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DESCRIPTION AND ANALYSIS OF TAX PROPOSALS RELATING TO INDIVIDUAL SAVING

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON FEBRUARY 9, 1995

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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ERRATA FOR JCS-3-95

("Description and Analysis of Tax Proposals Relating to Individual Saving")

° There is no footnote 19.

° In Table 2 on page 40, the side heading in the table should be:

"Joint Returns With One Earner"

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of certain proposals relating to individual saving. The Senate Committee on Finance has scheduled a public hearing on February 9, 1995, on the incentives for saving.

Part I of the pamphlet is a summary. Part II is a description of present law and legislative background. Part III describes the following proposals relating to saving: The Savings and Investment Incentive Act of 1995 (S. 12); The American Dream Restoration Act (H.R. 6); the Administration proposal; S. 287 (relating to IRA contributions for married couples); PRIME retirement accounts for small employers; and simplified qualified cash or deferred arrangements. Part IV provides an economic analysis of IRAs generally. Part V discusses issues related to tax incentives for saving generally, and Part VI discusses specific issues related to the proposals described in the pamphlet.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving (JCS–3–95), February 8, 1995.*

I. SUMMARY

A. Present Law and Legislative Background

Present law and legislative background of IRAs

Under present law, under certain circumstances, an individual is allowed to deduct contributions up to the lesser of $2,000 or 100 percent of the individual's compensation (or earned income) to an individual retirement arrangement (IRA). The amounts held in an IRA, including earnings on contributions, generally are not included in taxable income until withdrawn.

The $2,000 deduction limit is phased out over certain adjusted gross income (AGI) levels if the individual or the individual's spouse is an active participant in an employer-sponsored retirement plan. The phaseout is between $25,000 and $35,000 of AGI for single taxpayers and between $40,000 and $50,000 of AGI for married taxpayers. There is no phaseout of the deduction limit if the individual or the individuals spouse is not an active participant in an employer-sponsored retirement plan.

An individual may make nondeductible contributions (up to the $2,000 or 100 percent of compensation limit) to an IRA to the extent the individual is not permitted to make deductible IRA contributions. Nondeductible contributions provide the same tax benefits as deferred annuities, that is, earnings are not includible in income until withdrawn. However, deferred annuities are not subject to contribution limits.

Distributions from IRAs are generally includible in income when withdrawn. Distributions prior to death, disability, or attainment of age 59-1/2 are subject to an additional 10-percent tax. The 10-percent tax does not apply to distributions made in the form of an annuity.

The IRA provisions were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, an individual was permitted to make deductible IRA contributions only if the individual was not an active participant in an employer-sponsored retirement plan. The limit on IRA deductions was the lesser of $1,500 or 15 percent of compensation (or earned income).

The Economic Recovery Tax Act of 1981 increased the IRA deduction limit to its current level and removed the restriction on IRA contributions by individuals who were active participants in employer-sponsored plans. The IRA rules in their current form were enacted as part of the Tax Reform Act of 1986.

Tax-qualified retirement plans and cash or deferred arrangements

In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

The tax treatment of contributions under qualified plans is essentially the same as that of present-law IRAs. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. In return for greater tax benefits, qualified plans are subject to rules that do not apply to IRAs, such as nondiscrimination rules that ensure that a qualified plan benefits a broad group of employees and does not discriminate in favor of highly compensated employees.

Qualified plan benefits are generally subject to tax when received under rules similar to those that apply to IRA withdrawals. There are additional exceptions to the 10-percent early withdrawal tax for qualified plan distributions that do not apply to IRA withdrawals. For example, the 10-percent additional tax does not apply to distributions from a qualified plan that are used to pay extraordinary medical expenses.[1]

A qualified cash or deferred arrangement is one type of qualified plan. In general, a cash or deferred arrangement is an arrangement under which an employee can elect to receive an amount in cash or have it contributed to a tax-qualified pension plan. Amounts that are contributed to the plan are not included in income until withdrawn from the plan. Qualified cash or deferred arrangements are subject to the rules applicable to qualified plans generally, and are also subject to additional rules.

The maximum annual amount that an employee can elect to have contributed to a cash or deferred arrangement is limited to $9,240 (for 1995). This dollar limit is indexed for inflation. Elective contributions to cash or deferred arrangements are subject to a special nondiscrimination test that permits somewhat higher contributions to be made on behalf of highly compensated employees. The nondiscrimination test looks at actual contributions made by employees to ensure that the amount contributed by highly compensated employees does not exceed the amount contributed by nonhighly compensated employees by more than certain limits. A similar nondiscrimination test also applies to employer matching contributions, i.e., employer contributions that are conditioned on the employee's elective deferrals.

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[1] Extraordinary medical expenses are those that would be deductible as an itemized deduction, i.e., expenses that exceed 7.5 percent of AGI.

The rules relating to cash or deferred arrangements were originally set forth in Internal Revenue Service (IRS) rulings. In 1972, the IRS issued proposed regulations that would have changed the rules relating to cash or deferred arrangements. Congress enacted a temporary moratorium freezing the status quo. Rules relating to cash or deferred arrangements, including a special nondiscrimination test, were first codified in the Internal Revenue Code by the Revenue Act of 1978. The Tax Reform Act of 1986 revised some of the rules relating to cash or deferred arrangements. The revisions included changes to the nondiscrimination tests and imposition of the annual limit on elective deferrals.

Simplified employee pensions

In order to reduce unwanted administrative burdens on employers (particularly smaller employers), the Code permits employers to establish a simplified employee pension (SEP) for their employees. A SEP is an IRA. However, the same contribution limits that apply to qualified plans apply to SEPs, so that a SEP provides a greater opportunity for tax-favored saving than an individual IRA.

Employers with 25 or fewer employees may permit employees to make elective contributions to a SEP. A special nondiscrimination rule applies to such elective contributions. This rule is a simplified version of the special nondiscrimination test applicable to elective contributions under a qualified cash or deferred arrangement.

Other tax incentives for saving

The Internal Revenue Code contains a number of other provisions which permit individuals to save on a tax-favored basis. These include provisions relating to tax-sheltered annuities, annuity contracts, and life insurance.

B. Summary of Proposals

1. Savings and Investment Incentive Act of 1995 (S. 12)[2]

The Savings and Investment Incentive Act of 1995 would phase out the income limits on deductible IRA contributions and narrow the definition of active participant for married couples during the phaseout period so that fewer individuals would be affected by the income limits during the phase-out period. The bill would index the limit on deductible IRA contributions and coordinate the limit on elective deferrals with the IRA deduction limit.

In addition, the bill would permit nondeductible contributions to new "IRA Plus" accounts. Withdrawals from an IRA Plus would not be includible in income or subject to the 10-percent tax on early withdrawals if attributable to contributions at least 5 years earlier. The limits on contributions to traditional IRAs and IRA Plus accounts would be coordinated. Under certain circumstances, an individual could convert a present-law IRA into an IRA Plus by including the IRA balance in income over a 4-year period (and without imposition of the 10-percent early withdrawal tax).

The bill would allow withdrawals from an IRA and withdrawals of elective deferrals from qualified cash or deferred arrangements

[2] S. 12 was introduced by Senators Roth, Breaux, Pryor, and Murkowski on January 4, 1995.

and similar plans without imposition of the 10-percent early withdrawal tax to the extent the amount withdrawn is used for the purchase of a first home, for certain education expenses, or for extraordinary medical expenses. The bill would also exempt from the 10-percent tax withdrawals from IRAs by persons who have been unemployed for at least 12 weeks.

The bill would generally be effective for years beginning after December 31, 1994.

2. American Dream Restoration Act (H.R. 6)[3]

The bill would permit individuals to make nondeductible contributions to an American Dream Savings (ADS) account in addition to any deductible contributions the individual can make to an IRA under present law. An ADS account would be an IRA that is designated at the time of establishment as an ADS account. The maximum annual contribution that could be made to an ADS account would be the lesser of $2,000 or 100 percent of the individual's compensation. The $2,000 limit would be indexed for inflation. In 1996 and 1997, individuals could convert a present-law IRA into an ADS account by including the IRA balance in income over a 4-year period (and without imposition of the 10-percent early withdrawal tax). Distributions from an ADS account would not be includible in income if the distribution (1) is made at least 5 years after the individual first made a contribution to any ADS account and (2) is (a) made on or after attainment of age 59-1/2, (b) made on account of death or disability, or (c) is used for the purchase of a first home, or to pay higher education expenses, long-term care premiums, or medical expenses.

The bill would generally be effective for years beginning after December 31, 1995.

3. Administration Proposal[4]

The Administration proposal would double the income limits at which the IRA deduction is phased out for active participants in employer-sponsored plans (to between $50,000 and $70,000 for single taxpayers and $80,000 and $100,000 for married taxpayers), and index the limits for inflation. The proposal would also index the $2,000 limit on IRA contributions, and coordinate the IRA deduction limit with the annual limit on elective deferrals. The proposal would provide that the exception from the early withdrawal tax for distributions after age 59-1/2 does not apply to amounts that have been in the IRA for less than 5 years.

The proposal would permit individuals who are eligible to make deductible IRA contributions to elect to contribute to either a deductible IRA or a new Special IRA. Amounts contributed to a Special IRA would not be deductible. The contribution limit for Special IRAs would be coordinated with the limit on deductible IRAs. Amounts distributed from a Special IRA would not be includible in gross income or subject to the 10-percent early withdrawal tax to the extent attributable to contributions that have been in the Spe-

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[3] H.R. 6 was introduced by Representative Crane and others on January 4, 1995, as part of the "Contract with America."

[4] The Administration proposal is included in President Clinton's fiscal year 1996 budget proposal.

cial IRA for at least 5 years. In 1997, persons who are eligible to make Special IRA contributions could convert present-law IRAs into a Special IRA by including the IRA balance in income over a 4-year period (but without imposition of 10-percent early withdrawal tax).

The proposal would exempt from the early withdrawal tax distributions from IRAs or Special IRAs used for education or first-time home purchase and distributions to persons who have been receiving unemployment compensation for at least 12 weeks. In addition, the proposal would extend to IRAs the exception to the early withdrawal tax for distributions used for extraordinary medical expenses and would expand the scope of the exception.

The proposal would generally be effective for years beginning after December 31, 1995.

4. S. 287[5]

The bill would permit deductible IRA contributions of up to $2,000 to be made for each spouse if the combined compensation of both spouses is at least equal to the contributed amount. The present-law income limitations on IRA deductions for active participants in employer-sponsored retirement plans would continue to apply.

The bill would be effective for years beginning after December 31, 1994.

5. PRIME Retirement Accounts for Small Business

The proposal would permit employers with fewer than 100 employees to establish PRIME accounts to which their employees could make elective contributions. Contributions to a PRIME account would be made to an IRA. The employer would be required to provide a certain level of matching contributions to employees who make elective employee contributions. The maximum elective employee contributions that could be made per year would be one-half of the elective deferral limit (such limit is $9,240 in 1995). Amounts in PRIME accounts would be includible in income when withdrawn. An additional early withdrawal tax would apply in some cases. No nondiscrimination rules would apply to PRIME accounts.

6. Simplified Qualified Cash or Deferred Arrangements

The proposal would adopt safe harbors that would permit a cash or deferred arrangement to satisfy the special nondiscrimination tests applicable to elective deferrals and employer matching contributions through plan design, rather than through the testing of actual contributions. Under these safe harbors, a cash or deferred arrangement would be treated as satisfying the special test for elective contributions if the plan of which the arrangement is a part (or any other plan of the employer maintained with respect to the employees eligible to participate in the cash or deferred arrangement) meets (1) one of two contribution requirements and (2) a notice requirement. A plan would satisfy the safe harbor with respect to matching contributions if (1) the plan meets the contribu-

[5] S. 287 was introduced by Senator Hutchison and others on January 26, 1995.

tion and notice requirements under the safe harbor for cash or deferred arrangements and (2) the plan satisfies a special limitation on matching contributions.

The proposal would be effective for years beginning after December 31, 1995.

C. Issues Related to IRA and Saving

Economic analysis of IRAs generally

Deductible IRAs allow taxpayers to deduct IRA contributions from income in the year contributed and pay income tax on the contributions plus earnings when withdrawn. This treatment creates two potential tax benefits: (1) taxpayers effectively earn a tax-free rate of return on IRA investments and (2) the contributions may be taxed at a lower marginal tax rate than the taxpayer's marginal tax rate when the contributions were made because IRA contributions are not taxed until withdrawn, at which time the taxpayer may be retired.

S.12, H.R.6, and the Administration proposal all create a new type of nondeductible IRA, commonly referred to as a back-end IRA. Withdrawals from a back-end IRA are not taxable if contributions are held in the back-end IRA for a certain period of time.

From an economic perspective, back-end IRAs receive tax treatment generally equivalent to deductible IRAs. Because the taxpayer does not deduct back-end IRA contributions from income and pays no tax when amounts are withdrawn, the taxpayer is never taxed on the income earned on the investment. Whether the deductible IRA and back-end IRA are in fact economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year contributions are made and the marginal tax rate in the year IRA funds are withdrawn. When marginal tax rates decrease over time (because tax rates change generally or taxpayers fall into lower tax brackets), the deductible IRA is more advantageous than the back-end IRA because the deductible IRA permits taxpayers to defer payment of tax until tax rates are lower. When marginal tax rates increase over time, a back-end IRA is more advantageous.

Additional differences exist between the deductible and back-end IRAs in the proposals. First, because the dollar limit on contributions to both the deductible IRA and the back-end IRAs is $2,000, the $2,000 back-end IRA contribution limit effectively increases the amount of tax-free saving that can be invested relative to the deductible IRA. A back-end IRA permits a taxpayer to accumulate tax-free income on $2,000 of after-tax dollars, whereas a $2,000 investment in a deductible IRA (which has not yet been subject to tax) is equivalent to only $1,440 in after-tax dollars (assuming a 28-percent marginal tax rate).

Second, because the 10-percent additional income tax on early withdrawals generally applies to the back-end IRA only during the first 5 years after a contribution has been made to the IRA, in general, the benefits of the back-end IRA are greater than those of the deductible IRA for taxpayers who desire to invest funds in an IRA for a relatively short period of time. However, because of the 5-year holding period under the proposals, this advantage of the back-end

IRA exists only until a taxpayer attains age 59-1/2, after which time the deductible IRA becomes more beneficial to the short-term investor.

Present value of revenue cost of IRAs to the Federal Government

Assessing the cost (in the form of foregone tax receipts) to the Federal Government of IRAs may be more difficult than assessing the costs of other tax provisions because IRAs change not only the amount of tax collected, but also the timing of tax collections. Traditional budget scorekeeping accounts for the revenue effects of proposed legislation on a cash-flow basis; in other words, the effect of a provision on budget receipts for a fiscal period is estimated without regard to whether the provision will also affect budget receipts in a subsequent period. This method scores deductible IRAs as generating a larger revenue loss than back-end IRAs, because more of the revenue loss occurs in the earlier years. However, a present-value calculation demonstrates that the long-term cost to the Federal Government of deductible IRAs and back-end IRAs will be approximately equal, except for the effects of changes in tax rates generally or for specific taxpayers, and the difference in the effective contribution limits.

Providing a choice between a deductible IRA and a back-end IRA is likely to increase the overall cost of IRAs to the Federal Government as compared to the cost of either option alone if taxpayers make accurate judgments about their future tax rates. Taxpayers who have reason to believe that their tax rates will decline over time will be more likely to invest in the deductible IRA, and taxpayers who believe their tax rate will increase over time or who intend to invest for a relatively short period of time will generally choose the back-end IRA.

Effectiveness of IRAs at increasing saving

IRAs have a number of attributes that may affect a taxpayer's saving decision. First, investments in IRAs earn a higher after-tax rate of return than investments in other assets. Second, IRAs may provide an incentive for retirement saving, as opposed to other forms of saving. Third, deductible IRAs may provide a psychological incentive to save in the case of taxpayers who owe the Federal Government income tax in excess of the amounts withheld and estimated tax payments made during a year. Fourth, advertising of IRAs by banks and other financial institutions may influence decisions to save.

Deductible IRAs have been very popular with taxpayers. Contributions to IRAs increased significantly when eligibility restrictions were eliminated in 1982. At the peak in 1985, over $38 billion was contributed to IRAs; this represented almost 33 percent of personal saving for that year. However, there is no consensus within the economics profession as to the effect of the pre-1986 IRA rules on personal saving. Some economists believe that IRAs had no effect on overall personal saving (i.e., they believe that IRA contributors merely shifted savings from one vehicle to another. Other economists believe that IRAs increased personal saving. Still other economists believe that IRAs would have eventually increased sav-

ing if the universally available deductible IRA had not been significantly restricted by the Tax Reform Act of 1986.

In 1985, 17.8 percent of all eligible returns reported contributions to an IRA. Of the returns reporting contributions, most (71 percent) reported AGI below $50,000. However, high-income taxpayers contributed at a much higher rate than lower-income taxpayers--61.8 percent of eligible returns with AGI of $50,000 or above reported contributions to an IRA, while only 13.8 percent of eligible returns with AGI below $50,000 reported contributions.

Although research on the effectiveness of the pre-1986 IRA provisions may shed light on the potential of the proposal to increase saving, several differences should be noted. First, marginal tax rates for most taxpayers are lower than they were before 1987. Thus, the tax advantages of IRAs are less valuable now than they were before 1987. Second, the proposed IRAs permit penalty-free withdrawals under different circumstances than the pre-1986 IRAs. Third, the back-end IRAs permit penalty-free withdrawals after only 5 years. These differences may increase or decrease the effect of IRAs on saving.

Issues relating to tax incentives for saving

Goals of tax incentives for saving

Some argue that tax incentives for saving are appropriate because the income tax system penalizes saving by taxing the return to income that is saved. This can affect both the national saving rate, as well as the assets taxpayers accumulate for particular purposes. Tax incentives for saving could be designed to encourage saving for particular purposes or to increase national saving.

IRAs have historically been viewed as vehicles for retirement saving. However, IRAs can provide substantial benefits to taxpayers who are saving for nonretirement purposes. For example, if funds are held in an IRA long enough, the taxpayer will benefit from the IRA even after payment of the income tax and the 10-percent early withdrawal tax.

Role of saving in the national economy

National saving is important to the economy because of its relationship to investment. The sources for investment are national saving and foreign investment. Increased investment increases the capital stock, which leads to greater productivity, higher wages and salaries, and increases in a nation's standard of living. Because of the possibility of foreign investment in the United States, a low saving rate does not necessarily mean a low investment rate. However, when foreign saving finances domestic investment, the profits from such investment are transferred abroad.

