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IRAs and Other Savings Incentives: A Brief Overview

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Summary

Several types of savings are eligible for beneficial treatment under the individual income tax, and Individual Retirement Accounts (IRAs) have received considerable attention. Pension savings are actually more important in terms of revenue loss. There are other investments that are treated favorably as well. The President has proposed in previous budgets to significantly expand IRAs. Effects of these provisions on savings are uncertain, and, despite dollar limits on contributions and income phase outs, IRAs tend to benefit higher income individuals.

Description of Tax Treatment

Several types of investments are preferentially treated under the individual income tax, including Individual Retirement Accounts (IRAs), pensions, capital gains, dividends, owner occupied housing, and life insurance policy earnings.

There are two types of IRAs that have the effect of exempting investment earnings from tax — the traditional (deductible) IRA and the Roth IRA. For the deductible IRA (also called a front-loaded IRA), contributions are deducted when made and withdrawals are taxed; this treatment is similar to the treatment of pensions. Eligibility for the deductible IRA is phased out as income increases for individuals who are active participants in employer pension plans. (Individuals above the income phase-out can make non-deductible contributions, with earnings taxed when withdrawn, which allows deferral, but not elimination, of taxes.) There are penalties for early withdrawal and mandatory distribution requirements.

As described above, IRAs were treated the same way as pension plans, with contributions deductible and withdrawals taxable. The Roth IRA (also called a back-loaded IRA), was added as an option in 1997, when eligibility for both types of IRAs was expanded. The tax treatment of this account is similar to that of a tax exempt bond: earnings are simply not taxed. The earnings phase-outs are higher and treatment is, in general, more generous than in the case of the deductible IRA. The annual deduction limit for IRA contributions when expanded in 1997 was the lesser of $2,000 or 100% of compensation; that limit has been increased under the temporary provisions of the 2001 tax cut and is currently $4,000.

The 2001 act also introduced a tax credit for contributions by low income individuals.

Favorable tax treatment of pensions, namely allowing the firm to deduct contributions which are not included in employees income and exempting the earnings of pension trusts as in the case of deductible IRAs, has been in place almost since the inception of the tax law. Pensions fall into two types: defined benefit plans where payments depend on earnings and years of service at retirement, and defined contribution plans where payments depend on the amount accumulated in an account. Pensions are subject to many rules and regulations designed to ensure that tax benefits do not accrue to owners and highly compensated managers and that pension trusts are adequately funded in the case of defined benefit plans. Of course to the extent that pension assets (or IRA assets) are invested in corporate stock, tax is collected at the corporate level.

Tax benefits for pension plans are much more important in dollar terms than are tax benefits for IRAs. For FY2005, according the latest Joint Committee on Taxation (JCT) estimates, employer pensions resulted in a revenue loss of $99.3 billion, with plans for self-employed individuals (called Keogh plans) costing $6.5 billion. IRAs resulted in a loss of $15.5 billion.[1] In the case of dividends, about half of the income is not subject to tax because of tax preferred status.

There are other savings and investments that receive favorable treatment under the individual income tax. Capital gains has historically been favorably treated, both through lower tax rates, deferral (taxed only when realized), and forgiveness of tax if passed on at death. Dividends are also now eligible for lower tax rates. Of course, earnings on corporate stock are taxed under the corporate tax. Owner occupied housing is also favorably treated because imputed rent is not included in income, and earnings on investments in life insurance policies are deferred and, when passed on via death benefits, exempt from tax. These tax benefits are significant as well. Lower rates for capital gains and dividends are estimated by the JCT to lose $76.8 billion in FY2005, the failure to tax gains at death $37.7 billion, and the deferral of gain for gifts $4.6 billion. While there is not a separate estimate for excluding imputed rent, the value of deducting costs (even though gross rent is not included in income) through itemized deductions is $69.9 billion for mortgage interest and $16.7 billion for property taxes. The exemption of most capital gains on homes is estimated to cost $18 billion. The value of deferral and forgiveness of earnings on life insurance policies is $25.4 billion.

