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Individual Retirement Accounts (IRAs): Legislative Issues in the 106th Congress

James R. Storey
Specialist in Social Legislation
Domestic Social Policy Division

Summary

Proposals have been offered to raise the limit on annual contributions to individual retirement accounts (IRAs), raise the income limits on deductibility of IRA contributions for tax purposes, and expand the allowable reasons for penalty-free early withdrawals. Senator Roth has proposed elimination of the income eligibility limit for opening a Roth IRA and an increase in the income limit (to $1 million) for conversion of a traditional IRA to a Roth IRA. (This report tracks legislative issues and will be updated as action occurs in the 106th Congress.)

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) for workers not covered by employer pension plans. Such workers could make tax-deferred IRA contributions up to the lesser of $1,500 a year or 15% of earned income. In 1981, the Economic Recovery Tax Act of 1981 (P.L. 97-34) raised the contribution 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 tax rates and expanded the taxable income base. The latter reforms included restricting IRA tax 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 such coverage if their spouses were covered.

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. Between 1992 and 1995, Congress passed such provisions three times in bills that were vetoed. However, penalty-free withdrawals for certain health expenses (P.L. 104-191) and a $2,000 contribution limit for nonworking spouses (P.L. 104-188) did become law.

Major IRA changes were included in the Taxpayer Relief Act of 1997 (P.L. 105-34). It authorized the Roth IRA, which accepts only after-tax contributions and provides tax-free distributions. This law also raised the income limits on tax deductibility for contributions to traditional IRAs by workers with employer pension coverage, and it allowed spouses who lack employer coverage to make deductible contributions to traditional IRAs independent of their partner's coverage status. The 1997 law allows penalty-free early withdrawals if used for higher education or a first-home purchase.

Rules for Tax Year 1999

There are now two IRAs: the "traditional" IRA, in which income tax is deferred on contributions and investment earnings until funds are withdrawn; and the "Roth" IRA, contributions to which are taxed in the current year but the investment earnings of which may be withdrawn *tax free* if held for at least 5 years. Traditional IRAs also may receive taxable ("nondeductible") contributions, which accrue *tax-deferred* investment earnings.

The lesser of $2,000 or 100% of earnings can be contributed yearly to an IRA. A spouse with little or no earnings also can contribute up to $2,000, but a couple's combined contributions cannot exceed joint earnings. The $2,000 limit also 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 a like IRA once a year. Lump-sum distributions from qualified employer plans can be transferred tax-free (rolled over) to traditional IRAs without limit. IRAs can be invested in marketable securities, interest-bearing accounts, and some precious metals.

Contributions to a traditional IRA that qualify for tax deferral are netted from income before computing tax liability. A full $2,000 contribution can be deferred by an employed person only if the worker lacks coverage by an employer-sponsored retirement plan or adjusted gross income (AGI) does not exceed $31,000 ($51,000 for joint filers). Filers may defer less than $2,000 if their AGI is less than $41,000 ($61,000 for joint filers). 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 ($150,000 or less for joint filers). Roth IRA eligibility phases out at AGI of $110,000 ($160,000 for joint filers). The annual sum of an individual's contributions to all IRAs cannot exceed $2,000.

Withdrawals from an IRA before age 59½ incur a 10% excise tax on taxable amounts withdrawn unless withdrawn 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 any income tax owed 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 the accountholder (and beneficiary). A breach of this rule triggers a 50% excise tax on the deficiency. Mandatory withdrawals are not required from Roth IRAs.

A traditional 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. (Taxable amounts that were transferred before January 1, 1999, can be averaged over 4 years in computing income tax liability, however.)

A tax law (P.L. 105-206) signed on July 22, 1998, made technical changes to Roth IRAs effective for 1998. Beginning in 2005, this law will make it easier for persons over age 70½ to convert traditional IRAs to Roth IRAs by allowing AGI from mandatory IRA withdrawals to be ignored in applying the eligibility income limit on IRA conversions.