Net national savings declined through most of the 1980's, and is lower than that of other countries. Investment has declined as well over this period; however, foreign investment has compensated for some of the decline in domestic saving.

Adequacy of retirement savings

Social Security is the largest source of retirement income (38 percent in 1986), followed by income from assets (26 percent in 1986),

earnings (17 percent in 1986), and private and government employee pensions (14 percent in 1986). The adequacy of retirement income is commonly measured by the replacement rate, that is, the ratio of retirement income to income during working years.

Available data indicate that Social Security and pension benefits replace roughly 33 percent of career high earnings and 50 percent of earnings over the last 5 years of employment. When spousal benefits are taken into account, replacement rates are slightly higher as a percentage of final earnings, averaging 30 to 33 percent of highest earnings and 60 to 70 percent of earnings over the last 5 years. These replacement rates are higher for individuals who had lower earnings.

It is not clear what an appropriate replacement rate is. A rate lower than 100 percent may be adequate. For example, people may desire to have more income during working years because some of that income is saved for retirement. People may also have lower expenses in retirement; for example, they may no longer be making payments on a home. On the other hand, a replacement rate of 100 may be too low. For example, a retiree may face much higher medical expenses than a younger person.

Although coverage by employer pension plans and Social Security is expected to be higher for current workers than for current retirees, the saving rate of current workers is lower than the rate at which current retirees saved during their working lives. Also, it is possible that the need for retirement income is increasing over time because of increases in life expectancies, trends toward early retirement, and rapid rises in medical costs.

II. PRESENT LAW AND LEGISLATIVE BACKGROUND

A. Individual Retirement Arrangements (IRAs)

1. Present-law rules for IRAs

In general

Under certain circumstances, an individual is allowed a deduction for contributions (within limits) to an individual retirement account or an individual retirement annuity (an IRA) (Code sec. 219). An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. No deduction is permitted with respect to contributions made to an IRA for a taxable year after the IRA owner attains age 70-1/2.

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of $ 2,000 or 100 percent of an individual's compensation (earned income in the case of self-employed individuals). In addition, a married taxpayer who files a joint return with his or her spouse can make an additional contribution of up to $250 to an IRA established for the benefit of the spouse, if the spouse has no compensation or elects to be treated as having no compensation. A single taxpayer is permitted to make the maximum deductible IRA contribution for a year if the individual is not an active participant in an employer-sponsored retirement plan for the year or the individual has adjusted gross income (AGI) of less than $25,000. A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution for a year if neither spouse is an active participant in an employer-sponsored plan or the couple has combined AGI of less than $40,000.

If a single taxpayer or either spouse (in the case of a married couple) is an active participant in an employer-sponsored retirement plan, the maximum IRA deduction is phased out over certain AGI levels. For single taxpayers, the maximum IRA deduction is phased out between $25,000 and $35,000 of AGI. For married taxpayers, the maximum deduction is phased out between $40,000 and $50,000 of AGI. In the case of a married taxpayer filing a separate return, the deduction is phased out between $0 and $10,000 of AGI.[6]

An individual is an active participant in an employer-sponsored retirement plan for the taxable year if the individual is an active participant for the plan year ending with or within the individual's taxable year. An employer-sponsored retirement plan means (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a));

[6] A couple is not considered married for purposes of the IRA deduction rules if the individuals file separate returns and live apart from one another at all times during the taxable year; each spouse is treated as a single individual in such a case.

(2) a qualified annuity plan (sec. 403(a)); (3) a simplified employee pension plan (sec. 408(k)); (4) a plan established for its employees by the U.S., by a State or political subdivision, or by any agency or instrumentality of the U.S. or a State or political subdivision (other than an unfunded deferred compensation plan of a State or local government (sec. 457)); (5) a plan described in section 501(c)(18); and (6) a tax-sheltered annuity (sec. 403(b)).

The determination of whether an individual is an active participant depends on the type of plan involved. In general, in the case of a defined benefit pension plan, an individual is treated as an active participant if the individual is eligible to participate in the plan. An individual is an active participant in a defined contribution plan only if any amounts are allocated to the account of the participant for the year.[7] The extent to which a person is vested in his or her benefits under an employer-sponsored plan is not taken into account under the active participant rules.

Nondeductible IRA contributions

Individuals may make nondeductible IRA contributions to the extent deductible contributions are not allowed because of the AGI phaseout and active participant rules. A taxpayer may also elect to make nondeductible contributions in lieu of deductible contributions. Thus, any individual may make nondeductible contributions up to the excess of (1) the lesser of $2,000 or 100 percent of compensation over (2) the IRA deduction claimed by the individual. An individual making nondeductible contributions is required to report the amount of such contributions on his or her tax return. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions are not subject to income tax until withdrawn. Nondeductible IRAs provide the same tax benefit as deferred annuities. However, there are no limits on the amount of a deferred annuity.

Taxation of withdrawals

Amounts withdrawn from IRAs (other than amounts that represent a return of nondeductible contributions) are includible in income when withdrawn. If an individual withdraws an amount from an IRA during a taxable year and the individual has previously made both deductible and nondeductible IRA contributions, then the amount includible in income for the taxable year is the excess of the amount withdrawn over the portion of the amount withdrawn attributable to investment in the contract (i.e., nondeductible contributions). The amount attributable to nondeductible contributions is the portion of the amount withdrawn that bears the same ratio to the amount withdrawn as the total amount of nondeductible contributions bears to the total current value of all IRAs of the individual.

To discourage the use of amounts contributed to an IRA for nonretirement purposes, withdrawals from an IRA prior to age 59-1/2, death, or disability are generally subject to an additional 10-percent income tax (sec. 72(t)). The 10-percent additional income

[7] The definition of active participant under present law is generally the same as the definition of active participant that applied for purposes of determining eligibility to make IRA contributions prior to the IRA amendment adopted in the Economic Recovery Tax Act of 1981.

tax is intended to recapture at least a portion of the tax benefit of the IRA. The 10-percent additional income tax does not apply to withdrawals that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and the taxpayer's designated beneficiary. A similar early withdrawal tax applies to withdrawals from qualified retirement plans and deferred annuities.

Present law imposes a 15-percent excise tax on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs. The purpose of the tax is to limit the total amount that can be accumulated on behalf of a particular individual on a tax-favored basis. In enacting the excise tax, Congress believed that an individual should not be permitted to accumulate excessive retirement savings, regardless of whether such excess was attributable to the receipt of multiple maximum benefits from several employers, very large appreciation in defined contribution plans, or the use of IRAs by individuals receiving significant employer-provided benefits.

In general, excess distributions are defined as the aggregate amount of retirement distributions (i.e., payments from applicable retirement plans) made with respect to an individual during any calendar year to the extent such amounts exceed $150,000 (for 1995). The dollar limit is indexed for inflation. Special rules apply in the case of lump-sum distributions and post-death distributions.

2. Legislative background of IRAs

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 an employer. Individuals who were active participants in employer-sponsored retirement plans were not permitted to make contributions to an 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 (earned income in the case of a self-employed individual) for the year, or (2) $1,500.

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 retirement plans. After ERTA, the deduction limit for IRAs was generally the lesser of (1) 100 percent of the individual's compensation (earned income in the case of a self-employed individual), or (2) $2,000. Any individual was entitled to make a deductible contribution to an IRA even if the individual was an active participant in an employer-sponsored retirement plan.

The ERTA changes were motivated by Congressional concern that a large number of workers, including many who were covered by employer-sponsored retirement plans, faced the prospect of re-

tirement without the resources needed to provide adequate retirement income levels. The 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 (1986 Act) added the present-law restrictions on deductible IRA contributions by active participants in employer-sponsored retirement plans. These restrictions are similar to those originally included in ERISA. In addition, the 1986 Act added the present-law rules permitting individuals to make nondeductible contributions to an IRA.

These changes were made because Congress determined at the time that the expanded availability of IRAs had no discernible impact on the level of aggregate personal saving. In addition, Congress believed that the wide availability of the option to make elective deferrals under cash or deferred arrangements and tax-sheltered annuities reduced the prior concern that individuals in employer-maintained retirement plans should be able to save additional amounts for retirement on a discretionary basis. Congress was also concerned that data had shown that IRA utilization was low among lower-income taxpayers and that taxpayers for whom IRA utilization was the largest would generally have saved without regard to the tax incentives. However, Congress also wished to provide a tax incentive for discretionary retirement savings for all taxpayers and therefore permitted all taxpayers to make nondeductible IRA contributions.

B. Qualified Retirement Plans

In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified plan. Pre-tax employee contributions (e.g., contributions to a qualified cash or deferred arrangement (sec. 401(k) plan)) are treated the same as employer contributions for tax purposes.

The tax treatment of contributions under qualified plans is essentially the same as that of present law IRAs. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. The policy rationale for permitting greater accumulation under qualified plans than IRAs is that the tax benefits for qualified plans encourage employers to provide benefits for a broad group of their employees. This reduces

the need for public assistance and reduces pressure on the social security system.

The qualification standards and related rules governing qualified plans are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees. They also define the rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified plans.[8] Certain of the rules relating to qualified plans are designed to ensure that the amounts contributed to qualified plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from such plans, and the ability to obtain distributions prior to termination of employment from certain types of qualified plans is restricted.

Types of qualified plans

Qualified plans are broadly classified into two categories, defined benefit pension plans and defined contribution plans, based on the nature of the benefits provided.

Under a defined benefit pension plan, benefit levels are specified under a plan formula. For example, a defined benefit pension plan might provide an annual retirement benefit of 2 percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan. Benefits under a defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation (PBGC), a federal corporation within the Department of Labor.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Profit-sharing plans and qualified cash or deferred arrangements (called 401(k) plans after the section of the Code regulating such plans) are examples of defined contribution plans.

Limits on contributions and benefits

Under present law, overall limits are provided on contributions and benefits under qualified plans. In the case of a defined benefit pension plan, present law limits the annual benefits payable under the plan to the lesser of (1) 100 percent of the participant's average compensation for his or her high 3 years, or (2) $120,000 (for 1995).[9] The dollar limits are increased for cost-of-living adjustments in $5,000 increments.

Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000. Annual additions are the sum of employer contributions, employee

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[8] Qualified plans are subject to regulation under Federal labor laws (Title I of Employee Retirement Income Security Act of 1974 (ERISA)) as well as under the Internal Revenue Code. The ERISA rules generally relate to rights of plan participants and the obligations of plan fiduciaries.

[9] Annual benefits may in some cases exceed this dollar limitation under grandfather and transition rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 and other legislation.

contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.

Taxation of distributions

Under present law, a distribution of benefits from a qualified plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents the employee's investment in the contract (i.e., basis). Special rules apply to lump-sum distributions, distributions rolled over to an IRA, and distributions of employer securities.

Early distributions from qualified plans generally are subject to the same additional 10-percent early withdrawal tax that applies to early distributions from IRAs. However, certain additional exceptions to the tax apply. For example, the penalty does not apply to distributions used to pay medical expenses that exceed 7.5 percent of adjusted gross income. Qualified plan distributions are also subject to the excess distribution tax applicable to IRA distributions.

Qualified cash or deferred arrangements

Present law

As mentioned above, a qualified cash or deferred arrangement is a type of qualified pension plan. Thus, such arrangements are subject to the rules generally applicable to qualified pension plans. In addition, special rules apply to such arrangements.

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $9,240 for 1995. This dollar limit is indexed for inflation in $500 increments. An employee's elective deferrals must be fully vested. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements.

The special nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is satisfied if the actual deferral percentage (ADP) for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the ADP of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the ADP of all eligible nonhighly compensated employees or such ADP plus 2 percentage points. The ADP for a group of employees is the average of the ratios (calculated separately for each employee in the group) of the contributions paid to the plan on behalf of the employee to the employee's compensation.

Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are subject to a special nondiscrimination test similar to the special nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements.

The special nondiscrimination test is satisfied for a plan year if the actual contribution percentage (ACP) for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the ACP for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The ACP for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

Legislative background

Special rules relating to qualified cash or deferred arrangements were not initially codified in the Internal Revenue Code. In Revenue Ruling 56-497, the Internal Revenue Service (IRS) upheld the tax-qualified status of a cash or deferred profit-sharing plan where, in operation, over one-half of the employees who elected profit-sharing contributions (deferral), rather than current compensation, were among the lowest paid two-thirds of the employees who had met the plan's 3-year eligibility requirement.[10]

On December 6, 1972, the IRS issued proposed regulations which called into question the tax treatment of employees covered by cash or deferred profit-sharing plans. These proposed regulations were withdrawn in July, 1978. Under the rules in effect at the time of the proposed regulations, an employee was not taxed currently on amounts the employee chose to have contributed to a tax-qualified cash or deferred profit-sharing plan.

In order to allow time for Congressional study of this area, ERISA provided for a temporary freeze of the status quo. Under ERISA, the tax treatment of contributions to cash or deferred profit-sharing plans in existence on June 27, 1974, was governed under the law as it was applied prior to January 1, 1972,[11] and this treatment was to continue at least through December 31, 1976, or (if later) until regulations were issued in final form in this area, which would change the pre-1972 administration of the law.

In the case of plans not in existence on June 27, 1974, contributions to a cash or deferred profit-sharing plan were treated as employee contributions (until January 1, 1977, or until new regulations were prescribed in this area). This was intended to prevent a situation where a new plan might begin in reliance on pre-1972 law before Congress determined what the law should be in the future.

The Tax Reform Act of 1976 extended the temporary freeze of the status quo until January 1, 1978, in order to allow additional time for Congressional study of the area. The Foreign Earned Income Act of 1978 (P.L. 95-615) extended these rules until the related provisions of the Revenue Act of 1978 were effective (i.e., it extended the treatment through 1979).

The Revenue Act of 1978 included statutory provisions governing qualified cash or deferred arrangements. These provisions were en-

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[10] See also Rev. Rul. 63-180, 1963-2 C.B. 189, and Rev. Rul. 68-89, 1958-1 C.B. 402.

[11] Accordingly, employer contributions to these cash or deferred profit-sharing plans were not includible in the income of covered employees, provided the plans satisfied the requirements of pre-1972 law and otherwise complied with the standards of the Code for tax-qualified plans.

acted because Congress believed that the freeze of the status quo treatment of cash or deferred profit-sharing plans had prevented employers from setting up new plans of this type for their employees. Originally, it was thought that a relatively short period of time would be needed for Congressional study and that a permanent solution would be in place by January 1, 1977. The Congress concluded that the uncertainty caused by the state of the law had created the need for a permanent solution which would permit employers to establish new cash or deferred arrangements. Also, the Congress believed that prior law discriminated against employers who had not established such arrangements by June 27, 1974.

Among other provisions relating to qualified cash or deferred arrangements, the Revenue Act of 1978 included special nondiscrimination rules applicable to such arrangements, restrictions on withdrawals of elective contributions, and as a requirement that elective contributions be nonforfeitable.

The Tax Reform Act of 1986 revised certain of the rules relating to qualified cash or deferred arrangements. The changes were made because Congress was concerned that the rules relating to qualified cash or deferred arrangements under prior law encouraged employers to shift too large a portion of the share of the cost of retirement savings to employees. Congress was also concerned that the prior-law nondiscrimination rules permitted significant contributions by highly compensated employees without comparable participation by rank-and-file employees.

In making the changes, Congress recognized that individual retirement savings play an important role in providing for the retirement income security of employees, but also believed that excessive reliance on individual retirement savings (relative to employer-provided retirement savings) could result in inadequate retirement income security for many rank-and-file employees.

Among other changes, the Tax Reform Act of 1986 modified the nondiscrimination rules applicable to cash or deferred arrangements to reduce the permitted disparity between contributions by highly compensated and nonhighly compensated employees, modified the withdrawal restrictions on elective deferrals, and imposed an annual dollar limit on elective deferrals. In addition, the Tax Reform Act of 1986 provided that tax-exempt and governmental employers cannot maintain cash or deferred arrangements.

C. Simplified Employee Pensions

Under present law, certain employers (other than tax-exempt and governmental employers) can establish a simplified employee pension (SEP) for the benefit of their employees under which the employees can elect to have contributions made to the SEP or to receive the contributions in cash (sec. 408(k)(6)). Amounts the employee elects to have contributed to the SEP are not includible in gross income until withdrawn. Elective deferrals under a SEP are to be treated in the same manner as elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $9,240 (for 1995) cap on elective deferrals. Nonelective contributions can also be made to SEPs by the employer. SEPs are IRAs, and thus are generally subject to the same rules that apply to IRAs. In addition, certain other rules apply.

The election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, such election is available for a taxable year only if the employer maintaining the SEP had 25 or fewer eligible employees at all times during the prior taxable year.

Under present law, elective deferrals under SEPs are subject to nondiscrimination standards. The amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average deferral percentage (based solely on elective deferrals) for all nonhighly compensated employees who are eligible to participate. The deferral percentage for each highly compensated employee cannot exceed 125 percent of the average deferral percentage for all other eligible employees. Nonelective SEP contributions may not be combined with the elective SEP deferrals for purposes of this test. An employer may not make any other SEP contributions conditioned on elective SEP deferrals.

If any employee is eligible to make elective SEP deferrals, all employees satisfying the participation requirements must be eligible to make elective SEP deferrals. An employee satisfies the participation requirements if the employee (1) has attained age 21, (2) has performed services for the employer during at least 3 of the immediately preceding 5 years, and (3) received at least $400 (for 1995) in compensation from the employer for the year. An employee can participate even though he or she is also a participant in one or more other qualified retirement plans sponsored by the employer. However, SEP contributions are added to the employer's contribution to the other plans on the participant's behalf in applying the limits on contributions and benefits (sec. 415).

D. Other Tax Incentives for Saving

Tax-sheltered annuities

Tax-sheltered annuities are another form of employer-based retirement plan that provide the same tax benefits as qualified plans and IRAs. Employers may contribute to such annuities on behalf of their employees, and employees may contribute on a pre-tax basis through salary reduction. Tax-sheltered annuities are subject to rules similar to some of the rules applicable to qualified plans. Tax-sheltered annuity plans may be maintained only by certain types of organizations, in particular, tax-exempt charitable organizations and educational institutions.

Annuity contracts

Present law provides that income credited to a deferred annuity contract is not currently includible in the gross income of the owner of the contract nor is the income taxed to the insurance company issuing the contract. No deduction is provided for, and no dollar limits are imposed on, amounts used to purchase annuity contracts. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under or secured by the contract) are includible in gross income as ordinary income to the extent that the cash value of the contract exceeds the own-

er's investment in the contract. In addition, a portion of each distribution received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

A 10-percent additional income tax is imposed on certain early withdrawals under an annuity contract. This additional tax does not apply to any distribution made after the owner of the contract attains age 59-½, receives annuity payments under the contract, or satisfies certain other requirements.

