DESCRIPTION OF S. 1682

RELATING TO

INDIVIDUAL RETIREMENT ACCOUNTS

Scheduled for a Hearing

Before the

SENATE COMMITTEE ON FINANCE

On September 29, 1989

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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JCX-54-89

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INTRODUCTION

The Senate Committee on Finance has scheduled a hearing on September 29, 1989, on S. 1682 (introduced by Senator Bentsen and others on September 27, 1989). The bill would expand the current tax deduction for contributions to an individual retirement account (IRA), and permit certain distributions from an IRA without payment of the 10-percent early withdrawal tax.

This document,[1] prepared by the Staff of the Joint Committee on Taxation, provides a description of the background of the IRA provisions, present law, and the provisions of S. 1682.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of S. 1682 Relating to Individual Retirement Accounts (JCX-54-89), September 29, 1989.

I. BACKGROUND

Employee Retirement Income Security Act of 1974

The individual retirement savings provisions of the Internal Revenue Code were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA) to provide a tax-favored retirement savings arrangement to individuals who were not covered under a tax-qualified retirement plan maintained by their employer. Those who were active participants in employer-maintained retirement plans were not permitted to make contributions to an individual retirement account (IRA). As enacted in ERISA, the limit on the deduction for IRA contributions was generally the lesser of (1) 15 percent of the individual's compensation for the year, or (2) $1,500.

Under ERISA and present law, amounts withdrawn from an IRA are includible in gross income. In addition, a 10-percent additional income tax applies under prior and present law to early withdrawals. In general, early withdrawals are amounts withdrawn prior to the time the IRA owner attains age 59-1/2, becomes disabled, or dies. The 10-percent additional tax is designed to ensure that the funds are used for retirement purposes.

Economic Recovery Tax Act of 1981

The Economic Recovery Tax Act of 1981 (ERTA) increased the deduction limit for contributions to IRAs and removed the restrictions on IRA contributions by active participants in employer-sponsored plans. Under ERTA, the deduction limit for IRAs was generally the lesser of (1) $2,000, or (2) 100 percent of the individual's compensation. Any individual was entitled to make a deductible contribution, even if the individual was an active participant in an employer's plan.

As reflected in the ERTA legislative history, the ERTA changes were motivated by Congressional concern that a large number of the country's workers, including many who were covered by employer-sponsored retirement plans, faced the prospect of retirement without the resources needed to provide adequate retirement income levels. Congress concluded that retirement savings by individuals during their working years can make an important contribution towards providing retirement income security.

Tax Reform Act of 1986

The Tax Reform Act of 1986 (the 1986 Act), added the present-law restrictions on deductible IRA contributions by active participants in employer-sponsored retirement plans similar to those adopted by ERISA. In addition, the 1986 Act added the present-law rules permitting individuals to make nondeductible contributions to an IRA.

II. PRESENT LAW

Deduction limits

Under present law, the maximum deductible contribution that can be made to an IRA is generally the lesser of $2,000 or 100 percent of an individual's compensation. Individuals who are not active participants in an employer-sponsored retirement plan, single taxpayers with adjusted gross income (AGI) of less than $25,000, and married taxpayers with AGI of less than $40,000, may make the maximum deductible contribution. For taxpayers who are active participants in employer-sponsored retirement plans, the IRA deduction is phased out for single taxpayers with AGI between $25,000 and $35,000, and for married taxpayers with AGI between $40,000 and $50,000.

Taxpayers who are not entitled to the maximum IRA deduction may make nondeductible contributions to IRAs.
As is the case with earnings on deductible IRA contributions, earnings on deductible contributions accumulate on a tax-deferred basis.

Taxation of withdrawals

Amounts withdrawn from IRAs (other than nondeductible contributions) are includible in income when withdrawn. Early withdrawals, e.g., withdrawals prior to age 59-1/2, death, or disability, are generally subject to an additional 10-percent income tax (sec. 72(t)).

III. DESCRIPTION OF S. 1682[2]

In general

The deductibility of an individual's contributions to an IRA is expanded under the bill. Generally, the bill permits a deduction of one-half of the otherwise nondeductible portion of the contribution made by an individual. The bill also allows withdrawals from an IRA without imposition of the additional 10-percent tax to the extent the amount withdrawn is used for either the purchase of a first home or for expenses related to certain education expenses.

Expansion of present-law deduction rules

Under the bill, an individual who contributes to an IRA may deduct the amount of the contribution that is deductible under present law, plus 50 percent of the contribution that is not deductible under present law. This additional 50-percent deduction is only allowed with respect to contributions that would otherwise have been deductible but for the active participant rule. The present-law maximum dollar limitation ($2,000) and other limitations relating to deductibility (e.g., the requirement that the IRA owner be under the age of 70-1/2) continue to apply.

For example, assume that a married taxpayer who has a combined AGI of $45,000 and who is an active participant makes a $2,000 contribution to an IRA. Under present law, only $1,000 of this contribution is deductible because of the taxpayer's AGI level and participation in an employer's retirement plan. Under the bill, the taxpayer may deduct $1,500. This amount is the amount deductible under present law ($1,000), plus 50 percent of the nondeductible contribution ($500). If the same taxpayer contributes $1,500 to an IRA, then under the bill the taxpayer may deduct $1,250 [$1,000 + (.50 x $500)].

Withdrawals by first-time home buyers

Under the bill, withdrawals by first-time homebuyers that are used within 60 days to acquire, construct, or reconstruct the taxpayer's principal residence are not subject to the 10-percent additional tax. A first-time homebuyer is an individual who has not had an ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which the withdrawal relates. The date of acquisition is the date the individual

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[2] S. 1682, the Savings and Investment Incentive Act of 1989, was introduced by Senator Bentsen and others on September 27, 1989.

enters into a contract to purchase a principal residence or begins construction or reconstruction of such a residence. The bill requires that the spouse of the taxpayer also meet this requirement as of the date the contract is entered into or construction commences. Principal residence is defined as under the provisions relating to the rollover of gain on the sale of a principal residence (sec. 1034).

Under the bill, any amount withdrawn from an IRA for the purchase of a principal residence is to be used within 60 days of the date of withdrawal. The 10-percent additional income tax is imposed with respect to any amount not so used. However, if the 60-day rule cannot be satisfied due to a delay in the acquisition of the residence, the taxpayer may recontribute all or part of the amount withdrawn to the IRA prior to end of the 60-day period. Any amount recontributed is generally treated as a rollover contribution (sec. 408(d)), except that the frequency limitation on rollovers between IRAs does not apply. The taxpayer may subsequently withdraw any recontributed amounts to pay for the purchase of a home.

Rules relating to expenses for education

Under the bill, withdrawals used by a taxpayer during the year for qualified higher education expenses are not subject to the 10-percent additional tax. Qualified higher education expenses are tuition, fees, books, supplies, and equipment required for courses at an eligible educational institution, as defined under the provisions relating to educational savings bonds (sec. 135). Amounts withdrawn may be used for the education of the taxpayer, or the taxpayer's spouse, dependents, or grandchildren.

The amount that may be withdrawn for educational expenses for a taxable year without imposition of the 10-percent tax is reduced by any amount that is excludable from the taxable income of the taxpayer under the provisions relating to educational savings bonds.

Effective date

The expansion of the deduction provisions is effective for taxable years beginning after December 31, 1990. The provisions relating to the exception to the 10-percent additional income tax apply to distributions on or after January 1, 1990.