When an accountholder dies, a spouse beneficiary may treat an inherited IRA as his/her own, making it subject to the usual IRA rules regarding distribution and taxation. An IRA inherited by a spouse is not subject to the federal estate tax. A nonspouse beneficiary cannot treat an inherited IRA as his/her own and usually must take distributions from it at a rate fast enough to liquidate it over either a 5-year period or the beneficiary's life expectancy. The estate tax may apply to this beneficiary if the estate's total value exceeds an exempt level ($650,000 in 1999).

Proposals in the 106th Congress

Table 1 lists IRA proposals included in bills introduced in the 106th Congress. They are discussed below by major issue area.

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 totaled $7.6 billion, down 80% from 1985. However, IRA assets have grown rapidly as IRA investment earnings plus rollovers from employer retirement plans continue to outpace IRA withdrawals. At the end of 1997, IRA assets totaled $1.9 trillion, about twice as much as in 1993.

Several arguments are 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 have employer plan coverage have not had the chance that other uncovered workers had for tax-deferred saving; this curb on deferrals greatly reduced IRA saving by those still eligible for deferrals because financial institutions had less reason to market IRAs; and inflation has shrunk the population eligible for deferral. Had the $35,000 and $50,000 AGI deferral limits been indexed for inflation since 1986, they would have reached $52,004 and $74,291, respectively, in 1998.

Table 1. IRA Proposals Introduced in the 106th Congress

IRA proposal	Bill no.
Increase income limits for deductibility of contributions	H.R. 188, H.R. 876, S. 476
End income limits for deductibility of contributions	H.R. 1546, S. 649
Allow partial credit of contribution in lieu of deduction	H.R. 226, H.R. 1590
End phaseout of deductibility based on spouse pension coverage	H.R. 188

IRA proposal	Bill no.
Increase contribution limit	H.R. 188, H.R. 802, H.R. 876, H.R. 1102, H.R. 1322, H.R. 1357, H.R. 1546, S. 593, S. 649, S. 799
Index income limits on deductibility for inflation	H.R. 188, H.R. 876
Index contribution limit for inflation	H.R. 188, H.R. 876, H.R. 1322, H.R. 1546, S. 593, S. 649
Coordinate contribution limits with §401(k) plan limits	S. 476
Allow penalty-free early withdrawal when unemployed	H.R. 188, H.R. 876, H.R. 1590, S. 476
Allow penalty-free early withdrawal for long-term care expense	H.R. 188, S. 476
Allow penalty-free early withdrawal for any medical expenses of accountholder or lineal ancestors and descendants	H.R. 188, H.R. 876, S. 476
Allow tax-free withdrawal to pay for long-term care insurance	H.R. 275
Allow tax-free withdrawal for charitable donations	H.R. 1311
Forgive income tax on penalty-free early withdrawals if repaid to IRA in 5 years	H.R. 188
Allow loan from IRA to buy first home	H.R. 1333
Repeal mandatory withdrawal requirement after age 70½	H.R. 252
Increase age when minimum required distributions must begin	S. 741
Set standards for types of coins in which IRA can be invested	S. 163
Allow inherited IRA to be held by beneficiary until age 70½	H.R. 188
Exclude inherited IRA from taxable estate	H.R. 188
Allow rollover of inherited §401(k) to IRA	H.R. 188
Allow rollover of gain from farm sale to IRA	S. 62
Allow rollover from §457 plan to IRA	H.R. 739, H.R. 1102, H.R. 1213, H.R. 1590, S. 741
Allow rollover of IRA to employer plan	H.R. 739, H.R. 1102, H.R. 1213, S. 741
Authorize payroll deduction IRAs	H.R. 1213, H.R. 1590, S. 649, S. 741
End income limit for eligibility to contribute to Roth IRA	H.R. 1546, S. 649
Increase income limit to $1 million for eligibility to convert traditional IRA to Roth IRA	H.R. 1546, S. 649

The Taxpayer Relief Act of 1997 (P.L. 105-34) raises over 10 years the income limits for tax-deferral of IRA contributions (**Table 2**), and in 2007 it will widen (from $10,000 to $20,000) the phaseout interval for deductibility for joint filers. However, this law does not offset fully the inflationary erosion in these limits. H.R. 188 would raise these

deductibility limits and adjust them automatically for inflation. Senate Finance Committee Chairman Roth proposed complete elimination of the income limits (S. 649).