Life insurance

Under present law, the investment income ("inside buildup") earned on premiums credited under a life insurance policy generally is not subject to current taxation to the owner of the policy or to the insurance company issuing the contract. This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. The contract must satisfy the statutory definition of life insurance by meeting either of two statutory tests: the "cash value accumulation" test, or the "guideline premium/cash value corridor" test.

No deduction is provided for, and no dollar limits are imposed on, amounts used by an individual to purchase life insurance contracts.

Death benefits paid under a life insurance contract are excluded from income, so that neither the policyholder nor the policyholder's beneficiary is ever taxed on the inside buildup if the proceeds of the policy are paid to the policyholder's beneficiary by reason of the death of the insured.

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income only to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income. In the case of a modified endowment contract, however, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59-½ and in certain other circumstances.

III. DESCRIPTION OF PROPOSALS

A. The Savings and Investment Act of 1995 (S.12) [12]

In general

The Savings and Investment Incentive Act of 1995 (S. 12) would phase out the income limits on the deductibility of traditional IRA contributions and modify the definition of active participant during the phase-out period. The bill would index the $2,000 limit on deductible IRA contributions and coordinate the IRA deduction limit with the limit on elective deferrals. In addition, the bill would permit nondeductible contributions to a new IRA Plus account. Withdrawals from an IRA Plus would not be includible in income if attributable to contributions that had been held in the IRA Plus account for at least 5 years. The limits on contributions to traditional IRAs and IRA Plus accounts would be coordinated.

The bill would allow withdrawals from an IRA, a qualified cash or deferred arrangement (sec. 401(k) plan), a tax-sheltered annuity (sec. 403(b)), and a section 501(c)(18) plan without imposition of the 10-percent early withdrawal tax to the extent the amount withdrawn is used for the purchase of a first home, for certain education expenses, or for catastrophic medical expenses. The bill would also permit penalty-free withdrawals from IRAs by individuals who have been unemployed for at least 12 weeks.

Expansion of present-law IRA deduction rules

The bill would increase the AGI limits applicable to deductible IRA contributions for active participants in 1995, 1996, 1997, and 1998. Thereafter, the bill would repeal the limits on IRA deductions for active participants in employer-sponsored retirement plans.

In the case of married taxpayers, for years before 1999, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1995, $65,000 and $75,000; for 1996, $90,000 and $100,000; for 1997, $115,000 and $125,000; and for 1998, $140,000 and $150,000. The bill would also provide that a person is not considered an active participant merely because his or her spouse is an active participant in an employer-sponsored retirement plan.

In the case of single taxpayers, for years before 1999, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1995, $50,000 and $60,000; for 1996, $75,000 and $85,000; for 1997, $100,000 and $110,000; and for 1998, $125,000 and $135,000.

The bill would provide that the IRA deduction limit for any individual is coordinated with the limit on elective deferrals. Thus, an

[12] S. 12 was introduced by Senators Roth, Breaux, Pryor, and Murkowski on January 4, 1995.

individual's deductible contributions to an IRA and elective deferrals could not exceed the annual limit on elective deferrals.

Spousal IRAs

The bill would permit deductible contributions up to the maximum IRA deduction limit for each spouse if the combined compensation of both spouses is at least equal to the contributed amount. For example, in 1995, each spouse could make a deductible contribution of $2,000 to an IRA, provided the combined compensation of both spouses is at least $4,000 (assuming the income limits on deductible contributions for active participants do not apply in this case).

Inflation adjustment for IRA deduction limit

Under the bill, the $2,000 limit on contributions that could be made to an IRA would be indexed for inflation in $500 increments.

IRA investments in coins and metals

The bill would permit IRAs to acquire (1) any coin certified by a recognized grading service and traded on a nationally recognized electronic network or listed by a recognized wholesale reporting service and which is (or was at any time) legal tender in the country of issuance or issued under the laws of any State, or (2) gold, silver, platinum, or palladium bullion, if the coin or bullion in the possession of the IRA trustee.

Nondeductible tax-free IRAs

The bill would permit taxpayers to make nondeductible contributions to new IRA Plus accounts. Generally, IRA Plus accounts would be treated in the same manner as and be subject to the same rules applicable to deductible IRAs. However, a number of special rules would apply.

Contributions to an IRA Plus would be nondeductible. The amount of nondeductible contributions to an IRA Plus that could be made for any taxable year would be tied to the limits for deductible IRAs, so that the aggregate amount of contributions to an IRA Plus could not exceed the excess of (1) the IRA deduction limit for the year (determined without regard to the rule coordinating the IRA deduction limit with the elective deferral limit) over (2) the amount of IRA contributions actually deducted for the year.

Any amount paid or distributed from an IRA Plus generally would not be included in the gross income of the individual to whom the distribution is made if the contributions to which the distribution relates have been held in an IRA Plus account for at least 5 years. However, earnings on distributions attributable to contributions made during the 5-year period ending on the day before the distribution would be included in gross income and, unless an exception applied, would be subject to the 10-percent additional tax on early withdrawals.

In determining whether amounts are includible in income under the 5-year rule, distributions would be treated as having been made first from the earliest contributions (and earnings attributable to such contributions) remaining in the account at the time of distribution and then from other contributions (and earnings) in

the order made. Thus, distributions would be deemed to occur under a first-in, first-out (FIFO) method. Any portion of a distribution allocated to a contribution and earnings would be allocated first to the earnings on the contribution and then to the contribution. Earnings would be allocated to contributions in the manner prescribed by the Secretary of the Treasury. All contributions made during a taxable year would be treated as one contribution for purposes of the 5-year rule.

As an example of the operation of the 5-year rule, assume that an individual makes a $2,000 contribution to an IRA Plus on January 1, 1996, and a $2,000 contribution on January 1, 1997. Assume that earnings on the contributions are 10 percent per year. On July 1, 2001, the IRA Plus account balance is $6,456, with $3,382 of the balance attributable to the contribution made on January 1, 1996, and $3,074 attributable to the contribution made on January 1, 1997. If the individual withdraws $3,000 on July 1, 2001, the entire amount is attributable to the contribution made on January 1, 1996. Because the $2,000 contribution made on January 1, 1996, satisfies the 5-year requirement, the entire $3,000 withdrawal is not included in the taxpayer's income. After the withdrawal, the account balance is $3,456, $382 ($3,382-$3,000) of which is attributable to the January 1, 1996, contribution.

Assume that the taxpayer withdraws an additional $3,000 on August 1, 2001, and that no additional earnings have been credited to the account at that time. $382 is attributable to the January 1, 1996, contribution and, therefore, is not includible in gross income. The remaining $2,618 is attributable to the $2,000 contribution made January 1, 1997, which does not satisfy the 5-year requirement. The taxpayer is deemed to withdraw earnings on the January 1, 1997, contribution first; thus, $1,074 is attributed to earnings on the January 1, 1997, contribution and that amount is includible in the taxpayer's income and subject to the 10-percent additional tax on early withdrawals. $1,544 is a return of the January 1, 1997, contribution that is not includible in gross income. The remaining $456 in the IRA Plus is attributable to the January 1, 1997, contribution (but not to earnings, which have all been withdrawn).

Rollover contributions would be permitted to an IRA Plus only to the extent such contributions consist of a payment or distribution from another IRA Plus. Such rollover contributions would not be taken into account in determining the contribution limit for a taxable year. The normal IRA rollover rules would otherwise govern the eligibility of withdrawals from IRA Plus accounts to be rolled over. For purposes of the 5-year rule, the IRA Plus to which amounts are rolled over would be treated as having held the amounts during any period during which such contributions were held in the IRA Plus to which the contributions were first made.

The bill would permit amounts withdrawn from IRAs to be transferred into an IRA Plus. The amount transferred would be includible in gross income in the year the withdrawal was made, except that amounts transferred to an IRA Plus before January 1, 1997, would be includible in income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to amounts transferred from an IRA to an IRA Plus.

Exceptions to early withdrawal tax

In general

The bill would provide exceptions to the 10-percent additional income tax on early withdrawals in the case of distributions that are (1) qualified first-time homebuyer distributions or (2) qualified higher education distributions. The exceptions would be available with respect to withdrawals from an IRA, including an IRA Plus, or from amounts attributable to (1) elective deferrals to a qualified cash or deferred arrangement (sec. 401(k) plan), (2) salary reduction contributions to a tax-sheltered annuity (sec. 403(b)), or (3) contributions made to a plan described in section 501(c)(18). The bill would extend to IRAs the availability of the qualified plan exception to the early withdrawal tax in the case of extraordinary medical expenses and expand the scope of the exception. Finally, the bill would provide an exemption to the tax for distributions from IRAs to certain unemployed individuals.

Withdrawals by first-time homebuyers

Under the bill, the 10-percent additional income tax on early withdrawals would be waived for withdrawals that are used within 60 days to pay costs (including reasonable settlement, financing, or other closing costs) of acquiring, constructing, or reconstructing the principal residence of a first-time homebuyer who is the taxpayer, taxpayer's spouse, or a child, grandchild, or ancestor of the taxpayer or taxpayer's spouse. A first-time homebuyer would be 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 bill would require that the spouse of the taxpayer also meet this requirement as of the date the contract is entered into or construction commences. The date of acquisition would be the date the individual enters into a binding contract to purchase a principal residence or begins construction or reconstruction of such a residence. Principal residence would be 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 for the purchase of a principal residence would be required to be used within 60 days of the date of withdrawal. The 10-percent additional income tax on early withdrawals would be imposed with respect to any amount not so used. However, in the case of withdrawals from an IRA, if the 60-day rule could not be satisfied due to a delay in the acquisition of the residence, the taxpayer would be able to recontribute all or part of the amount withdrawn to the IRA prior to the end of the 60-day period without adverse tax consequences. Any amount recontributed would be treated as a rollover contribution without regard to the limitations on the frequency of IRA-to-IRA rollovers.

Withdrawals for education expenses

Under the bill, withdrawals used by a taxpayer during the year for qualified higher education expenses would not be subject to the 10-percent additional income tax on early withdrawals. Qualified higher education expenses would be defined as tuition, fees, books,

supplies, and equipment required for courses at an eligible educational institution, as defined under the provisions relating to education savings bonds (sec. 135). Amounts withdrawn would be available for use for the education of the taxpayer or the taxpayer's spouse, or a child, grandchild, or ancestor of the taxpayer or the taxpayer's spouse.

The amount that could be withdrawn for education expenses for a taxable year without imposition of the 10-percent additional tax would be reduced by any amount that is excludable from the taxable income of the taxpayer under the provisions relating to education savings bonds (sec. 135).

Financially devastating medical expenses

The bill would provide that the present-law exception to the early withdrawal tax for medical expenses in excess of 7.5 percent of adjusted gross income would be available in the case of withdrawals from IRAs as well as qualified pension plans. In addition, the exemption would be expanded to apply to medical expenses of a child, grandchild, or ancestor of the taxpayer or the taxpayer's spouse, whether or not that individual is a dependent of the taxpayer for income tax purposes.

Distributions to unemployed individuals

The bill would exempt from the early withdrawal tax distributions from an IRA to an individual who has received unemployment compensation for at least 12 consecutive weeks under any Federal or State unemployment compensation law if the distribution is made during the taxable year such unemployment compensation is paid or the next taxable year.

Effective dates

The bill would generally be effective for years beginning after December 31, 1994. The provisions relating to exceptions from the 10-percent early withdrawal tax would be effective for distributions after the date of enactment.

B. American Dream Restoration Act (H.R. 6) [13]

In general

The bill would permit individuals to establish and maintain an American Dream Savings (ADS) account to which they could make nondeductible contributions. If certain requirements are satisfied, distributions from an ADS account would not be includible in gross income.

Nondeductible tax-free IRAs

The bill would permit individuals to make nondeductible contributions to an ADS account. Contributions to an ADS account would be in addition to any contributions that can be made to an IRA under the present-law rules. An ADS account would be an IRA which is designated at the time of establishment as an ADS account. Qualified distributions from an ADS account would not be

[13] H.R. 6 was introduced by Representative Crane and others on January 4, 1995, as part of the "Contract with America."

includible in income. In general, ADS accounts would be treated the same as IRAs. Some special rules would also apply.

The maximum annual contribution that could be made to an ADS account would be the lesser of $2,000 or the individual's compensation (earned income in the case of self-employed individuals) for the year. In the case of a married couple, the aggregate compensation of the couple would be taken into account in determining the maximum permitted contribution. Thus, for example, in 1996 both spouses in a married couple could each make an ADS contribution of $2,000 (for a total contribution by the couple of $4,000), provided the couple has at least $4,000 in compensation. The $2,000 contribution limit would be adjusted annually for inflation beginning after 1996. Inflation adjustments would be rounded to the nearest $50.

Contributions to an ADS account could be made even after the individual for whom the account is maintained has attained age 70-½, and the minimum distribution rules that apply to IRAs would not apply to ADS accounts.[14]

Qualified distributions from an ADS account would not be includible in gross income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution would be a distribution that is made after the 5-taxable year period[15] beginning with the first taxable year in which the individual made a contribution to an ADS account, and (2) which is (a) made on or after the date on which the individual attains age 59-½, (b) made to a beneficiary (or to the individual's estate) on or after the death of the individual, (c) attributable to the individual's being disabled, or (d) a qualified special purpose distribution.

Qualified special purpose distributions would be distributions for the purchase or acquisition of a principal residence of a first-time homebuyer, for higher education expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild, for medical expenses, or for long-term care insurance premiums.

Distributions from an ADS account other than qualified distributions would be includible in gross income under the rules applicable to distributions from IRAs and subject to the 10-percent tax on early withdrawals.

Distributions from ADS accounts could be rolled over tax free to another ADS account. In addition, amounts withdrawn from an IRA could be rolled over to an ADS account after December 31, 1995, and before January 1, 1998. The amount rolled over would be included in gross income ratably over a 4-taxable year period. The early withdrawal tax would not apply to such rollovers.

Effective date

The provision would be effective for taxable years beginning after December 31, 1995.

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[14] In general, the minimum distribution rules require that distributions from an IRA must begin no later than age 70-½. Tax penalties are imposed if minimum distributions are not made as required.

[15] In the case of rollover contributions that are not from another ADS account, the 5-year holding period would begin on the date on which the rollover was made.

C. Administration Proposal [16]

Deductible IRA contributions

The proposal would increase the income limits at which the IRA deduction is phased out for active participants in employer-sponsored retirement plans. The maximum IRA deduction would be phased out between $80,000 and $100,000 of AGI for married taxpayers and between $50,000 and $70,000 of AGI for single taxpayers. These limits, and the $2,000 limit on deductible IRA contributions, would be indexed for inflation beginning after 1996.

The IRA deduction limit would be coordinated with the limit on elective deferrals so that the maximum allowable IRA deduction for a year could not exceed the excess of the elective deferral limit over the amount of elective deferrals made by the individual.

The proposal would provide that the exception to the early withdrawal tax for distributions after age 59-½ does not apply to amounts that have been held in an IRA for less than 5 years.

Nondeductible IRAs

Individuals who are eligible to make deductible IRA contributions would also be eligible to make nondeductible contributions to a new "Special IRA". Special IRAs generally would be treated the same as IRAs, but also would be subject to special rules. The IRA deduction limit and the limit on contributions to Special IRAs would be coordinated. Thus, the maximum contribution that could be made in a year to a Special IRA would be the excess of the IRS deduction limit applicable to the individual over the amount of deductible IRA contributions. Distributions from Special IRAs would not be includible in income to the extent attributable to contributions that had been in the Special IRA for at least five years. Withdrawals of earnings from Special IRAs before five years would be subject to income tax, and would also be subject to the 10-percent tax on early withdrawals (even if made after reaching age 59-½, unless an exception to the tax applies.

An individual whose AGI for a year falls below the upper end of the eligibility thresholds for deductible IRAs could convert an existing IRA into a Special IRA without being subject to the 10-percent tax on early withdrawals. The amount transferred from the deductible IRA to the Special IRA generally would be includible in the individual's income in the year of the transfer. However, if a transfer is made before 1997, the amount to be included in the individual's income with respect to the transfer would be spread evenly over 4 taxable years.

Exceptions to the early withdrawal tax

The proposal would provide exemptions from the 10-percent early withdrawal for distributions from IRAs or Special IRAs used for certain purposes. Penalty-free withdrawals could be made for (1) qualified higher education expenses, (2) acquisition of a principal residence for a first-time homebuyer, and (3) distributions to individuals who have been receiving unemployment compensation for

[16] The Administration proposal is contained in President Clinton's fiscal year 1996 budget proposal.

at least 12 consecutive weeks. The proposal also would extend to IRAs the exception for distributions from qualified plans for extraordinary medical expenses and would expand the scope of the exception.

Qualified higher education expenses generally would be those meeting the requirements for tuition and fees at most colleges and universities and certain vocational schools. A taxpayer could make a penalty-free IRA withdrawal for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, the taxpayer's dependent, or any child or grandchild of the taxpayer (even if not a dependent for tax purposes).

First-time homebuyers would be individuals who did not own an interest in a principal residence during the three years prior to the purchase of a home and who were not in an extended period for rolling over the gain from the sale of a principal residence. Penalty-free IRA withdrawals could be made for the acquisition, construction, or reconstruction costs of a principal residence for a first-time homebuyer who is the taxpayer or the taxpayer's spouse, child, or grandchild.

An unemployed individual would be permitted to make a penalty-free IRA withdrawal if the individual has received unemployment compensation for at least twelve consecutive weeks during the taxable year in which the withdrawal is made or the preceding taxable year.

The proposal would extend to IRAs the present-law exception to the early withdrawal tax for distributions from tax-qualified plans for medical care expenses exceeding 7-½ percent of adjusted gross income. The proposal would extend the exception to apply to medical expenses of the taxpayer's child, grandchild, parent, or grandparent, regardless of whether such person would otherwise qualify as the taxpayer's dependent. In addition, for this purpose, the definition of medical care would include qualified long-term care services for incapacitated individuals. Qualified long-term care services generally would be services that are required by an incapacitated individual, where the primary purpose of the services is to provide needed assistance with any activity of daily living or protection from threats to health and safety due to severe cognitive impairment. An incapacitated individual generally would be a person who is certified by a licensed professional within the preceding 12-month period as being unable to perform (without substantial assistance) at least two activities of daily living, or as having severe cognitive impairment.

Effective date

The proposal would generally be effective for taxable years beginning after December 31, 1995.

