ withdrawals. At the end of 1992, IRA assets totalled $610 billion, 12% of all assets held in tax-deferred retirement plans. Some advocates of retirement saving seek to reverse the trend of falling IRA contributions.

Several arguments have been made to relax the limits on tax deferment of IRA contributions: some people covered by employer plans retire with inadequate benefits; workers denied tax deferment because their spouses had employer plan coverage did not have the chance that other uncovered workers had for tax-deferred saving; the curb on deferrals greatly reduced IRA saving, even by those eligible for full deferral, because financial institutions had less reason to market IRAs; and inflation had shrunk the population eligible for deferral. Had the $35,000 and $50,000 AGI limits for deferral been indexed for inflation, they would have reached $49,573 and $70,819, respectively, in 1997.

P.L. 105-34 raises the income limits for tax-deferral of IRA contributions over 10 years (**Table 2**). It eventually (in 2007) will widen the $10,000 phaseout interval for deductibility to $20,000 for joint filers. However, this law does not offset the inflationary

erosion in these limits. Some proposals, for example H.R. 446 (Representative Thomas), would raise the income limits for deductibility to much higher levels.

Table 1. IRA Proposals Introduced in the 105th Congress

IRA proposal	House bill no.	Senate bill no.
Expand deductibility	17, 83, 228, 446, 891, 1130, **105-34**	2, 14, 197, 883
Allow partial credit of contribution in lieu of deduction	17, 1130	14
Reduce or eliminate linkage of deductibility to spouse's coverage by employer pension	17, 446, **105-34**	2, 14, 180, 883, 889
Increase contribution limit	17, 228, 891	20
Increase nondeductible contribution limit	3225	
Index contribution limit for inflation	83, 228, 446, 891, 1130, 3102	14, 197, 883
Allow tax-free withdrawal after age 59½ if funds given to charity	2821	1734
Allow penalty-free early withdrawal for higher education expenses	83, 228, 446, 553, 891, 1130, **105-34**	2, 14, 197
Allow penalty-free early withdrawal when unemployed	83, 446, 615, 891, 1130, 3101	2, 197
Allow penalty-free early withdrawal for purchase of first home	83, 228, 446, 891, 1130, **105-34**	14, 197
Allow penalty-free early withdrawal for long-term care expenses	83, 228	
Allow penalty-free early withdrawal for medical expenses of lineal ancestors and descendants	83, 228, 891, 1130, 3600	14, 197
Allow penalty-free early withdrawal to start a business		2
Allow penalty-free early withdrawal for adoption expenses	891, 2164	935
Apply withdrawal penalty after age 59½ if funds held less than 5 years	83, 1130	14
Repeal rule requiring mandatory withdrawals after age 70½	3079	
Allow borrowing for certain purposes	228, 1123, 2026	
Expand ability to invest in precious metals	446, **105-34**	197
Allow investment in state prepaid tuition programs	83	
Exclude inherited IRA from taxable estate	228	
Allow rollover of farm sale proceeds to IRA	1518	20, 80
Set early withdrawal tax to 25% for rollover IRA held less than 2 years	3101	
Establish payroll deduction as means for IRA contribution	1130, 3672	14, 883, 889
Authorize "backdoor" IRA	83, 446, **105-34**	2, 197, 883
Allow conversion of regular IRA to "backdoor" IRA	83, 446, **105-34**	2, 197, 883

Table 2. AGI Limits for Full IRA Deductibility Under P.L. 105-34[a]

Tax year	Single filer	Joint filer	Tax year	Single filer	Joint filer
1998	$30,000	$50,000	2003	$40,000	60,000
1999	31,000	51,000	2004	45,000	65,000
2000	32,000	52,000	2005	50,000	70,000
2001	33,000	53,000	2006	50,000	75,000
2002	34,000	54,000	2007 & later	50,000	80,000

[a]These AGI limits apply to accountholders who have employer pension coverage. There are no limits for single filers who lack such coverage. For joint filing units in which only one spouse has employer coverage, the limits shown here apply only to the covered spouse. Full deductibility is allowed for the uncovered spouse up to AGI of $150,000, effective for 1998 and later years.

The new law ends the denial of tax deferrals to those whose spouses have employer plan coverage if an income limit is met. That is, if only one spouse in a joint filing unit has employer coverage, the uncovered spouse can deduct contributions fully if the unit's AGI is below $150,000, or partially if AGI is below $160,000.