P.L. 105-34 ended 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 filing unit's AGI is below $150,000. Partial deductions are allowed if AGI is below $160,000. H.R. 188 would erase this income limit for the uncovered spouse.

Two proposals (H.R. 226, H.R. 1590) offer tax filers the option of a partial tax credit in lieu of a deduction for IRA contributions. Credits are often more valuable to lower-income taxpayers than deductions.

Annual IRA Contribution Limits

Unlike contribution limits for employer plans, the $2,000 IRA limit is not adjusted for inflation. Had the original 1974 limit of $1,500 been adjusted annually, it would have reached $5,227 in 1998. The $1,500 limit was raised to $2,000 in 1981. Had that limit been adjusted, it would have reached $3,654 in 1998. P.L. 105-34 did not change this limit. However, numerous bills would raise the limit and provide for future inflation adjustments. For example, S. 649 proposes a $5,000 ceiling and inflation indexing.

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
1987-1998	$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.

Penalties for Early Withdrawals from IRAs

A 10% excise tax discourages premature use of IRA assets. P.L. 105-34 expanded penalty-free withdrawals, allowing them for higher education expenses, and first-home purchases up to a lifetime limit of $10,000. New proposals would extend penalty-free withdrawals to: long-term care expenses, medical expenses of relatives, and expenses while jobless for 12 or more weeks. Tax-free withdrawals are proposed for funds used to purchase long-term care insurance and for charitable donations.

Some retirement experts advocate tougher penalties for early withdrawals. They fear that too many accountholders may opt to use IRA funds before old age, thereby lowering

their retirement assets. H.R. 188 encourages repayment of early withdrawals to IRAs by proposing forgiveness of income tax paid on withdrawn amounts if repaid within 5 years.

Inherited IRAs

A person who inherits an IRA from a deceased spouse can convert it to his/her own IRA to limit its exposure to federal income taxation and can use a spousal exemption to protect the IRA from the federal estate tax. However, a nonspouse beneficiary must take distributions from an inherited IRA, and it may be subject to estate taxation if the estate's total value is above $650,000. H.R. 188 would exclude inherited IRAs from the estate tax and would permit beneficiaries to retain inherited IRAs intact until age 70½.

Eligibility for a Roth IRA

The Roth IRA was authorized by P.L. 105-34 effective in 1998. It permits tax-free withdrawals of assets that were accumulated in IRAs funded by after-tax contributions and held at least 5 years. Taxpayers must meet an AGI eligibility limit of $150,000 ($160,000 for joint filers) to open Roth IRAs. There is also a $100,000 AGI limit on eligibility to convert a traditional IRA to a Roth IRA. S. 649 and H.R. 1546 propose ending the AGI limit for opening a Roth IRA and raising to $1,000,000 the AGI limit on converting a traditional IRA to a Roth IRA.

Economic and Budgetary Issues Raised by IRAs

Experts worry that workers are not saving enough for retirement. Will expanded IRAs yield more saving? The May 1993 Current Population Survey found that 12% of workers with no employer pension coverage had IRAs, compared to 25% of those with pension coverage. Thus, the prime IRA target group, those with no employer pensions, saved less in IRAs than did others. Making IRAs more attractive may draw more savings dollars into the accounts, but some of the new IRA saving would represent saving that would have occurred in other forms 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 affects the federal budget since this deferred revenue ($9.8 billion in FY1998) is unavailable to pay current obligations. For FY1998-FY2002, IRA provisions in P.L. 105-34 were estimated to cost another $2.6 billion. The 10-year cost was estimated to be $21.9 billion, a much higher figure, because the budget impact of the Roth IRA is hidden. In the short run, Roth IRAs attract more taxable saving and yield a revenue windfall as some accountholders convert traditional IRAs to Roth IRAs and pay tax on the converted amounts. However, large revenue losses will occur later when investment earnings are withdrawn tax free.