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D. S. 287[17]

Spousal IRAs

The bill would permit deductible IRA contributions of up to $2,000 to be made for each spouse if the combined compensation of both spouses is at least equal to the contributed amount. Thus, for example, each spouse could make up to a $2,000 contribution to an IRA if the combined compensation of both spouses is at least $4,000. The present-law income limitations on IRA deductions for active participants in employer-sponsored plans would continue to apply.

Effective date

The bill would be effective for years beginning after December 31, 1994.

E. PRIME Retirement Accounts for Small Business

Simplified retirement plan

The proposal would create a simplified retirement plan for small business called the private retirement incentives matched by employers (PRIME) account.

A PRIME retirement account would allow employees to make contributions under a qualified salary reduction arrangement to an IRA. A qualified salary reduction arrangement would be a written arrangement of an eligible employer under which an employee could make elective salary reduction contributions to a PRIME retirement account. The amount of such contributions would have to be expressed as a percentage of the employee's compensation, and could not exceed one-half of the limit on elective deferrals in effect for the year.[18] The employer would be required to match employee salary reduction contributions to the extent such contributions do not exceed 3 percent of the employee's compensation.

Only employers who normally employ fewer than 100 employees on any day during the year and who do not maintain a qualified plan could establish PRIME retirement accounts for their employees. For this purpose, a qualified plan would include a qualified retirement plan described in section 401(a), a qualified annuity plan (sec. 403(a)), a governmental plan, a tax-sheltered annuity (sec. 403(b)), and a simplified employee pension (sec. 408(k)).

All contributions to an employee's PRIME retirement account would be 100 percent vested. No nondiscrimination rules would apply to PRIME retirement accounts.

Tax treatment of PRIME retirement accounts

Contributions to an employee's PRIME account would not be includible in gross income. Distributions from a PRIME retirement account generally would be taxed under the rules applicable to IRAs.

Early withdrawals from a PRIME retirement account generally would be subject to an additional tax on certain early withdrawals.

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[17] S. 287 was introduced by Senator Hutchison and others on January 26, 1995.

[18] As described above, the limit on elective deferrals for 1995 is $9,240.

F. Simplified Qualified Cash or Deferred Arrangements

In general

The proposal would adopt safe harbors which would permit a cash or deferred arrangement to satisfy the special nondiscrimination tests applicable to elective deferrals and employer matching contributions through plan design, rather than through the testing of actual contributions.

Under these safe harbor rules, a cash or deferred arrangement would be treated as satisfying the actual deferral percentage test if the plan of which the arrangement is a part (or any other plan of the employer maintained with respect to the employees eligible to participate in the cash or deferred arrangement) meets (1) one of two contribution requirements and (2) a notice requirement. A plan would satisfy the safe harbor with respect to matching contributions if (1) the plan meets the contribution and notice requirements under the safe harbor for cash or deferred arrangements and (2) the plan satisfies a special limitation on matching contributions.

Safe harbor for cash or deferred arrangements

Contribution requirements

A plan would satisfy the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the plan (1) satisfies a matching contribution requirement or (2) the employer makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes elective contributions under the arrangement.

A plan would satisfy the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective contributions up to 3 percent of compensation and (b) 50 percent of the employee's elective contributions from 3 to 5 percent of compensation; and (2) the level of match for highly compensated employees is not greater than the match rate for nonhighly compensated employees at any level of compensation.

Alternatively, if the matching contribution requirement is not satisfied at some level of employee compensation, the requirement would be deemed to be satisfied if (1) the level of employer matching contributions does not increase as employee elective contributions increase and (2) the aggregate amount of matching contributions with respect to elective contributions up to that level of compensation at least equals the amount of matching contributions that would be made if matching contributions satisfied the percentage requirements. For example, the alternative test would be satisfied if an employer matches 125 percent of an employee's elective contributions up to the first 3 percent of compensation, 25 percent of elective deferrals from 3 to 4 percent of compensation, and provides no match thereafter. This is because the employer match does not increase and the aggregate amount of matching contributions

is at least equal to the matching contributions required under the general safe harbor rule.

An arrangement would not satisfy the contribution requirements unless the requirements are met without regard to the permitted disparity rules (sec. 401(1)), and contributions used to satisfy the contribution requirements could not be taken into account for purposes of determining whether a plan of the employer satisfies the permitted disparity rules.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules would have to be nonforfeitable and subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)(2)(B) and (C)).

Notice requirement

The notice requirement would be satisfied if each employee eligible to participate in the arrangement is given written notice, with a reasonable period before any year, of the employee's rights and obligations under the arrangement. This notice must be sufficiently accurate and comprehensive to apprise the employee of his or her rights and obligations and must be written in a manner calculated to be understood by the average employee eligible to participate.

Alternative method of satisfying special nondiscrimination test for matching contributions

The proposal would provide a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions. Under this safe harbor, a plan would be treated as meeting the special nondiscrimination test if (1) the plan meets the contribution and notice requirements applicable under the safe harbor method of satisfying the special nondiscrimination requirement for qualified cash or deferred arrangements, and (2) the plan satisfies a special limitation on matching contributions. After-tax employee contributions would continue to be tested separately under the ACP test.

The limitation on matching contributions would be satisfied if (1) the matching contributions on behalf of any employee may not be made with respect to employee contributions or elective deferrals in excess of 6 percent of compensation and (2) the level of an employer's matching contribution does not increase as an employee's contributions or elective deferrals increase.

Effective date

The proposal would be effective for years beginning after December 31, 1995.

IV. ECONOMIC ANALYSIS OF IRAS GENERALLY

A. Comparison of Deductible IRAs, back-end IRAs, and Nondeductible IRAs

1. General comparison of IRAs

Present law and proposals to create back-end IRAs present the taxpayer with three different tax-preferred saving vehicles, each of which is called an Individual Retirement Arrangement: deductible IRAs, back-end IRAs, and nondeductible IRAs. In general, the deductible IRA and back-end IRA both offer the taxpayer a greater after-tax return than does the nondeductible IRA. The difference in return arises because the deductible and back-end IRAs effectively exempt earnings on invested funds from tax, while the nondeductible IRA taxes the earnings, but on a deferred basis.

Deductible IRAs

Deductible IRAs allow taxpayers to deduct IRA contributions from income in the year contributed, but include the entire amount in income when withdrawn. There are two potential advantages of deductible IRAs over fully taxable savings vehicles. First, taxpayers earn a tax-free rate of return on IRA investments. Second, taxpayers postpone taxation of the contribution until the contributions are withdrawn, at which time they may be taxed at a lower rate than when the contribution is made.

The following example illustrates why a deductible IRA investment receives a tax-free rate of return. Assume a taxpayer with a marginal tax rate of 28 percent contributes $1,000 to an IRA. The initial savings from the IRA is $280, the tax that would have been paid on the $1,000. For the purpose of this example, assume that the taxpayer withdraws the funds after 1 year without penalty. If the annual rate of return on the IRA assets is 10 percent, the value of the IRA is $1,100, total tax due is $308, and the taxpayer is left with $792. Notice that if the taxpayer had paid the initial tax of $280 and invested the remaining $720 at 10 percent, then the taxpayer would have had $792 after one year. If the income had not been invested in an IRA, the taxpayer would have to pay tax on $72 dollars of earnings, and would be left with $771.84 after payment of taxes. The value of the IRA is that the taxpayer does not have to pay additional tax. Thus, the deductible IRA allows the taxpayer to get a tax-free rate of return on an investment of $720.

This analysis is independent of the number of years the IRA investment is held. The value of the tax exemption, however, increases with the number of years the IRA is held. For instance, if in the above example, the taxpayer holds the IRA for 10 years, the IRA would be worth $1,867, whereas a fully taxed investment would be worth $1,443 after 10 years.

The deductible IRA investment can be viewed as an investment that is jointly owned by the government and the taxpayer. The government's ownership share is equal to the tax rate (28 percent in the above example). When the IRA funds are withdrawn, the government receives its share of the funds. In the above example, when the funds are withdrawn after one year, the government receives 28 percent of $1,100 ($308), and the taxpayer receives 72 percent of $1,100 ($792). The taxpayer pays no tax on the earnings attributable to the taxpayer's share of the investment, and thus receives a tax-free rate of return on the investment. This is one advantage of investing through an IRA.

A second advantage of a deductible IRA arises if the taxpayer's marginal tax rate in the year the funds are withdrawn is lower than the marginal tax rate in the year of the contribution. Because the government's share of the investment is equal to the taxpayer's tax rate in the year the funds are withdrawn, the lower the tax rate prevailing at that time, the smaller the government's share. In the example above, for instance, if the tax rate when the funds are withdrawn is 15 percent, then the tax paid after 1 year would be $165. Not only does the taxpayer receive a tax-free rate of return on the taxpayer's share of the investment, but the taxpayer share of the investment is 85 percent rather than 72 percent.

Tax rates might be lower at the time the funds are withdrawn because the beneficiaries may be receiving untaxed social security benefits and reduced taxable income from other sources. However, the marginal tax rate could be lower or higher because tax rate schedules may change over time.

Back-end IRAs

From an economic perspective, back-end IRAs are similar to deductible IRAs. With a back-end IRA, the taxpayer does not deduct the IRA contribution from income, but pays no tax when the funds are withdrawn. In other words, the government takes its share before the funds are invested. The taxpayer is never taxed on the interest earned on the investment, and thus earns a tax-free rate of return on the IRA investment. This is the same tax benefit provided to deductible IRAs.

However, in the case of the back-end IRA, the tax is paid on the initial contribution at the time of contribution, and in the case of the deductible IRA, the tax is paid on the initial contribution at the time of withdrawal. In effect, the government's share of the back-end IRA is equal to the taxpayer's marginal tax rate at the time the funds are contributed, whereas the government's share of the deductible IRA is equal to the taxpayer's marginal tax rate at the time the funds are withdrawn. Whether the deductible IRA and back-end IRA are economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year the contribution is made and the taxpayer's marginal tax rate in the year the IRA funds are withdrawn.

If these two marginal tax rates are equal, then the back-end IRA provides the same overall benefits as the deductible IRA. For example, if a taxpayer earns $1,000 and chooses to use it for a back-end IRA, the taxpayer first pays tax on it. If the taxpayer's marginal tax rate is 28 percent, the taxpayer will have $720 to invest. After

1 year earning interest at 10 percent per year, the taxpayer has $792, the same amount that the taxpayer has in the deductible IRA example above.

If the tax rate in the year the contribution is made is different from the tax rate in the year the funds are withdrawn, then the deductible IRA and the back-end IRA are no longer equivalent. When tax rates decrease over time (either because tax rates change or taxpayers fall into lower tax brackets), the deductible IRA is more advantageous, because it permits taxpayers to defer payment of tax until tax rates are lower. When tax rates increase over time, a back-end IRA is more tax-favored.

Nondeductible IRAs

Present law permits taxpayers who cannot make the maximum amount of deductible IRA contributions (because they are covered under an employer-provided pension plan and their income exceeds the dollar limits) to make nondeductible contributions to IRAs. Unlike back-end IRAs, earnings on present-law nondeductible IRA contributions are includible in income when withdrawn. The tax advantage of these IRAs is that taxes on earnings are deferred, rather than assessed annually. This permits the earnings to compound faster than with annual taxation of earnings. This advantage is the same advantage implicit in the tax treatment of the earnings on deferred annuities, which are taxed when the annuities are paid rather than when the earnings accrue.

For example, compare the accumulation of income for an investor with a 28-percent marginal tax rate on $720 which is invested for a period of 10 years at an 10 percent annual rate of return. If the earnings are taxed annually, the total available funds at the end of 10 years would be $1,443.05. The investor's annual after-tax return is 7.2 percent. If the tax is deferred for 10 years and assessed on the accumulated interest at the end of the 10-year period at a 28-percent marginal tax rate, the value of the taxpayer's investment would be $1,344.60, which represents an annual return of 7.9 percent. Unlike the deductible and back-end IRAs discussed above, the after-tax rate of return of investment in a nondeductible IRA increases as the holding period increases; as the holding period increases, accumulated earnings increase, and thus the value of deferring tax on the accumulated earnings increases.

Summary

Table 1 compares the funds available after 10 years to a taxpayer who saves $1,000 of pre-tax income in a deductible IRA, a back-end IRA, and a nondeductible IRA, assuming that no penalty tax applies and that the rate of return on the IRA assets is 10 percent per year. The tax rate in the year contributed is labeled t_0, and the tax rate in the year the funds are withdrawn is labeled t_{10}. Table 1 also summarizes the timing of the Federal Government's tax receipts.

As was noted above, the difference in the funds available to the taxpayer investing $1,000 of pre-tax income in the deductible IRA compared to the back-end IRA depends only on the difference between the marginal tax rate the taxpayer faces in the year the funds are contributed, t_0, and the marginal tax rate in the year the

funds are withdrawn, t_{10}. The funds available in the nondeductible IRA are always smaller than those in the back-end IRA. Both of these IRAs tax the contribution at a tax rate t_0 but the back-end IRA effectively exempts earnings from additional tax, whereas the nondeductible IRA only defers earnings from tax.

Table 1.– Funds Available to Taxpayer and Pattern of Tax Receipts Under Deductible IRA, IRA, and Nondeductible IRA

Taxpayer has $1,000 of pre-tax income to invest in IRA, and the annual rate of return on IRA assets is 10 percent.
t_0 = marginal tax rate in year of IRA contribution
t_{10} = marginal tax rate in year of IRA withdrawal

Funds Available to Taxpayer After 10 Years

	Funds contributed to IRA	Funds available after 10 years	Taxes due in year 10	Funds available after tax in year 10
Deductible IRA	$1,000	$2,594	2,594 (t_{10})	2,594 (1-t_{10})
Back-end IRA	$1,000 (1-$t_{10}$)	$2,594 (1-$t_{10}$)	0	2,594 (1-t_0)
Nondeductible IRA	$1,000 (1-$t_{10}$)	$2,594 (1-$t_{10}$)	$(2,594-1,000) (1-$t_0$)$t_{10}$	2,594 (1-t_1)-$1,594 (1-$t_0$)$t_{10}$

Pattern of Income Tax Payments Under Three IRAs

	Tax payments in		
	Current Year	Year 1-9	Year 10
Deductible IRA	0	0	$2,594 ($t_{10}$)
Back-end IRA	$1,000	0	0
Nondeductible IRA	$1,000	0	$1,594 (1-$t_{10}$)$t_{10}$

Example: t_0=.28, t_{10}=.28

	Funds contributed to IRA	Funds available after 10 years	Taxes due in year 10	Funds available after tax in year 10
Deductible IRA	$1,000	$2,594	$726	$1,868
Back-end IRA	$720	$1,868	0	$1,868
Nondeductible IRA	$720	$1,868	$321	$1,547

	Tax payments in		
	Current Year	Year 1-9	Year 10
Deductible IRA	0	0	$726
Back-end IRA	$280	0	0
Nondeductible IRA	$280	0	$321

2. Other potential differences between deductible IRAs and back-end IRAs

The deductible and back-end IRAs may have a number of differences in addition to those due to differences in marginal tax rates. These differences involve the contribution limit, the holding period requirement, the penalty for early withdrawals, and the interaction with social security benefits.

Contribution limit

Assume the contribution limit applied to back-end IRAs is the same as that presently applicable to deductible IRAs, $2,000. Contributions to a deductible IRA are limited to $2,000 of pre-tax income, whereas contributions to a back-end IRA are limited to $2,000 of after-tax income. The $2,000 back-end IRA contribution limit effectively increases the amount of tax-free saving that can be invested in the back-end IRA relative to the deductible IRA. The following example illustrates this difference. In the case of a taxpayer with a marginal tax rate of 28 percent who contributes $2,000 to a deductible IRA earning 10 percent per year, the IRA balance will be $2,200 after one year. The taxpayer will owe $616 in tax, leaving $1,584. This is equivalent to the taxpayer having paid an initial tax of $560, or 28 percent of $2,000, and investing the remaining $1,440 at an after-tax return of 10 percent. Thus the $2,000-limit on pre-tax income is like a limit of $1,440 on after-tax income for a taxpayer with a 28-percent marginal tax rate. If instead the investor had contributed $2,000 to a back-end IRA, the funds available to the taxpayer after one year would be the full $2,200, since no additional tax would be due.[20] The difference in the limits is only valuable to taxpayers who want to invest more than $2,000 of pre-tax income in an IRA. However, according to the Taxpayer Usage Survey, in 1984, approximately 75 percent of all IRA contributors contributed the maximum permissible amount, indicating that this difference between the deductible IRA and the back-end IRA may be significant for a large number of taxpayers.

Holding period and penalties for early withdrawal

Funds in a deductible IRA that are withdrawn within five years and are withdrawn before age 59-½ are subject to a 10-percent additional tax, unless certain exceptions apply. In contrast, some proposals would permit funds invested in an IRA to be withdrawn after only five years without additional tax. Thus, such proposals would provide benefits for taxpayers who plan to keep funds invested for a relatively short period of time, as well as for taxpayers who have longer investment horizons.[21]

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[20] More generally, for a taxpayer facing a marginal tax rate of t, the equivalent contribution limit for a deductible IRA is C/(1-t) where C is the contribution limit for the back-end IRA.

[21] Note that for taxpayers older than age 54-½, the required holding period for new contributions will actually be shorter for deductible IRAs than for proposals that require a five-year holding period (because of the age 59-½ rule for deductible IRAs). Thus, older taxpayers may prefer to contribute to deductible IRAs.

Treatment of IRA withdrawals for purposes of taxing social security benefits

Another potential difference between the deductible and the back-end IRAs is the effect of withdrawals on the taxation of social security benefits. Under present law, social security benefits are exempt from tax except for taxpayers whose income exceeds certain income thresholds. The income thresholds are defined by reference to modified adjusted gross income (AGI). Modified AGI is the taxpayer's AGI increased by the amount of interest received or accrued by the taxpayer during the taxable year that is otherwise exempt from tax. The IRS has stated that tax-exempt interest required to be included in modified AGI is the amount of interest on tax-exempt obligations received or accrued by the taxpayer during the taxable year.[22] Interest earnings that accrue on contributions to a deductible IRA are arguably not included in modified AGI because tax on such earnings is deferred, rather than exempt. However, taxable distributions from the taxpayer's IRA are part of AGI and consequently are part of modified AGI. Since distributions from a deductible IRA are taxable, but those from a back-end IRA are not, distributions from a deductible IRA are included in the taxpayer's modified AGI, but distributions from a back-end IRA are not, except perhaps to the extent that the amounts attributable to the earnings on back-end IRA contributions are deemed to be exempt interest required to be included in modified AGI.[23]

This may be an additional advantage of the back-end IRA for taxpayers who are making withdrawals from IRAs when they are also receiving social security benefits. However, it is an advantage only for taxpayers who expect their incomes to be close enough to the threshold income level that distributions from IRAs make them exceed that level.

