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Tax Credits for Individual Development Accounts

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Summary

An individual development account (IDA) is a structured savings instrument for lower income individuals. Currently, IDAs are associated with (1) state programs using Temporary Aid to Needy Families (TANF) block grants; (2) a federal five-year demonstration project established by the Assets for Independence Act (Title IV of P.L. 105-285); and (3) accounts established for refugees by the Office of Refugee Resettlement. These IDA programs use government funds to encourage the establishment of IDA programs and participation by qualified individuals and program sponsors.

A new approach, that of using federal tax credits to encourage establishing and funding IDA programs, was a component of legislation introduced in the 108th Congress (Savings for Working Families Act of 2003). In the 109th Congress, legislation (S. 6, S. 922, and S. 1780) has been introduced to establish IDA programs utilizing tax benefits to encourage program development. This report will be updated as warranted by legislative activity.

Current (Government Funded) IDA Programs

There are three current forms of individual development account (IDA) programs, all of which are funded by federal, state, or local governments.[1] Based on the funding mechanism and statutory authority for the program, the three types of programs are as follows.

Temporary Aid to Needy Families Programs. The 1996 welfare reform law (P.L. 104-193) allowed states to use funds from the Temporary Aid to Needy Families (TANF) block grant for IDAs for TANF-eligible persons. States may establish IDA

[1] For more information on federal IDA grant programs, see CRS Report RS22185, *Individual Development Accounts (IDAs): Background and Current Legislation for Federal Grant Programs to Help Low-Income Families Save*, by Gene Falk.

programs and match funds deposited by IDA participants. States may also pay administrative costs for the IDA program in addition to, or in lieu of, matching IDA deposits.

Federal Demonstration Programs. The Assets for Independence Act (AIA, Title IV of P.L. 105-285) authorized a five-year demonstration program, begun in 1999, for IDAs. Federal funds are provided directly to nonprofit community groups, state and local governments, or certain financial institutions to establish IDA programs. Federal funds are used to match contributions made by program participants. Program sponsors that match contributions by program participants as part of the demonstration program, must have secured funding for all of the match before receiving federal funds.

Refugee Programs. The Office of Refugee Resettlement (ORR) uses agency funds to establish and maintain IDAs for refugees, including a match of contributions by program participants.

For each of these forms of IDA programs, government funds are used to match participant contributions. For state programs associated with TANF, states may use part of the federal TANF block grant, for the federal demonstration program discretionary federal funds are used, and for the refugee program federal agency funds are used. For some state programs associated with TANF, the state may also provide state tax credits for contributors to the program.

For an IDA established under the federal demonstration program, there may be two components: (1) a main account for the participant's deposits and earnings on those deposits; and (2) a parallel account maintained by the program's financial partner containing the matching contributions and earnings on the matching contributions. Unlike the main account, the parallel account is not controlled by the program participant, but by the IDA program and its financial partner.

Under current federal law for IDAs established under the federal demonstration program, the parallel account funds, when distributed to third parties as a benefit to the participant, are considered a gift and are not included in the income of the IDA program participant. Because they are not included in the participant's income, they are not taxable. The interest earned on the main account (IDA deposits by the participant) is taxable to the IDA participant.[2]

For tax-exempt program contributors there are no tax benefits associated with making the matching contributions or providing any administrative assistance. Taxable entities, such as financial institutions, may receive a tax deduction for matching contributions and administrative or other assistance as charitable contributions, subject to the limits on charitable contributions. Under current law, charitable contributions are subject to annual limitations with excess contributions (above the limit) carried over to future tax years.[3]

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[2] Internal Revenue Service, Revenue Ruling 99-44, Internal Revenue Bulletin No. 1999-44, Nov. 1, 1999.

[3] For example, for individual in tax year 2005, total contributions are limited to 50% of adjusted

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Using Federal Tax Credits to Fund IDA Programs

The funding structure for the current federal IDA demonstration program is based on discretionary funds appropriated in the Department of Health and Human Services annual budget. As a budget item, the federal IDA demonstration program is subject to the annual budget process, and the possibility that the federal demonstration program is partly funded or not funded at all. Similarly, the refugee program relies on the availability of discretionary funds in the annual agency (ORR) budget, and IDA programs associated with TANF rely on the availability of federal TANF block grants (including TANF authorization). Any future federal IDA program that relies on direct federal funding also would be subject to the federal budget process and the risk of a reduction or elimination of funding.

A tax credit is a form of indirect government spending, a tax expenditure, and is reflected in the budget as a reduction in revenues. Although a tax expenditure can be reduced or eliminated, many think that a program funded by a tax expenditure is less likely to be eliminated than a program funded through direct government spending. In addition, many think that private entities, using tax benefits, can provide certain public goods or services more efficiently, and at a lower cost, than the government.

One major issue with a switch from a budgeted program to a tax expenditure is whether the tax expenditure would provide a benefit significant enough to continue a program that was in the past directly funded by the government, or encourage expansion of such a program. The impact of the incentive will depend upon a number of factors including the tax status and general tax situation of the entity making IDA matching contributions or administering IDAs. A nonrefundable tax credit will have no value to a tax-exempt entity or a tax entity with no tax liability in a given tax year.

In the 109th Congress, legislation has been introduced (S. 6, S. 922, and S. 1780) that would create an individual development account investment credit to encourage participation and fund matching by private entities. In addition, the President's FY2007 budget contains a proposal to establish IDAs and provide a tax credit for administrative costs of maintaining the accounts and matching of funds deposited by account holders.

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[3] (...continued)
gross income. However, certain types of contributions may have a separate limitation of 20% or 30% of adjusted gross income. Excess contributions (above the limitations) may be carried over for five tax years.