Annual IRA Contribution Limits

Unlike contribution limits for employer plans, the $2,000 IRA limit is not adjusted for inflation. Had the original $1,500 limit been adjusted, it would have been $4,486 in 1997. The $1,500 limit was raised to $2,000 in 1981. Had that limit been adjusted, it would have reached $3,540 in 1997. P.L. 105-34 did not change the limit, but several bills would do so. H.R. 3102 (Representative Neal) would index the $2,000 limit for inflation. H.R. 891 (Representative Saxton) would increase the limit in steps to $7,000 and then index it.

Penalties for Early Withdrawals from IRAs

A 10% early withdrawal tax discourages the premature use of IRA assets. P.L. 105-34 expands penalty-free withdrawals by allowing them for higher education expenses and first-home purchases. Penalty-free education withdrawals cannot exceed higher education expenses less scholarships received. There is a lifetime limit of $10,000 on home-purchase withdrawals. Further proposals still pending for penalty-free withdrawals would allow them for: long-term care expenses (H.R. 228), medical expenses of relatives (H.R. 3600), and adoption expenses (S. 935).

Roth IRAs

The new law allows after-tax contributions up to $2,000 to "Roth" IRAs. This limit is phased out for AGI in excess of $95,000 (single filers) or $150,000 (joint filers), reaching $0 at $110,000 (single) or $160,000 (joint). Unlike traditional IRAs, contributions to Roth IRAs can continue after age 70½. Withdrawals of contributions and investment earnings are tax free for funds held at least 5 years if withdrawals are made after age 59½, upon the accountholder's death or disability, or to buy a first home.

The Internal Revenue Service Restructuring and Reform Act of 1998 (H.R. 2676) includes several technical changes to Roth IRAs. One provision, effective in 2005, would make it easier for a person over age 70½ to convert a deductible IRA into a Roth IRA by disregarding from AGI any IRA distributions required by the person's age in applying the $100,000 eligibility income limit for such conversions. This bill also includes several technical corrections to the language in P.L. 105-34 that authorized Roth IRAs.

Other IRA Issues

P.L. 105-34 broadened allowable IRA investments in precious metals to include bullion, increased the tax on prohibited transactions from 10% to 15%, and permanently repealed the 15% tax on large withdrawals retroactive to January 1, 1997. This tax on annual withdrawals in excess of $160,000 and lump-sum withdrawals of more than $800,000 had already been waived through 1999 by P.L. 104-188. Other issues addressed by introduced bills include: tax-free withdrawals after age 59½ for IRA funds donated to charities (H.R. 2821, S. 1734); repeal of required minimum withdrawals after age 70½; and authorization of loans from IRAs for certain purposes (H.R. 2026).

Economic and Budgetary Issues Raised by IRAs

Experts worry that workers are not saving enough for retirement. Would expanded IRAs yield more retirement saving? The May 1993 Current Population Survey found that 12% of workers with no employer pension coverage had IRAs, compared to 25% with such coverage. Thus, the prime IRA target group, those with no employer pensions, saved less in IRAs than did others. Raising the contribution limit might produce more saving by those who have IRAs while encouraging few noncontributors to open IRAs. Relaxing early withdrawal rules might attract new contributors, but preretirement use of savings probably would rise. Broader eligibility for tax deferral would prompt more saving, especially in the higher tax brackets. However, some new IRA saving would consist of savings that would have occurred anyway without new tax breaks.

Some argue against larger IRA tax deferrals because the lost revenue is likely to benefit mainly higher-income workers, who are also more likely to have employer pensions. The highly paid have more disposable income from which to save and realize larger benefits from tax deferral. In 1985, a year before deferrals were limited, only 8% of tax filers with AGI between $10,000 and $20,000 reported IRA contributions, compared to 58% of filers with AGI above $50,000.

Deferring income tax on IRA contributions and investment earnings constitutes an opportunity cost to government since the deferred revenue is unavailable to pay current obligations. This IRA "tax expenditure" was worth $9.3 billion for FY1997. For FY1998-FY2002, IRA provisions in P.L. 105-34 are estimated to cost another $2.6 billion. The new Roth IRAs do not add to short-run costs, but critics argue that their budget impact simply is postponed. In the short run, Roth IRAs will attract more taxable saving and will yield a revenue windfall as some accountholders convert old IRAs to Roth IRAs and pay tax on the transferred amounts. However, large revenue losses will occur later when investment earnings are withdrawn tax free. Indeed, the 10-year cost for the IRA provisions of P.L. 105-34 is estimated to be $21.9 billion, or eight times the 5-year cost.