3. Eligibility for deductible IRAs under present law

Both present law and proposals to modify IRAs limit IRAs to taxpayers with earned income. Thus, the 25 percent of tax returns that report no earned income cannot contribute to an IRA, and will not be affected by the proposals.[24]

Table 2 focuses on taxpayers with earned income. Under present law, taxpayers who are covered by employer-sponsored pension plans and whose income exceeds certain thresholds are not eligible to make deductible IRA contributions. These restrictions prohibit 29 percent of all tax returns with earned income from claiming deductible IRA contributions, and limit eligibility for an additional 15 percent.

The percentage of taxpayers eligible to make deductible IRA contributions differs significantly by filing status and by number of earners. For instance, 45 percent of joint returns with two earners, 33 percent of joint returns with one earner, and 18 percent of all returns of taxpayers who are single, head of household, or married filing separately cannot claim any deductible IRA contributions. Taxpayers in the phaseout range can claim some deductible IRA

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[22] Rev. Rul. 84-173, 1984-2 C.B. 16.

[23] Present law is unclear on this point. See Code section 86 and its legislative history.

[24] S. 287 does not require both spouses to have earned income, but limits total contributions by reference to the combined earned income of the couple.

contributions, but less than the maximum; 14 percent of joint returns with two earners, 12 percent of joint returns with one earner, and 16 percent of the single, head of household, and married filing separately returns fall in this category. On average, these taxpayers can contribute roughly 50 percent of the maximum contribution amount.

Table 2. – Eligibility of Taxpayers With Earned Income to Make Deductible IRA Contributions Under Present Law, Projected 1995 Returns[1]

Adjusted gross income	Returns with earned income			
	Returns (thousands)	Percent eligible for maximum deductible IRA contribution	Percent in phaseout range	Percent not eligible for any IRA deduction
Joint Returns With Two Earners				
Less than $10,000	653	100.0	0.0	0.0
$10,000 to $20,000	1,439	100.0	0.0	0.0
$20,000 to $30,000	1,985	100.0	0.0	0.0
$30,000 to $40,000	2,360	100.0	0.0	0.0
$40,000 to $50,000	2,073	67.1	33.0	0.0
$50,000 to $75,000	3,547	11.4	35.8	52.8
$75,000 to $100,000	1,667	8.2	0.1	91.8
$100,000 to $200,000	1,477	12.9	0.0	87.1
$200 000 and over	682	9.8	0.0	90.2
All income classes	15,883	54.3	12.3	33.4
Average dollars eligible per return		[2] $2,145	[3]$1,356	------

Table 2. -- Eligibility of Taxpayers With Earned Income to Make Deductible IRA Contributions Under Present Law, Projected 1995 Returns

Adjusted gross income	Returns with earned income			
	Returns (thousands)	Percent eligible for maximum deductible IRA contribution	Percent in phaseout range	Percent not eligible for any IRA deduction
Joint Returns With Two Earners				
Less than $10,000	464	100.0	0.0	0.0
$10,000 to $20,000	1,368	100.0	0.0	0.0
$20,000 to $30,000	2,576	100.0	0.0	0.0
$30,000 to $40,000	3,596	99.9	0.1	0.0
$40,000 to $50,000	3,964	67.9	32.1	0.0
$50,000 to $75,000	8,432	7.9	36.4	57.6
$75,000 to $100,000	5,042	5.9	0.1	94.0
$100,000 to $200,000	3,371	9.6	0.0	89.4
$200 000 and over	640	14.7	0.0	85.3
All income classes	29,453	41.0	14.3	44.8
Average dollars eligible per return		[2]$3,211	[3]$1,755	----

Table 2. -- Eligibility of Taxpayers With Earned Income to Make Deductible IRA Contributions Under Present Law, Projected 1995 Returns[4]

Adjusted gross income	Returns with earned income			
	Returns (thousands)	Percent eligible for maximum deductible IRA contribution	Percent in phaseout range	Percent not eligible for any IRA deduction
Heads of Households, Single Returns, and Married Filing Separately				
Less than $10,000	9,742	99.9	0.0	0.1
$10,000 to $20,000	13,331	99.9	0.0	0.1
$20,000 to $30,000	11,319	89.6	10.3	0.2
$30,000 to $40,000	7,861	10.3	84.5	5.2
$40,000 to $50,000	4,589	2.5	10.8	86.8
$50,000 to $75,000	4,011	5.8	0.4	93.8
$75,000 to $100,000	847	9.4	0.0	90.6
$100,000 to $200,000	544	11.0	0.0	89.0
$200 000 and over	177	10.7	0.0	89.3
All income classes	52,421	65.8	15.9	18.3
Average dollars eligible per return		$1,949	$698	----
Total, all returns	97,755	56.6	14.8	28.7
Average dollars eligible per return		$2,255	$1,094	

[1] Note that the table includes imputed returns of taxpayers who do not file income tax returns, and is thus intended to be representative of the population, rather than of taxable returns. The table also includes returns filed by dependents, and may include some returns of taxpayers over age 70-1/2 who have earned income but who are not eligible to make deductible IRA contributions.

[2] Average eligible contribution amount for taxpayers eligible to make maximum contribution.

[3] Average contribution amount for taxpayers in phaseout range.

[4] Some returns with income below $40,000 are phased out because they are returns of married individuals filing separately. IRA eligibility is phased out between $0 and $10,000 of AGI for such married individuals who live together and between $25,000 and $35,000 of AGI for such married individuals who live apart.

Source: Joint Committee on Taxation estimates for 1995.

These eligibility percentages and the real value of the IRA contribution limits will decrease over time, because present law does not index the contribution limits or the income eligibility limits for inflation. For example, the $40,000 AGI-limitation for joint filers to claim a fully deductible IRA contribution is equivalent to an adjusted gross income today of almost $55,000 after adjusting for inflation. The real value of a $2,000 contribution has declined 27 percent since 1986 because of inflation.

Taxpayers whose eligibility is limited by the present-law rules may be likely to contribute to IRAs if eligibility were restored. As Table 4, below, demonstrates, in 1985, taxpayer returns reporting income of $50,000 or more were more than four times as likely to claim deductible contributions to an IRA as were lower-income taxpayers. After eligibility was limited in 1986, IRA contributions fell substantially. Total IRA contributions fell from a high of $38.2 billion in 1985 to $8.7 billion in 1992 (see Table 3, below). In 1994 dollars (i.e., adjusting for inflation), total IRA contributions were $53.3 billion in 1985 and $9.3 billion in 1992, representing a real decrease of 82 percent.

Under present law, for joint returns with AGI between $50,000 and $75,000, 11 percent of returns with one earner and only 8 percent of returns with two earners can claim the maximum deductible IRA contribution because neither spouse is an active participant in an employer-sponsored retirement plan. In the case of a joint return with two earners, it is possible that only one spouse is an active participant in an employer-sponsored plan. Thus, the spouse who is not an active participant is not eligible to make deductible IRA contributions because of the income reflected on the joint return. If the income phaseouts and active participant rules were applied separately to spouses filing joint returns (i.e., if all taxpayers were treated as single individuals for purposes of determining eligibility for deductible IRA contributions), then more taxpayers would be eligible to make deductible IRA contributions.

Another reason that the IRA eligibility of married couples with two earners is so low is that the income of these couples is higher generally than the income of married couples with one earner. Almost 50 percent of married couples with two earners have AGI greater than $50,000, whereas only 25 percent of couples with one earner do.

B. Present Value of Revenue Cost of IRAs to Federal Government

Assessing the cost (in the form of foregone tax receipts) to the Federal Government of IRAs may be more difficult than assessing the costs of other tax provisions, because IRAs not only change the amount of tax collected, but also change the timing of tax collections. For instance, the traditional deductible IRA can be viewed as a provision which both delays payment of tax on the contribution until withdrawal, and effectively exempts from tax any earnings on capital accumulation beyond the amount that represents interest on the delayed tax. Thus, the timing of tax payments results in a revenue loss to the government in the first years, but a revenue gain in the later years when the funds are withdrawn (see Table 1). The back-end IRA, on the other hand, loses little revenue in the

beginning years, but gains no revenue in the later years because withdrawals are not taxed.

Traditional budget scorekeeping accounts for the revenue effects of proposed legislation on a cash-flow basis; in other words, the effect of a provision on budget receipts in the 5-year budget period is estimated without regard to whether the provision will also affect budget receipts in any year beyond the 5-year period. This method scores deductible IRAs as bigger revenue losers than back-end IRAs. However, a present-value calculation demonstrates that the long-term cost to the Federal Government of deductible IRAs and back-end IRAs will be approximately equal. This is because a present-value approach recognizes that tax will eventually be collected on funds in IRAs, although possibly at a lower tax rate when withdrawn.

In order to evaluate the present value of the program's cost,[25] it is also necessary to know how taxpayers would have behaved in the absence of the IRA provision. Consider first the case of a taxpayer whose tax rate in the contribution year is the same as in the year the funds are withdrawn. Then, the tax advantage of the IRA is the ability to earn a tax-free rate of return on savings. However, the cost to the government depends on what the taxpayer would have done in the absence of the program. If, in the absence of the tax benefits accorded to IRAs, the taxpayer would not have saved the money invested in the IRA, then the IRA program does not lose any government revenue in the long run. For instance, consider the example of a taxpayer who decides to invest $1,000 in an IRA. If, in the absence of the IRA, the taxpayer would have paid the $280 tax on the earnings, and spent the remaining $720, the total amount of tax collected from that $1,000 over the taxpayer's lifetime by the government would have been $280. If instead of spending the income, the taxpayer invests it in a back-end IRA, the government collects $280 from the earnings, and then never taxes the income again. Once again, the total amount collected over the taxpayer's lifetime is $280. Further, assume that the taxpayer invests in a deductible IRA for 10 years in a fund that earns 8 percent per year. In the first year, the government loses $280 in revenue, since the taxpayer deducts the $1,000 from income. In year 10, the $1,000 has grown to $2,158.93, and the taxpayer owes $604.50. Since $604.50 is exactly equal to $280 plus 10 years of interest at 8 percent per year, the government receives the $280 with interest, and collects the same amount of revenue that it would have had there been no IRA program. In present value terms, the taxpayer pays $280 over his or her lifetime. To the extent that deductible IRAs permit taxpayers to pay tax on their funds at a lower marginal rate than when the contribution was made, the government does lose revenue even if the funds invested in the IRA represent funds which would otherwise have been consumed (i.e., new saving.)

On the other hand, if the contribution to the IRA represents income that would have been invested for the same 10 years in an interest-bearing account (i.e., old saving), the IRA reduces revenues

[25] To calculate the present value of the cost to the government of IRAs, it is necessary to use the government's discount rate. If repayment of taxes is uncertain, then the discount rate used should be higher than the government's borrowing rate.

to the government. If the earnings in the above example would have instead been invested in a fully taxable asset earning 8 percent per year, the government would have collected the $280 tax on the initial earnings, plus an additional $136 in present value (using a discount rate of 8 percent) of taxes on the annual interest earnings. Thus, the cost of the IRA program in this case for this particular taxpayer would be $136.

The above examples represent the polar cases of the present value of the revenue effect for IRA contributions--contributions that represent only new savings and contributions that represent savings that would otherwise have been invested in a fully taxable asset.[26] Other possibilities can also be considered. For instance, saving for an IRA may be diverted from other tax-favored assets, in which case the tax loss is not as great. For example, under the bill, if taxpayers who contribute to a deductible IRA would have invested in a nondeductible IRA under present law, then the tax loss consists of the difference between the tax advantage of the deductible IRAs and the tax advantage of the nondeductible IRAs. Similarly, investment in housing is currently tax favored. If taxpayers divert income that would have been invested in housing to IRAs, the present value of the revenue cost to the Federal Government may be relatively small.

Finally, giving taxpayers the choice between the deductible and the back-end IRA is likely to increase the present value of the revenue cost of the IRA program relative to a program offering either IRA alone. Taxpayers who have reason to believe that their tax rates will decline over time should be more likely to choose the deductible IRA, and taxpayers who believe their tax rates will increase over time should choose the back-end IRA.

If IRAs do not generate new saving, then IRAs reduce the present value of revenues of the Federal Government. If the Federal Government responds to these reduced revenues by reducing expenditures or increasing other taxes, then IRAs that do not increase personal saving will have no effect on national saving. If, on the other hand, the Federal Government offsets the reduced revenues by borrowing, then IRAs will actually reduce the national saving rate.

C. The Effectiveness of IRAs at Increasing Saving

1. Theoretical effects

In general

IRAs have a number of attributes that may affect a taxpayer's saving decision. First, investments in IRAs earn a higher after-tax rate of return than investments in other assets. Second, IRAs may provide an incentive for retirement saving, as opposed to other forms of saving. Third, deductible IRAs may provide a psychological incentive to save. Fourth, advertising by banks and other financial institutions of IRAs may influence people's saving decisions. The following discussion focuses on each of these attributes.

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[26] Actually, the revenue loss can be even greater than the case presented. If IRAs reduce saving, then not only does the government lose the tax revenue that would have been collected on the IRA investment, but it also loses the tax revenue on the saving that was not undertaken because of the IRA. The possibility that IRAs reduce private saving is discussed below.

Rate of return

In general

Both the deductible IRA and the back-end IRA effectively exempt the return on savings from tax, thereby increasing the rate of return to saving. When the return on saving increases, the price of future consumption decreases, because the taxpayer has to forego fewer dollars today to consume a dollar's worth of consumption in the future.

This price decrease can affect saving in two ways. Since future consumption is now cheaper, taxpayers may choose to substitute future consumption for current consumption. This effect increases saving. When the price of future consumption falls, though, the amount of investment necessary to achieve any particular level of income in the future decreases. For example, a taxpayer in the 28-percent marginal tax bracket may set aside $1,300 today to help defray tuition expenses of his child 15 years from now. If the taxpayer's investment earns 8 percent annually and those earnings are taxed annually at a 28-percent tax rate, in 15 years the investment will be worth $3,000. If the taxpayer instead invested in a back-end IRA, an investment of only $946 today would be worth $3,000 in 15 years (assuming the same 8-percent return). This effect decreases saving because the tax benefit permits the taxpayer to save less to accumulate the same amount of money in the future.

Substantial disagreement exists among economists as to the effect on saving of increases in the net return to saving. Some studies have argued that one should expect substantial increases in saving from increases in the net return.[27] Other studies have argued that large behavioral responses to changes in the after-tax rate of return need not occur.[28] Empirical investigation of the responsiveness of personal saving to after-tax returns provides no conclusive results. Some find personal saving responds strongly to increases in the net return,[29] while others find little or a negative response.[30]

Even if increasing the rate of return on all saving does increase saving generally, it is still possible that increasing the rate of return on IRAs would not affect saving. For increased rates of return to influence taxpayers to substitute future consumption for current consumption, the marginal rate of return on savings must increase so that if the taxpayer increases saving, that saving receives a higher rate of return. In order for IRAs to increase the marginal return to saving, taxpayers must not be able to finance the IRA profitably by borrowing, must not have other similar assets that can be easily shifted into an IRA, and must intend to save less than the maximum contribution allowed. The following discussion provides examples of how each of these situations may affect the impact of IRAs on saving.

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[27] See, Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, 71, (September 1981).

[28] See, David A. Starrett, "Effects of Taxes on Saving," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, (Washington: Brookings Institution), 1988.

[29] See, Michael Boskin, "Taxation, Saving, and the Rate of Interest," 1T3Journal of Political Economy, 86, April 1978.

[30] See, George von Furstenberg, "Saving," in Henry Aaron and Joseph Pechman (eds.), *How Taxes Affect Economic Behavior*, Brookings Institution, 1981.

Borrowing.

When interest on borrowed funds is deductible, it may be profitable for a taxpayer to borrow to contribute to an IRA. For example, consider a taxpayer with a 28-percent marginal tax rate without any assets. If the taxpayer can borrow at an interest rate equal to the rate of return on an IRA investment, then one would not expect the taxpayer to increase the amount of income saved. Instead, the borrower can borrow $2,000, invest in the IRA and deduct the interest cost. Since the IRA earnings are effectively exempt from tax, the taxpayer receives the full value of the IRA benefit, but does not increase saving.[31] Given that the taxpayer can receive the IRA benefit without increasing saving, the decision of whether to save an extra dollar is unaffected, because that extra dollar will not receive a higher after-tax return than it would have without the availability of tax benefits for IRAs.

If the taxpayer must pay a higher interest rate on the loan than can be received on the investment, the benefits to borrowing to finance an IRA are reduced, but not eliminated. For example, if investments in IRAs earn 10 percent per year and the taxpayer's marginal tax rate is 28 percent, the taxpayer could profitably borrow to fund the account even if the annual interest rate on the loan was as high as 13.8 percent. However, in this case, the taxpayer would gain little from borrowing, and might choose to finance the IRAs with increased savings instead.

Present law permits taxpayers to deduct investment interest but not most personal interest. It is unclear whether interest on a loan used to finance a deductible IRA would be considered investment interest or personal interest. It is likely, however, that interest on a loan used to finance a back-end IRA would not be deductible, whether or not secured by the taxpayer's home, because it would be viewed as interest on amounts used to finance tax-exempt interest and subject to section 265. Furthermore, present law does not allow IRA assets to be used as security for a loan. Because interest paid on home-equity loans generally is deductible, the easiest way to borrow to finance IRAs may be through home-equity loans. Borrowing against home equity to finance IRAs is similar to shifting existing assets into IRAs.

Shifting of existing assets.

Taxpayers who have existing assets that exceed the IRA contribution limits can also receive the benefit of IRAs without increasing saving. Consider a taxpayer who saves only $400 annually, but has been saving for years, and has $4,500 in financial assets. The first year the taxpayer has the opportunity to invest in an IRA, the taxpayer can shift $2,000 from the financial assets to the IRA. The second year, the taxpayer can once again shift $2,000 into the IRA. Only in the third year will the tax benefits accorded to IRAs increase the rate of return on new saving.

[31] However, if the taxpayer begins repaying the loan before the IRA funds are withdrawn, even this loan-financed IRA investment might be associated with increased saving. This possibility is discussed in greater detail below.

Shifting of planned assets.