[1] See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for 2004-2008,* JCS-8-03, Washington, DC, U.S. Government Printing Office, Dec. 22, 2003.

Recent Legislative Activity

IRAs were expanded by the 2001 tax bill, H.R. 1836, which was signed into law on June 7, 2001. IRA limits increased to $3,000 in 2002, $4,000 in 2005 and $5,000 in 2008, with indexation afterwards. Individual 50 and over had an extra $500 increase in 2002 and will have a $1,000 increase in 2008. This bill also increased contribution limits for pension plans, including 401(k) plans.

Because of budget rules the tax cuts in this bill were sunsetted. On April 18, 2002, the House passed H.R. 586 , a bill to make the provisions of H.R. 1836 permanent. On June 21, 2002, the House passed H.R. 4931, a bill to make the IRA and pension provisions permanent. In addition, general concerns about stock market performance and the slowly growing economy also led to the consideration of an investor relief package (H.R. 5553, reported out of the Ways and Means Committee) which included speedups in IRA and pension contribution limit increases, as well as an increase in the age at which distributions from IRAs must begin. None of these bills was enacted. Tax bills to speed up the phase-ins of the 2001 law adopted in the 108th Congress did not include these provisions.

President Bush proposed in his FY2004 and FY2005 budget plans to eliminate the deductible IRA form. His proposal would rename the Roth IRAs as Retirement Savings Accounts (RSAs), and also allow Lifetime Savings Accounts (LSAs).[2] The contribution limits would be greatly increased (to $5,000 for each type of account under the most recent proposal) and the income limits would be eliminated. Individuals could roll over existing accounts into these new accounts, by paying tax on the rollovers, which would increase revenue in the short run. The proposal is expected to initially gain and then lose revenue, with loss in the tenth year of $4.7 billion. In the long run, the provision would cost much more. His proposal would also combine a variety of employer savings accounts into a single account and simplify the rules designed to prevent discrimination in favor of highly compensated employees. This proposal might form part of an the President's proposal for fundamental tax reform.

The Enron scandal and the slow recovery of the economy led to legislative proposals regarding pensions in the 107th Congress that did not see completion and these issues have not been addressed in the 108th Congress. However, H.R. 1776, commonly known as the Portman-Cardin bill, which would provide a variety of revisions and liberalizations of pension policy, was reported from the Ways and Means Committee and may be considered in the 109th Congress.

Issues

The original rationale for IRAs, first introduced in 1962, was to provide parity with individuals covered by employer pensions. IRAs were made universally available in 1981, with the primary rationale to encourage savings. Income limits that disallowed deductible

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[2] See CRS Report RL32228, *Proposed Savings Accounts: Economic and Budgetary Effects*, by Jane G. Gravelle and Maxim Shvedov, for an economic analysis of this proposal.

IRA coverage for most individuals were adopted as part of the base broadening in the 1986 Tax Reform Act; the 1997 legislation increased these limits and introduced Roth IRAs. All but the very high income individuals and couples now have access to IRAs.

There has been considerable debate among economists about the effect of IRAs on savings. Some statistical studies have found powerful savings effects of IRAs and have argued that advertising of the tax benefit has caused people to save. Others have disputed the evidence from those studies and argued that there is no historical evidence of an IRA savings effect, and that economic theory does not support such an effect. Still others have argued that IRAs are less important in increasing overall savings than the more generous thrift savings accounts (e.g., 401(k) plans) provided through employers.

Although the dollar contribution ceilings and income limits on IRAs keep the provision from providing benefits to very high income individuals, IRAs do generally benefit well-off individuals who are more likely to save.[3]

The evidence that lower taxes on the return to investments increase savings in general is mixed. Income and substitution effects, which in the one case lower and the other case raise savings, may net out to little or no effect, and most simple evidence suggests that savings rates do not change very much as tax rules change (although there has been a trend downward in private savings rates).

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[3] See CRS Report RL30255, *Individual Retirement Accounts (IRAs): Issues and Proposed Expansion*, by Jane G. Gravelle, for further discussion of savings and distributional effects of IRAs.