Finally, taxpayers who would have saved without the IRA may not increase their saving due to the availability of IRAs. For example, consider a taxpayer who habitually saves $4,000 per year. If this taxpayer is provided the opportunity to invest in an IRA, then $2,000 of these savings will be diverted to the IRA. However, the IRA does not provide a marginal incentive to save. If the taxpayer saves $4,001, the return on that extra dollar of saving will be no higher than it would have been without the IRA program. The taxpayer may even decrease the amount saved, since the first $2,000 of saving that is in the IRA will provide more income in the future, and hence the need for saving may decrease.

Type of saving

The above discussion focused on saving in general. Many authors have noted that certain IRAs may provide incentives for retirement saving, as opposed to saving for other purposes. For instance, consider the effect of the deductible IRA, which is subject to additional tax unless held until retirement or used for other qualified purposes. An individual who is saving only for a "rainy day" may not have much saving that is expected to last until retirement. When offered a higher rate of return on retirement saving, that individual may choose to increase the total amount of saving by maintaining the rainy day saving and adding retirement saving.

Similarly, an individual who takes out a home equity loan to finance an IRA may not save any additional money in the year the IRA contribution is made. But if that individual slowly repays that loan, and this repayment represents saving the taxpayer would not otherwise have done, then the IRA increased that individual's saving.

To the extent the provisions for penalty-free early withdrawal of the IRA and the reduced holding period requirements of the proposals to modify IRAs increase the substitutability of IRA saving for other saving, this retirement saving attribute of IRAs is diminished, making substitution of current savings for IRA savings more likely.

Psychological impact of IRAs and effects of increased advertising

Some observers have noted that IRAs may have a larger impact on saving than standard economic analyses would predict. These observers suggest that active marketing campaigns in the mid-1980s contributed to the high IRA participation rates observed; in fact, IRA participation was larger than was expected. The sharp decline in advertising after 1986 may explain the decline in IRA contributions among taxpayers who are still eligible.

Furthermore, there may also be a psychological factor that contributes to the impact of IRAs on saving. One study found that taxpayers who owed money to the IRS in excess of taxes withheld were significantly more likely to make IRA contributions than were

other taxpayers.[32] One might expect this psychological factor only to induce deductible IRA contributions, which will have an immediate effect on taxes paid. However, another author[33] noted that taxpayers who owe the IRS money generally have higher incomes and this may be why they are more likely to contribute to IRAs, rather than any psychological factor.

2. Empirical research on the effect of IRAs on saving

Deductible IRAs have been very popular with taxpayers. As Table 3 reports, contributions to IRAs increased significantly when eligibility restrictions were eliminated in 1982. At the peak in 1985, over $38 billion was contributed to IRAs. This represented almost 20 percent of personal saving for that year.

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[32] Feenberg, Daniel, and Jonathan Skinner, "Sources of IRA Saving," in Lawrence Summers (ed), *Tax Policy and the Economy*, vol. 3, (Cambridge: Massachusetts Institute of Technology Press), 1989.

[33] Gravelle, Jane, "Do Individual Retirement Accounts Increase Savings?", *Journal of Economic Perspectives*, 5, Spring 1991.

Table 3.-- IRA Participation 1980-1993

Year	Returns Claiming IRA Deduction (millions)	Percentage of all returns (percent)	Deductions Claimed ($ billions)
1979	2.5	2.6	3.2
1980	2.6	2.7	3.4
1981	3.4	3.6	4.8
1982	12.0	12.6	28.3
1983	13.6	14.1	32.1
1984	15.2	15.3	35.4
1985	16.2	15.9	38.2
1986	15.5	15.1	37.8
1987	7.3	6.8	14.1
1988	6.4	5.8	11.9
1989	5.8	5.2	10.8
1990	5.2	4.6	9.9
1991	4.7	4.1	9.0
1992	4.5	3.9	8.7
1993[1]	4.4	3.8	8.6

NOTE: [1] - prelimnary data

Source. Statistics of Income

However, it is unclear whether IRAs actually increased total saving. There is no consensus within the economics profession on the effect of the pre-1986 IRAs on personal saving. Some economists believe that IRAs had no effect on overall personal saving; some believe that IRAs increased personal saving; and some economists believe that IRAs would have eventually increased saving if the universally available deductible IRA had been maintained.

A number of economists argue that most of the IRA contributions consisted of taxpayers shifting into IRAs from existing assets.[34] They point to the fact that IRA contributions were concentrated at the top of the income distribution, and that IRA contributors had large stocks of financial assets compared to noncontributors with the same income. Both of these facts suggest that IRA contributors had assets and desired saving above the contribution limit.

Economists who believe that IRAs did not increase saving point to the fact that personal savings in the United States was not higher during the years that deductible IRAs were available to all taxpayers.[35]

A number of economists argue that IRA contributions between 1982 and 1986 consisted largely of new saving.[36] Some of these economists have investigated whether IRA contributors shifted existing assets from taxable accounts into IRAs. If such shifting had occurred, they argue, one would expect to find a reduction in taxable asset earnings following the IRA contribution. However, one study found that taxpayers who contributed to IRAs generally were also increasing their investment in taxable assets.[37] Although this does not prove that the money invested in IRAs would not have been saved otherwise, it may provide evidence against the simple existing asset shifting view.

Further, proponents of IRAs note that to the extent that taxpayers do shift existing assets into IRAs, most taxpayers do not have enough financial assets to continue asset shifting indefinitely. Hence, they conclude, IRAs would eventually provide a marginal incentive to save.[38]

Some economists have noted that the introduction in Canada of savings incentives similar to the IRA was followed by large increases in Canadian saving. They argue that this can be taken as evidence that IRAs are effective in increasing national saving.[39]

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[34] See, for example, Galper, Harvey and Charles Byce, "Individual Retirement Accounts: Facts and Issue," *Tax Notes*, vol. 31, June 2, 1986, pp. 917-921.

[35] See Gravelle, Jane "Do Individual Retirement Accounts Increase Savings?".

[36] See, Venti, Steven F. and David A. Wise, "The Evidence on IRAs," *Tax Notes*, vol. 38, January 25, 1988, pp. 411-416. Venti and Wise have authored several studies that use different data to analyze IRAs and household saving. They generally conclude that IRAs increase household saving. The aforementioned article summarizes these studies. Some analysts have criticized the methodology of studies which claim IRAs create new saving and argue that the reported results of the effect of IRAs on saving are implausibly large. See Gravelle, Jane G., "Capital Gains Taxes, IRA's, and Savings," CRS Report for Congress 89-543, September 26, 1989. A recent critique is provided by Gale, William G. and John Karl Scholz, "IRAs and Household Saving," *American Economic Review*, 84, December 1994.

[37] See, for example, Feenberg, Daniel, and Jonathan Skinner, "Sources of IRA Saving." Also, Venti, Steven F. and David A. Wise, "Government Policy and Personal Retirement Saving," in James Poterba (ed.). *Tax Policy and the Economy*, vol. 6, (Cambridge; Massachusetts Institute of Technology Press), 1992.

[38] See Skinner, Jonathan, "Do IRAs Promote Saving? A Review of the Evidence", *Tax Notes*, vol. 54, January 13, 1992, pp. 201-202.

[39] See, Carroll, Chris, and Lawrence H. Summers, "Why Have Private Saving Rates in the U.S and Canada Diverged?" *Journal of Monetary Economics*, 20, September 1987.

However, others note that since Canadians are not able to deduct home mortgage interest from taxable income, they should be less likely to finance tax-favored savings with home borrowing, and therefore savings incentives in Canada may be more likely to induce increased saving than in the United States.

3. Distributional effects of IRAs under present and prior law

Tables 4 and 5 summarize information on IRA participation in 1985 and 1992. In 1985, 71 percent of all returns reporting IRA contributions had AGI below $50,000, and 29 percent had AGI of $50,000 or above. However, taxpayers with AGI of $50,000 or above represented only 8 percent of all returns eligible for IRAs. Thus, although many lower-income individuals contributed to IRAs, most did not, whereas most taxpayers with AGI of $50,000 or above did contribute when eligible. Taxpayers with AGI of $50,000 or above were more than four times as likely to contribute to an IRA than were taxpayers with AGI below $50,000--61.8 percent of eligible returns with AGI of $50,000 or above reported contributions to an IRA, while only 13.8 percent of eligible returns with AGI below $50,000 reported contributions.

Higher-income taxpayers made larger contributions as well. Taxpayers with adjusted gross incomes of $50,000 or more constituted approximately 29 percent of all IRA contributors in 1985, but accounted for more than 35 percent of IRA contributions. In 1992, taxpayers with adjusted gross incomes of $50,000 or more constituted approximately 20 percent of all IRA contributors, but accounted for almost 29 percent of IRA contributions.

Because the value of the IRA is the effective exemption of the earnings from tax, the higher a taxpayer's marginal tax rate, the more valuable the ability to invest through an IRA. Because people in higher income classes generally have higher tax rates, the value of their IRA is larger than the value of IRAs for taxpayers in lower income classes. However, the value of the IRA depends on tax rates throughout the period the IRA is held, and not just the marginal tax rate in the year the contribution is made.

Table 4.-- IRA Participation By Income Class, 1985

Adjusted gross income class	Returns reporting IRA Contributions		
	Number in millions	Percent of eligible returns[1]	Contributions (billions of dollars)
All classes	16.2	17.8	38.2
Under $10,000	0.6	2.3	1.1
$10,000 to $ 30,000	5.1	13.6	9.7
$30,000 to $ 50,000	5.7	32.9	13.5
$50,000 to $ 75,000	3.0	56.5	8.7
$75,000 to $100,000	0.9	74.1	2.7
Over $100,000	0.8	76.1	2.6

Source: Internal Revenue Service, 1985 Statistics of Income.

[1] eligible taxpayers include self-employed persons as well as wage and salary employees. However, taxpayers whose income consists solely of interest income, for example, were ineligible to contribute to IRAs.

Table 5.—IRA Participation By Income Class, 1992

Adjusted gross income class	Returns reporting IRA Contributions		
	Number in millions	Percent of returns with wage and salary income[1]	Contributions (billions of dollars)
All classes	4.5	4.7	8.7
Under $10,000	0.3	1.1	0.4
$10,000 to $ 30,000	1.8	5.1	3.1
$30,000 to $ 50,000	1.5	7.6	2.7
$50,000 to $ 75,000	0.4	4.0	1.0
$75,000 to $100,000	0.2	5.6	0.6
Over $100,000	0.3	8.8	0.9

[1] Includes self-employed persons reporting wage income as well as wage and salary employees. However, because the income limitations enacted by the Tax Reform Act of 1986, not all such taxpayers are eligible to make deductible contributions to IRAs.

Source: Internal Revenue Service, 1992 Statistics of Income.

Other authors have noted that even the taxpayers with low income who did contribute to IRAs owned more financial assets than other low-income taxpayers and that, therefore, IRA contributors may not be representative of taxpayers in general. Table 6 presents information on the assets of households with IRAs compared to the assets of households without IRAs. Part of the reason that IRA contributors have larger holdings of assets than noncontributors is that contributors to IRAs tend to be older than noncontributors, and older taxpayers have been accumulating assets longer.

Table 6. — Estimated Median Financial Assets of Households with IRAs and Households Without IRAs, 1985

Income	Households with IRAs	Households without IRAs
Less than $10,000	$ 7,625	$ 0
$10,000 to $20,000	6,538	200
$20,000 to $30,000	6,365	900
$30,000 to $40,000	6,015	1,692
$40,000 to $50,000	10,000	2,694
$50,000 to $75,000	14,516	5,100
$75,000 and over	36,085	9,735

Source: Steven Venti and David Wise, "The Saving Effect of Tax-Deferred Retirement Accounts: Evidence from SIPP," in B. Douglas Bernheim and John Shoven (eds.), National Saving and Economic Performance, (Chicago: University of Chicago Press), 1991, p. 110.

4. Expected differences between effects of pre-1986 IRAs and proposed modificatoins

Although research on the effectiveness of the pre-1986 IRA provisions can shed light on the potential of IRAs to affect savings, several differences between the pre-1986 experience and today should be noted. First, marginal tax rates for most taxpayers are lower now than they were before the passage of the Tax Reform Act of 1986. The tax advantage of IRAs is the exemption from tax of the investment's return and, for the deductible IRA, the possibility that the rate at which the contribution is taxed will be lower when the contribution is withdrawn. Both of these advantages may be less valuable now than they were before 1987, especially for higher income taxpayers because their marginal tax rates decreased the most. For example, if prior to 1987, a taxpayer in the 50-percent marginal tax bracket received a 10-percent return on his or her investment, excluding such income from tax would increase his or her net return to 10 percent from an after-tax return of 5 percent. At the present, such a taxpayer would be in the 39.6-percent marginal tax bracket and the exemption would increase his or her net return to 10 percent from an after-tax return of 6.04 percent. Thus, the exemption provided a greater increase in net return prior to 1987. Similarly, if taxpayers believe that tax rates are likely to increase over time because of the Federal government's budget deficit, or because current tax rates are relatively low from a historical perspective, then the deductible IRA will look less attractive than it appeared in the past.

Second, some proposals to modify IRAs would create IRAs that are different from the pre-1986 IRAs, both because they provide additional exceptions to the early withdrawal penalty, or by requiring a relatively short required holding period. These differences may alter the effectiveness of IRAs at increasing saving. To the extent that taxpayers already save for education, housing, and medical expenses, allowing IRAs to be used for these purposes increases the likelihood that existing assets or existing planned saving will be shifted into IRAs, reducing the effectiveness of IRAs at increasing savings. Similarly, to the extent that taxpayers already save for short-term goals and for rainy days, reducing required holding periods may also encourage more asset shifting. Further, permitting short holding periods and penalty-free early withdrawal may cause taxpayers to keep their money in the IRAs a shorter period of time.[40] On the other hand, to the extent that taxpayers who would otherwise choose to save in the form of IRAs would not do so because they believe they might need the funds before retirement, this added flexibility may encourage more taxpayers to invest in IRAs and increase their saving rate. Finally, permitting penalty-free withdrawals before retirement age diminishes the effectiveness of IRAs as explicit retirement savings vehicles, but may not change the overall effectiveness of IRAs to increase saving.

The ability of individuals to save through employer-sponsored retirement plans, particularly qualified cash or deferred arrangements (sec. 401(k) plans) may affect the level of IRA contributions.

[40] Although once funds are withdrawn from an IRA, they can only be replaced at a rate no faster than the annual contribution limit per year.

While such plans existed prior to 1986, they have become more prevalent since then. Section 401(k) plans offer benefits similar to those of IRAs. However, individuals may contribute more to such plans on a pre-tax basis ($9,240 for 1995), and may obtain increased benefits if, as is often the case, the employer matches employee contributions. Despite these advantages, some may still view an IRA as attractive, for example, because IRA funds may be withdrawn at any time (subject to the early withdrawal tax), whereas the ability to obtain withdrawals from section 401(k) plans prior to termination of employment is more limited. On the other hand, many section 401(k) plans permit individuals to borrow from their account, making investments in such plans more liquid.

The ability to contribute both to a section 401(k) (or similar) plan and an IRA could affect IRA contributions in a number of ways. For example, some individuals would save only through a section 401(k) plan, others would chose the IRA, and still others would split savings between a section 401(k) plan and an IRA. A number of factors may affect such choices, including the amount the individual wishes to save, the period and purpose for which they wish to save, and the particular terms of the section 401(k) plan they are eligible to participate in.

V. ISSUES RELATING TO TAX INCENTIVES FOR SAVING

A. Comparison of IRAs With Other Tax-Favored Assets

Present law contains various tax incentives for savings. Tax incentives are provided to encourage taxpayers to save for certain purposes and to encourage taxpayers to save in certain forms. Saving for the purpose of education and retirement is subsidized through the tax treatment of certain Treasury bonds and of certain retirement plans. Incentives are also provided for people to save in the form of housing, life insurance, and municipal bonds.

Tax-favored treatment of assets does not always increase the rate of return on saving. If the supply of a tax-favored asset is limited relative to the demand for that asset, much of the benefit of the tax treatment will be realized by the initial owners of the asset, rather than by the holders of the asset. For instance, holders of municipal bonds may not receive a higher after-tax rate of return than holders of taxable bonds because, even though the earnings are tax exempt, municipal bonds offer lower rates of return. The issuers of municipal bonds receive a tax benefit because they can pay lower interest rates than the rates paid on other securities.

The tax benefits of IRAs and pension funds, however, are not limited to particular assets. Because investors in IRAs and pension funds can invest in a wide range of assets, and because the amount of funds permitted to be invested through these tax-favored vehicles is limited (the demand is small relative to the supply of assets), investors in IRAs and pension funds do receive a higher rate of return than that available through other investments, and thus do benefit from the tax favored treatment.

Enactment of additional saving incentives would be expected to alter taxpayers' choices among various taxable and tax-preferred assets. Because the income earned on assets held in IRAs effectively is exempt from tax, the taxpayer maximizes the benefit of the tax preference by directing the investment of IRA contributions in assets which are not otherwise tax preferred. The benefits of tax preferences for assets that are tax preferred to one degree or another are maximized when such assets are held outside an IRA.

The expansion of IRAs could be expected to increase the demand for otherwise taxable instruments at the expense of instruments which are tax preferred under present law. On the other hand, the annual contribution limitation of the IRA would limit the effect on the demand for other tax-preferred instruments. Moreover, to the extent that savings incentives generate increases in saving, the demand for all instruments would increase. If this were to occur, the issuers of instruments which are tax-preferred under present law conceivably could benefit as the cost of capital declined.

B. Goals of Tax Incentives for Saving

Some argue that tax incentives for saving are appropriate because the income tax system taxes the return to income that is saved, thereby lowering the return to saving. This lower return on saving affects both the national saving rate, as well as the assets that taxpayers accumulate for particular purposes. There is some disagreement about whether the goal of tax incentives for saving should be to encourage saving for particular purposes or to increase national saving.[41] These purposes are not mutually exclusive; if effective, incentives to save for particular purposes will increase national saving. However, general saving incentives will not necessarily fulfill more specific goals. Whether new tax incentives for saving should be aimed at increasing national saving in general, or increasing retirement saving, depends on the perceived adequacy of each type of saving.

In particular, IRAs have historically been viewed as vehicles for retirement savings. When IRAs were introduced in 1974, they were provided only to individuals without employer-provided pension plans. The original intention of the IRA was explicitly to encourage individuals not participating in an employer-sponsored plan to increase their retirement savings and to provide a higher return on such savings. Even with the liberalization of eligibility requirements for IRAs in the Economic Recovery Tax Act of 1981, IRAs still have been largely devoted to retirement saving. Withdrawals of IRA funds before age 59-1/2 generally are still subject to an additional 10-percent tax.

However, IRAs can provide substantial benefits to taxpayers who are saving for nonretirement purposes. For example, consider a taxpayer with a 28-percent marginal tax rate who has $1,000 of earnings to devote to saving. Without an IRA, the taxpayer would pay a tax of $280, leaving $720 to be invested. If this amount earns 8 percent annually and the earnings are taxed annually at a 28-percent marginal tax rate, the taxpayer will have $1,261 at the end of 10 years. If, however, the taxpayer can deduct the $1,000 and accumulate 8-percent annual interest tax free, the investment will be worth $2,159 at the end of 10 years. After including the distribution in income, subject to the additional 10-percent tax on early withdrawals, the taxpayer will have $1,339, or $78 more than the taxpayer has if a taxable investment is made.

Similarly, the present-law exceptions to the early withdrawal tax may permit taxpayers to use deductible IRAs for nonretirement saving. Under present law, a taxpayer may make penalty-free withdrawals from an IRA prior to attaining the age of 59-1/2 if the distributions are made over certain periods. For example, a taxpayer could purchase an annuity which promises level payments for the remainder of the taxpayer's life. This exception may offer many taxpayers a way to receive a substantial percentage of the tax-favored funds prior to age 59-1/2 and avoid the 10-percent penalty. At age 50, the average American male has a life expectancy of ap-

[41] Part V. C, below discusses [redacted]portance of national saving. Part V. D, below, discusses the adequacy of retirement savin[redacted]

proximately 26 years.[42] At a 10-percent discount rate, an annuity which pays $1,000 per year for 26 years has a present value of approximately $9,160. The present value of the payments received during the first 10 years of such annuity is approximately $6,145, or 67 percent of the total value of the annuity. Consequently, if the taxpayer withdrew the $9,160 from his IRA to purchase the $1,000 annuity, he would receive 67 percent of the total value of the annuity prior to age 60.[43]

C. Role of Saving in the National Economy

Investment and economic growth

When an economy's rate of investment increases, the economy's stock of capital increases. A larger, capital stock permits greater production of goods and services. Because the larger a country's capital stock, the more productive its workers, investment also leads to higher wages and salaries. Thus, increases in investment lead to future increases in a nation's standard of living.

It is important to distinguish gross investment from net investment. Gross investment includes investment in new capital as well as investment that is undertaken to replace depreciated or worn out capital. Net investment measures increases to the capital stock. (Net investment is equal to gross investment less depreciation).

In the short run, increases in gross investment will increase the capital stock. As the capital stock increases, worker productivity increases and the economy will experience a higher rate of growth. In the long run, any given rate of investment will just be sufficient to replace the existing, though larger, capital stock as it depreciates. Thus, in the long run, an increase in the level of investment increases a nation's standard of living, but may not increase a country's long run rate of growth.

It is possible that a higher investment level can lead to a higher growth rate even in the long run. Even if there is no growth in net investment, investment to replace depreciated capital may still enhance economic growth to the extent that the replacement capital embodies improved (and more efficient) equipment and technologies. The higher the gross investment rate, the more new capital is purchased each year, and thus the rate at which new technologies get adopted may be higher.

Sources of investment funds

Investment involves a trade-off between consumption today and consumption tomorrow. Investment can either be financed by national saving, or by foreign borrowing (saving by foreigners). A basic accounting identity of the national income and product accounts states that:[44]

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[42] Bureau of the Census, U.S. Department of Commerce, *Statistical Abstract of the United States, 1990*, p. 73.

[43] If an 8-percent discount rate were used, the percentage recovered in the first 10 years would be approximately 62 percent.

If such an annuity were purchased by a 40-year old male (life expectancy an additional 35 years), he would receive approximately 64 percent of the present value of the annuity (discounting at 10 percent) in the first 10 years and 88 percent by age 60.

[44] The national income and product accounts measure the flow of goods and services (product) and income in the economy. The gross national product (GNP) of the economy is the total annual

Continued

INVESTMENT =

PRIVATE SAVING + GOVERNMENT SAVING

+ NET FOREIGN BORROWING.

Many analysts in the past ignored the foreign sector, primarily because at the time it was small relative to the U.S. economy. These analysts interpreted this basic relationship as saying that national investment must equal national saving, where national saving is the sum of private saving and public saving.

However, national investment need not equal national saving if foreigners can invest in the United States. The experience of the 1980s, when investment in the United States greatly exceeded national savings, demonstrates how important this source of funds can be. When demand for investment funds in the United States outstrips the supply of national savings, interest rates rise in response. Increases in interest rates attract foreign capital to the United States, and the excess of investment over national saving is financed by foreigners' saving.

Foreign investment in the United States is also related to the value of the dollar and the trade deficit. To take advantage of high interest rates in the United States, foreign investors first must convert their currencies to dollars. This increases demand for the dollar, thereby increasing the dollar's exchange rate relative to the foreign currency. A stronger dollar makes imported goods relatively cheaper and our exports relatively more expensive. As a consequence, net exports fall and the trade deficit increases. A further accounting identity states that[45]

NET FOREIGN BORROWING = (IMPORTS-EXPORTS)

When net foreign borrowing increases, the trade deficit (the difference between imports and exports of goods and services) also increases. Thus, many people have blamed the trade deficits of the 1980s on the low national savings rate during that period.[46]

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value of goods and services produced by the economy and may be measured in several ways. One way is to measure GNP by expenditure on final product in the economy. By this measure,

(1) GNP = C + I + G + (X-M).

Equation (1) is an accounting identity which states that gross national product equals the sum of consumption expenditures (C), investment expenditures on plant, equipment, inventory, and residential construction (I), governmental purchases of goods and services (G), and net exports (exports less imports of goods and services or X-M).

An alternative is to measure GNP by the manner in which income created in the economy is disposed of. By this measure,

(2) GNP = C + S + T.

Equation (2) is another accounting identity which states that gross national product equals the sum of consumption expenditures, saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less domestic transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity,

(3) I = S + (T-G) + (M-X)

This is the basis for the statement that national investment equals private saving (S), plus public saving (T-G), and net imports (M-X).

[45] This ignores the relatively small amount of unilateral transfers to foreigners. For a more detailed discussion of foreign trade and domestic saving and investment, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

[46] For instance, see Hatsopoulos, Krugman, and Summers, "U.S. Competitiveness: Beyond the Trade Deficit", *Science*, 15 July 1988, Volume 241, pp. 299-307.

Is the United States' saving rate too low?

Consequences of a low saving rate

The consequences of a low saving rate depend on the mobility of international capital. If capital is not mobile, then, as discussed above, investment is equal to national savings. When the saving rate is low, so is the investment rate. Historically, there has been a strong relationship between a country's rate of investment and its rate of saving.[47] Although this relationship has become weaker over time,[48] it is still true that countries with high saving rates also generally have high investment rates.

If capital is mobile (that is, if foreigners can invest in the United States at low cost and without a lot of added risk), then investment will not decline as much when the saving rate falls. Instead, investment will be financed by foreigners, either by direct foreign investment in the United States or by foreign lending to American investors. When domestic saving rates are low, foreign financing of domestic investment results in a higher rate of investment than would be possible if investment were financed by domestic saving. Foreign investment in the United States does increase the productivity of American workers. However, the profits generated by foreign investment flow abroad, since the United States has to pay interest on the funds it borrows. Furthermore, eventually the debt will have to be repaid, so the net wealth that is left to future generations of Americans is smaller than it would be if the investment were financed by domestic saving.

Trends in national saving and investment

National saving is generally divided into private saving and public saving. Private saving is comprised of household or personal saving and business saving. Households save by not spending all of their disposable income (i.e., after-tax income). Businesses save by retaining some of their earnings. Public saving reflects the extent to which the Federal, State, and local governments run budget surpluses or deficits. Table 7 presents data on the components of net national saving in the United States.

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[47] See, for instance, Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *Economic Journal*, vol. 90 (June 1980) pp. 314-29.

[48] See Phillippe Bacchetta and Martin Feldstein, "National Saving and International Investment", National Bureau of Economic Research Working Paper #3164, November 1989.

Table 7.—Components of Net National Saving, Selected Years, 1929-1992
[In billions of dollars]

Year	Private saving			Public saving			Total net national saving
	Net personal saving	Net business saving	Total net private saving	Federal surplus or deficit (-)	State and local surplus or deficit (-)	Total public saving	
1929	2.6	2.4	5.0	1.2	-0.2	1.0	6.0
1939	1.8	0.3	2.1	-2.2	0.0	-2.2	-0.1
1949	7.4	10.5	17.9	-2.6	-.7	-3.4	14.5
1954	16.4	9.8	26.2	-6.0	-1.1	-7.1	19.1
1959	22.0	15.9	37.9	-2.6	-0.5	-3.1	34.8
1964	31.6	26.1	57.7	-2.6	1.0	-1.6	56.1
1969	43.3	24.7	68.0	8.5	1.5	10.0	78.0
1974	93.4	22.4	115.8	-11.6	7.1	-4.5	111.3
1975	100.3	40.8	141.1	-69.4	4.6	-64.8	76.3
1976	93.0	47.2	140.2	-52.9	14.6	-38.3	101.9
1977	87.9	61.9	149.8	-42.4	25.6	-16.8	133.0
1978	107.8	70.2	178.0	-28.1	31.1	2.9	180.9
1979	123.3	62.1	185.4	-15.7	25.1	9.4	194.8
1980	153.8	33.8	187.6	-60.1	24.8	-35.3	152.3
1981	191.8	31.7	223.5	-58.8	28.5	-30.3	193.2
1982	199.5	18.4	217.9	-135.5	26.9	-108.6	109.3
1983	168.7	54.3	223.0	-180.1	40.3	-139.8	83.2
1984	222.0	87.5	309.5	-166.9	58.1	-108.8	200.7
1985	189.3	91.9	281.2	-181.4	56.1	-125.3	155.9
1986	187.5	55.3	242.8	-201.0	54.3	-146.8	96.0
1987	142.0	86.5	228.5	-151.8	40.1	-111.7	116.8
1988	155.7	112.6	268.3	-136.6	38.4	-98.3	170.0
1989	152.1	86.9	239.0	-122.3	44.8	-77.5	161.5
1990	170.0	88.5	258.5	-163.5	25.1	-138.4	123.1
1991	201.5	102.3	303.8	-203.4	7.3	-196.2	107.6
1992	238.7	90.4	329.1	-276.3	7.2	-269.1	60.1

Source: Department of Commerce, Bureau of Economic Analysis.

Table 8 presents net saving by component as a percentage of gross domestic product (GDP). As the table demonstrates, net business saving,[49] net private saving, and public saving were all lower during the 1980s then in any of the three previous decades. Net national saving declined through most of the 1980s.

[49] Tables 7 and 8 present net saving, which equals gross saving less capital consumption (depreciation).

Table 8.—Components of Net National Savings as a Percentage of GDP, Selected Years, 1929-92

Year	Net personal saving	Net business saving	Total net private saving	public saving	Total national saving
1929	2.5	2.3	4.8	1.0	5.8
1939	2.0	0.3	2.3	-2.4	-0.1
1949	2.8	4.0	6.9	-1.3	5.6
1954	4.4	2.6	7.0	-1.9	5.1
1959	4.5	3.2	7.7	-0.6	7.0
1964	4.9	4.0	8.9	-0.2	8.7
1969	4.5	2.6	7.1	1.0	8.1
1974	6.4	1.5	7.9	-0.3	7.6
1975	6.3	2.6	8.9	-4.1	4.8
1976	5.3	2.7	7.9	-2.2	5.8
1977	4.5	3.1	7.6	-0.9	6.7
1978	4.8	3.1	8.0	0.1	8.1
1979	5.0	2.5	7.4	0.4	7.8
1980	5.7	1.2	6.9	-1.3	5.6
1981	6.3	1.0	7.4	-1.0	6.4
1982	6.3	0.6	6.9	-3.4	3.5
1983	5.0	1.6	6.5	-4.1	2.4
1984	5.9	2.3	8.2	-2.9	5.3
1985	4.7	2.3	7.0	-3.1	3.9
1986	4.4	1.3	5.7	-3.4	2.2
1987	3.1	1.9	5.0	-2.5	2.6
1988	3.2	2.3	5.5	-2.0	3.5
1989	2.9	1.7	4.6	-1.5	3.1
1990	3.1	1.6	4.7	-2.5	2.2
1991	3.5	1.8	5.3	-3.4	1.9
1992	4.0	1.5	5.5	-4.5	1.0
Average 1950-59	4.7	2.8	7.5	-0.1	7.4
Average 1960-69	4.7	3.6	8.3	-0.1	8.1
Average 1970-79	5.5	2.6	8.1	-1.0	7.2
Average 1980-89	4.8	1.6	5.9	-2.5	3.9
Average 1990-92	3.5	1.6	5.2	-3.5	1.7

Source: Department of Commerce, Bureau of Economic Analysis.

Some analysts suggest that because households save out of their disposable income (i.e., after-tax income), it is more appropriate to examine personal saving relative to disposable income than to examine personal saving relative to GDP. Table 9 presents personal saving as a percentage of disposable income. Generally, the same trends observed in Table 8 are evident in Table 9.

Table 9.--Personal Saving as a Percentage of Disposable Personal Income, Selected Years, 1929-90

Year	Personal saving as a percentage of disposable personal income
1929	3.2
1939	2.6
1944	25.1
1949	3.9
1954	6.3
1959	6.3
1964	6.9
1969	6.5
1974	8.9
1975	8.7
1976	7.4
1977	6.3
1978	6.9
1979	7.0
1980	7.9
1981	8.8
1982	8.6
1983	6.8
1984	8.0
1985	6.4
1986	6.0
1987	4.3
1988	4.4
1989	4.0
1990	4.2
1991	4.8
1992	5.3
1993[1]	4.0

[1] Estimate.

Source: Department of Commerce, Bureau of Economic Analysis.

Prior to 1980, domestic saving generally financed domestic investment as well as providing funds for Americans to be net investors abroad (negative net foreign investment). During the 1980s, net savings fell short of domestic investment as a share of GDP. Domestic investment declined from its 1984 peak and net foreign investment provided for the difference in domestic savings and investment. Thus, although the decline in saving was coincident with a decline in investment, this decline was not as severe as it might have been had there not been foreign investment.

Comparison between the saving rates of the U.S. and other countries

The United States' national saving rate is low when compared to that of other nations. This comparison is shown in Table 10 for total national saving and in Table 11 for household or personal saving. As Table 10 indicates, the net saving rate of the United States during the 1980s was below the saving rates of most countries in the OECD.[50]

[50] The data on international saving rates in Tables 10 and 11 are not directly comparable to the data in Tables 8 and 9 because such data are not always compiled consistently across nations. For example, in computing household saving rates, the OECD subtracts household interest expense from income to determine U.S. household disposable income. The Bureau of Economic Analysis does not make a similar adjustment in defining household disposable income. Also, while the source of the international comparisons draws on data from the OECD, which attempts to provide data on an internationally comparable basis, the data are not fully comparable. For example, in computing household saving rates, the definition of the household sector is not identical acrossall countries. In particular, except in Japan, France, and Italy, private nonprofit institutions are included in the household sector. See, Andrew Dean, Martine Durand, John Fallon, and PeterHoeller, "Saving Trends and Behaviour in OECD Countries," OECD, Economics and Statistics Department Working Paper, No. 67, June 1989.

Table 10.—Net National Saving as a Percentage of GDP in Selected Countries Selected Years, 1962-1989

Country	1962	1967	1972	1975	1978	1981	1982	1983	1984	1985	1986	1987	1988	1989
United States	9.1	9.7	8.8	6.0	8.9	6.4	2.7	2.2	4.4	3.3	2.2	2.1	3.1	3.2
Japan	21.7	22.2	24.4	19.4	20.0	17.9	17.0	16.1	17.0	18.0	18.0	18.3	19.2	20.0
Germany	18.6	15.0	16.0	9.6	11.4	8.0	7.7	8.5	9.2	9.6	11.6	11.3	12.4	14.1
France	17.3	18.4	17.6	13.2	13.0	8.5	7.2	6.4	6.3	6.4	7.6	7.3	8.2	8.8
United Kingdom	8.6	9.4	9.1	3.5	6.9	4.3	4.6	5.3	5.1	5.8	4.4	4.3	4.7	4.5
Italy	19.7	16.3	15.0	10.9	14.1	10.2	9.3	9.5	10.0	9.2	9.1	8.5	8.8	8.5
Canada	8.6	10.8	11.2	11.2	10.0	11.1	7.5	7.1	8.7	7.8	6.0	7.2	8.9	8.6
Belgium	12.1	14.5	15.8	12.4	11.1	4.8	4.4	5.0	6.2	5.6	7.6	8.1	10.0	11.7
Greece	14.3	14.7	22.0	16.3	18.6	16.1	8.3	8.0	6.7	4.4	4.8	4.9	8.0	5.7
Netherlands	17.4	17.9	18.3	14.0	12.0	10.4	10.8	11.2	12.9	13.6	12.7	10.5	12.4	13.4
Sweden	13.6	13.6	12.8	12.7	6.0	3.6	1.9	3.8	5.9	5.7	6.2	6.4	6.8	7.3
Switzerland	18.5	19.5	20.5	17.0	16.2	17.8	17.7	17.7	18.7	19.5	21.1	21.6	22.5	23.3
Australia	10.6	9.5	13.4	8.5	6.6	4.2	0.7	3.0	3.4	2.3	2.4	4.7	7.4	6.3

Source: National Accounts, 1960-1989, volume 1, 1991.

Table 11.--Net Household Saving as a Percentage of Disposable Household Income, Selected Years, 1972-1994

Country	1972	1976	1980	1984	1988	1989	1990	1991	1992	1993	1994[1]	Average 1984-1993
United States	7.5	7.6	8.1	8.3	4.5	4.1	4.3	4.9	5.0	4.6	4.3	5.3
Japan	18.2	23.2	17.9	15.8	14.3	14.6	14.1	15.1	14.3	14.6	14.8	14.9
Germany	14.4	13.3	12.8	11.4	12.8	12.4	13.9	12.8	12.9	12.1	11.3	12.5
Canada	8.7	11.8	13.6	15.0	9.7	10.4	9.9	10.3	10.8	10.6	10.4	11.0
Australia	11.8	11.1	10.1	9.3	6.5	7.1	8.0	6.5	5.4	4.2	3.6	6.8

NOTE: [1] - estimate

Source: Organization for Economic Co-Operation and Development, OECD Economic Outlook, 55, June 1994.

Generally, saving rates of all nations have declined from the rates of the late 1960s. In percentage terms, the decline in the national saving rate of the United States between 1967 and 1989 update is greater than the decline of the saving rates of Japan and Germany, but comparable to the decline of the saving rates of France and Italy.

Although many people have pointed to the low saving rate in the United States as a cause of declining productivity, others argue that the United States has long been a relatively low-saving nation, and yet has enjoyed substantial economic growth. They note that many of the nations with higher saving rates were nations which needed to rebuild after the destruction of war on their own territory.

Furthermore, some argue that the low saving rate in the United States may be a product of demographics, and that the saving rate will increase as the baby boomers enter their forties and fifties, typically the years during which people do much of their retirement saving. However, others note that in the past, demographic changes have not been very successful at predicting saving rates.

In general, the decline in private saving rates is not well understood. It is likely that demographic changes, capital market liberalization, increased insurance availability, and increased social security benefits have all contributed to the decline. However, these factors have not proved significant enough to account for the total decline in the saving rate. Similarly, there is no convincing explanation for why saving rates have declined in other nations as well.

D. The Adequacy of Retirement Savings

1. Economic status of the elderly

Sources of retirement income

Social security is the largest source of retirement income (38 percent in 1986), followed by income from assets (26 percent in 1986), earnings (17 percent in 1986), and private and government employee pensions (14 percent in 1986).[51] Many researchers have attempted to measure whether people have adequate savings for retirement. A common measure of retirement savings adequacy is called the replacement rate, which is defined as the ratio of retirement income over income during the working years.

The issue of what replacement rate should be called adequate depends on a number of factors. A replacement rate of 100 percent means that the person's income during retirement is equal to their income during working years. There are a number of reasons that a replacement rate of 100 percent may not be optimal. First, people may desire to have more income during the working years because some of that income is saved for retirement. If people choose to have constant consumption over time, they save during their working years and dissave during retirement. Second, most elderly own their own homes (75 percent of households in 1987[52]), and most of these (83 percent in 1987[53]) have paid off their mortgages.

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[51] *EBRI Data Book on Employee Benefits, 1990, p. 73.*
[52] *Statistical Abstract of The United States 1990,* Table 1277, p. 722.
[53] *Statistical Abstract of The United States 1990,* Table 1278, page 722.

Thus, most elderly receive housing without incurring any expenses beyond maintenance and utilities, whereas during their working years, they were likely to have been making mortgage payments. Third, few elderly households care for children, and therefore household expenses are likely to be lower. Fourth, the elderly are generally covered by Medicare, which provides insurance against large medical expenses and pays for most expenditures on health. Fifth, social security benefits, which represent the major source of retirement income, are largely untaxed.[54] Thus, social security benefits can be smaller than income earned during the working years and still provide the same after-tax income. For the lowest income groups, this effect is not large since earned income is subject to the payroll tax, but probably not subject to the income tax.

These arguments suggest that the appropriate replacement rate for the elderly to have adequate retirement savings is less than 100 percent. However, there may be some factors which dictate that the replacement rate should be higher than 100 percent. First, although the elderly are covered by Medicare, they are also more likely to incur large medical expenses which may not be completely covered by medicare. Similarly, Medicare generally does not cover nursing home care or the costs of care in other long-term care facilities, and only those elderly poor enough to receive Medicaid or eligible through veterans' assistance are covered.

Replacement rates for social security and pension income for retired workers are calculated using two methods. The first method calculates the ratio of social security and pension benefits relative to a worker's highest career earnings.[55] The second method calculates benefits relative to the average earnings in the 5 years preceding retirement.[56] It seems likely that the career high earnings overstate average earnings, and earnings during the 5 years preceding retirement understate average earnings. Thus, these two replacement rates may be seen as upper and lower bounds of estimates of the replacement of average career earnings. These replacement rates measure the replacement of income through retirement benefits, and do not include any income earned during retirement or any income from savings. Such calculations indicate that social security and pension benefits replace roughly 33 percent of the career high earnings and 50 percent of earnings over the last 5 years for individuals. When spousal benefits are taken into account, replacement rates are slightly higher, averaging 30 to 33 percent of highest earnings but 60 to 70 percent of last earnings. Such calcualtions also demonstrate that replacement rates are highest for the poor. For the lowest income quartile, individual replacement rates varied between 34 and 39 percent of highest earnings, and 72 to 94 percent of last earnings. [57]

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[54] Social security benefit recipients with modified AGI exceeding certain limits have to include up to 50 percent of their benefits in income. In 1990, 21% of all elderly included some portion of social security benefits in taxable income.

[55] Earnings are indexed by the rate of wage growth. Highest career earnings are defined as the average of the highest 5 years of earnings.

[56] This measure is calculated only for those individuals who worked a significant amount during the 5 years preceding retirement.

[57] Susan Grad, "Earnings Replacement Rates of New Retired Workers," *Social Security Bulletin 53, October 1990.*

Finally, social security benefits have increased over time. Social security benefits relative to the income of the elderly have increased substantially over the past forty years.

Poverty

Another method used to examine the economic status of the elderly is to compare their rates of poverty to those of the general population. Poverty among the elderly has declined dramatically over the last 30 years, from over 35 percent in 1959 to 12 percent in 1988. By 1988, the poverty rate of the elderly was less than the poverty rate of the general population. The poverty rate of elderly persons living in families (with a spouse or children) was 6.2 percent, lower than for any other group. The major explanation for this decline in poverty is the increase in social security benefits and coverage described above.

2. Expected retirement income and needs of current workers

The above discussion demonstrates that, as a group, the elderly are as well off as the rest of society, indicating that given social security and pension benefits, savings were adequate. However, to determine whether the savings of current workers are enough to provide adequate retirement income, it is necessary to examine how this group might differ from current retirees.

Social security and employer-provided pension plan coverage

Because social security coverage of workers has increased over time,[58] and because the labor force participation of women has also been increasing, current workers are more likely to be covered by social security than current retirees. Similarly, pension coverage of current workers is also substantially larger than of current retirees.[59]

Personal saving

Although coverage by pensions and social security is expected to be higher for current workers than it is for current retirees, the saving rate of current workers may be lower than the rate at which current retirees saved during their working lives. This would imply that although one source of retirement income, retirement benefits, is expected to be higher for current workers, another source, income from savings, may be lower.

The measure of personal saving used in the National Income and Product Accounts attributes all corporate pension contributions and earnings to the household sector. Thus, the increased pension coverage is already included in the measure of household saving. Table 8, above, shows that personal saving has been declining over the past 15 years. Private saving, which includes the saving of business, and which may provide a better measure of total households saving since businesses are ultimately owned by households, exhibits the same downward trend. Thus, the saving of the current

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[58] For a discussion of the legislative history of social security coverage, see Committee on Ways and Means, *Overview of Entitlement Programs* (WMCP 102-9), May 7, 1991, pp. 105-106.

[59] *EBRI Databook on Employer Benefits*, 1990, p. 75.

generation of workers for their retirement seems to be low relative to the past.

In a recent study, the Congressional Budget Office reported that while the saving rate of current workers appears low relative to the past, this may not imply that the level of savings is inadequate for retirement. That CBO study concludes that the so-called "baby boom" generation appears to be accumulating assets at a rate equivalent to that of their parents who are currently retired. The CBO concludes that the continued increase in real wages, the fact that baby boomers are more highly educated than their parents, and the increased participation of women in the labor force portend "increases in household incomes of baby boomers in retirement."[60] Some have criticized the conclusion of this study as too optimistic. Critiques note that finding that baby boomers have accumulated approximately the same amount of assets as had their parents at a similar age does not bode well for retirement income. Having the same amount of assets would imply only the potential for the same amount of income as experienced by current retirees, and as incomes grow this would imply future retirees would be less well off compared to the rest of society than are current retirees. Critics also note that current retirees benefited from increases in social security benefits and unexpected capital gains on housing that the baby boomers may not reasonably expect to experience.[61]

3. Increased retirement costs

Finally, it is possible that the need for retirement income is increasing over time. Increases in life expectancies and trends toward earlier retirement increase the number of years in retirement and therefore, increase the need for saving. Furthermore, the normal retirement age for social security was changed in 1983. In 1995, the normal retirement for social security (the age at which retirees receive full benefits) is 65. By 2010, normal retirement will be 67 years. If the increase in the normal retirement age means that individuals will be working more years, then current saving need not adjust. However, if the historical trend toward earlier retirement continues, then the increase in normal retirement age for receipt of full social security benefits means that individuals should increase their retirement saving.

Similarly, increased life expectancies and rapid medical cost inflation increase the probability of large medical expenses. Out-of-pocket medical expenditures for the elderly have been steadily increasing over the last 15 years. Also, many people have noted that the probability of an individual requiring long-term care some time in their lifetime has been increasing.

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[60] Congressional Budget Office, "Baby Boomers in Retirement: An Early Perspective," September 1993, p. xiv. Also see, Joyce Manchester, "Baby Boomers in Retirement: An Early Perspective," in Dallas Salisbury and Nora Super Jones (eds.), *Retirement in the 21st Century: Ready or Not?* (Washington: Employee Benefits Research Institute), 1994.

[61] B. Douglas Bernheim, "Adequacy of Savings for Retirement and the Role of Economic Literacy," in Dallas Salibury and Nora Super Jones (eds.), *Retirement in the 21st Century: Ready or Not?* (Washington: Employee Benefits Research Institute), 1994.

VI. ISSUES RELATED TO SPECIFIC PROPOSALS

A. Issues Relating to Individual Retirement Account Proposals

Recordkeeping and administrability

S. 12, H.R. 6, and the Administration proposal raise a number of issues regarding recordkeeping and administrability. First, adequate records would have to be kept to distinguish amounts held in deductible IRAs from amounts held in the new IRAs created by the proposals because the taxation of withdrawals would differ. The proposals address this issue by providing that the new IRAs must be held in separate accounts specifically designated as back-end IRAs.

It is unclear, however, whether such rules will be effective in assuring that taxpayers and the IRS are aware of which type of IRA particular funds are invested in or withdrawn from, and whether, if IRA funds are mixed, the taxpayer or the IRS will be able to identify taxable amounts accurately.

Similar recordkeeping issues arise under present law because of the availability of nondeductible IRAs. Present law requires that an individual report nondeductible contributions on his or her tax return for the year of contribution and subsequent years. The IRS has not had sufficient experience to know whether these rules have been effective in properly identifying taxable and nontaxable amounts because of the limited period during which nondeductible IRAs have been available and the limited utilization of nondeductible IRAs.

A second issue arises because the tax treatment of earnings on contributions to the new back-end IRAs would depend on how long the contributions to which the earnings relate had been in the IRA. A back-end IRA would be likely to hold contributions made in more than one year, so that it would be necessary to allocate earnings to particular contributions.

There are a number of different ways that earnings can be allocated to contributions. Thus, it will be important for the Treasury to issue prompt guidance as to which method or methods are acceptable. Even when guidance is issued, errors may occur depending on how complicated the rules are and whether individual taxpayers or the IRA trustee will be required to make the calculations.

Complexity

The proposals would provide taxpayers with additional investment and savings decisions. Some taxpayers might have difficulty (1) understanding the different requirements (such as holding periods) applicable to each vehicle and (2) obtaining sufficient information to determine the most appropriate vehicle to use when the taxpayer's individual circumstances are taken into account. Financial

institutions, which would have an incentive to market and explain the availability of the various types of IRAs, would be likely to provide some assistance to taxpayers. However, such institutions might not necessarily give advice as to which type of IRA is best for a particular taxpayer; the institution would benefit no matter which vehicle were chosen. The taxpayer also would benefit under either option, though, so choosing the less appropriate IRA may have a minimal effect on the taxpayer. The decision as to which vehicle to choose could be more difficult if the taxpayer has the option of contributing to a tax-favored retirement plan.

Under present law, some taxpayers may have difficulty determining whether or not they are eligible for an IRA deduction and, if so, the size of the deduction, because of the active participant rules and income phaseouts. S. 12 would eliminate this source of complexity because it would ultimately make deductible IRAs available to all taxpayers with compensation or earned income.

Effect on qualified retirement plans

S. 12 and the Administration proposal would also affect certain qualified retirement plans. The bill would increase the number of situations in which penalty-free withdrawals could be made from a qualified cash or deferred arrangement (sec. 401(k) plan) or tax-sheltered annuity (sec. 403(b)), making it more likely that participants would withdraw assets from such plans for purposes other than retirement. In addition, because these proposals would permit participants to withdraw amounts from these plans not only for themselves, but also for certain family members, the amounts withdrawn might not benefit the participants directly. The proposals would not limit the amount of penalty-free withdrawals that could be made in this manner. Some would argue that the increased ability to withdraw funds penalty-free from retirement plans runs counter to sound retirement policy. On the other hand, some would argue that the increased access to plan funds in emergencies might make individuals more likely to save the funds in the first place and, in fact, the funds may be left in the plan until retirement.

B. Simplified Cash or Deferred Arrangements

The special nondiscrimination requirements for cash or deferred arrangements are often cited as a source of complexity. The sources of complexity generally associated with those requirements are the recordkeeping necessary to monitor employee elections, the calculations involved in applying the tests, and the correction mechanism, i.e., what to do if the plan fails the tests. Some argue that these complexities may discourage employers from adopting such plans.

The nondiscrimination rules were adopted because Congress was concerned that the rules relating to qualified cash or deferred arrangements encouraged employers to shift too large a portion of the share of the cost of retirement savings to employees. Congress was also concerned that the nondiscrimination rules permitted significant contributions by highly compensated employees without comparable participation by rank-and-file employees, a result which some believe is inconsistent with a basic reason for extending favorable tax treatment to employer-provided pension plans.

On the other hand, it is argued that the complexity of the nondiscrimination requirements, particularly after the Tax Reform Act of 1986 changes that impose a dollar cap ($9,240 for 1995) on elective deferrals, is not justified by the marginal additional participation of rank-and-file employees that might be achieved by the operation of these requirements. Some argue that the rate of rank-and-file employee participation in cash or deferred arrangements is more directly related to the age of the employee than to the employee's compensation and that the nondiscrimination rules do not take this factor into account. They believe that the failure of young employees, who are more likely to be nonhighly compensated, to make elective deferrals should not restrict the ability of older employees to contribute to their retirement savings. Further, the definition of a highly compensated employee may include some middle-income taxpayers for whom adequate retirement savings is essential and the operation of the nondiscrimination rules may prevent such an employee from saving.

Some people believe that the nondiscrimination rules unnecessarily restrict the ability of highly compensated employees to save for retirement. The fact that the Federal Government waived the application of nondiscrimination requirements to the cash or deferred arrangement maintained for Federal employees is often cited as a justification for the repeal of the special nondiscrimination test for all employers. In addition, they argue that the result that the nondiscrimination rules is intended to produce can also be achieved by creating an incentive for employers to provide matching contributions on behalf of rank-and-file employees. Matching contributions, it is argued, create a sufficient inducement to rank-and-file employee participation.

Some practitioners have suggested that the present-law nondiscrimination tests should be eliminated or replaced with a design-based test. Under a design-based test, a plan is nondiscriminatory if it is designed in a certain way. Some people have serious tax and retirement policy concerns with a test that is not based on actual contributions and would argue that such a test permits cash or deferred arrangements to operate essentially like an individual retirement arrangement (IRA) with a much higher contribution limit. This type of IRA-equivalent arrangement is only available to employees whose employers offer such a plan. Thus, some would argue that the absence of nondiscrimination rules based on actual utilization would cause the Federal tax laws to treat similarly situated taxpayers differently.

Some believe that a test based on actual participation is the best way to prevent elective plans from disproportionately benefiting high-paid employees and the only way to ensure that low-paid employees actually benefit under the plan. It is argued that special nondiscrimination rules are necessary in the case of elective plans because higher income employees naturally are in a position to defer greater amounts of income than lower paid employees. Indeed, if an elective plan is the employee's only retirement plan, lower income employees may not be able to defer enough current income to provide sufficient retirement income. For this reason, some believe that elective retirement plans do not operate as efficiently as nonelective plans from a retirement policy perspective.

However, some argue that the adoption of a design-based nondiscrimination test for cash or deferred arrangements and matching contributions will promote expanded coverage for rank-and-file employees. The adoption of a nondiscrimination safe harbor that eliminates the testing of actual contributions to the plan removes a significant administrative burden that may act as a deterrent to employers who would not otherwise set up such a plan. Thus, the adoption of a simpler nondiscrimination test may encourage more employers, who do not now provide any tax-favored retirement plan for their employees, to set up a plan. However, some argue that the rapid rate of establishment of cash or deferred arrangements is inconsistent with arguments that the nondiscrimination requirements act as a deterrent to employers to set up such plans.

The bill addresses concerns that rank-and-file employees may not participate by requiring a certain level of employer contributions. These contribution provide an incentive for lower-paid employees to contribute. In addition, the bill assures that lower-paid employees will be aware of the plan by requiring employers to communicate the plan to employees.

In addition, a design-based nondiscrimination test provides certainty to an employer that does not exist under present law. Under such a test, an employer will know at the beginning of each plan year whether the plan satisfies the nondiscrimination requirements for the year. On the other hand, some point out that there are alternative ways to achieve this result.

Under the bill, the design-based nondiscrimination tests are provided as alternatives to the present-law nondiscrimination tests. The addition of optional methods of satisfying the nondiscrimination requirements for cash or deferred arrangements may be perceived by some employers as adding, rather than reducing, the complexity of the requirements.

C. PRIME Retirement Accounts for Small Employers

Pension coverage of employees of small employers is significantly lower than that of employees of medium or large employers. A number of factors may contribute to this, including the cost to the employer (both in terms of wage cost and administrative cost of maintaining the plan) as well as the desire of the employees to have pension benefits rather than wages in other forms. The PRIME retirement account proposal attempts to address one factor that may affect an employer's decision to establish a pension plan--administrative burdens--by enabling an employer to establish a salary reduction plan without testing to ensure that the plan operates in a manner that does not discriminate in favor of highly compensated employees and by reducing the employer's reporting obligations.

Nondiscrimination rules generally are enacted to ensure that the tax benefits for qualified plans benefit an employer's rank and file employees as well as highly compensated employees and to provide broad-based pension coverage. The issues relating to nondiscrimination rules are discussed above under the provision relating to cash or deferred arrangements.

In addition, even if one concludes that nondiscrimination rules are generally desirable from a policy perspective, some argue that

in the case of small employers such rules may be an impedient to establishment of any type of retirement program and that relaxation of such rules is appropriate if doing so will encourage small employers to establish retirement plans. Further, concerns about nondiscrimination rules may be less given the lower limits on maximum contributions to PRIME retirement accounts (one-half of the elective deferral limit).

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