

# CRS Report for Congress

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## **Individual Retirement Accounts (IRAs): Legislative Issues in the 106<sup>th</sup> Congress**

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### **Summary**

Bills introduced in the 106<sup>th</sup> Congress would have raised the limit on contributions to individual retirement accounts (IRAs) and eased other federal IRA rules. The House passed H.R. 5203, incorporating the higher IRA contribution limits of H.R.1102, on September 19, 2000. The IRA provisions of the bill would have cost \$21.7 billion in foregone revenue over 10 years. The Senate Finance Committee ordered H.R. 1102 reported (with amendments) on September 7, 2000, but the bill did not reach the Senate floor before the 106<sup>th</sup> Congress adjourned in December 2000. The Finance Committee's bill, in addition to raising contribution limits, would have allowed tax credits in lieu of deductions for a portion of IRA contributions.

### **Legislative History**

In 1971, President Nixon proposed that workers be allowed to defer from taxable income an amount of earnings set aside in an IRA. IRAs were first authorized by the Employee Retirement Income Security Act (ERISA) of 1974 (P.L. 93-406) for workers not covered by employer pension plans. They could make tax-deferred IRA contributions up to the lesser of \$1,500 a year or 15% of earned income. In 1981, the Economic Recovery Tax Act of 1981 (P.L. 97-34) raised the contribution limit to the lesser of \$2,000 or 100% of earnings and made all workers eligible. A total of \$2,250 could be contributed by a worker and a nonworking spouse. The Tax Reform Act of 1986 (P.L. 99-514) restricted IRA tax deferrals to: (1) workers with no employer plan coverage; and (2) workers in employer plans who meet an income test. Married couples were treated as having employer coverage if at least one spouse had such coverage.

In the 1990s, pressure built to restore tax deferrals, ease early withdrawal penalties, and allow "backdoor" IRAs that receive taxable contributions and pay tax-free benefits. Between 1992 and 1995, Congress passed such provisions three times in bills that were vetoed. However, penalty-free withdrawals for certain health expenses (P.L. 104-191) and a separate \$2,000 contribution limit for nonworking spouses (P.L. 104-188) did become law. Major IRA changes finally were adopted in the Taxpayer Relief Act of 1997 (P.L.

105-34). It authorized the Roth IRA, which accepts only after-tax contributions and provides tax-free distributions. This law also raised the income limits on tax deductibility for contributions to traditional IRAs by workers with employer pension coverage, and it allowed a spouse who lacks employer coverage to make deductible contributions to traditional IRAs independent of the partner's coverage status. The 1997 law authorized penalty-free early withdrawals if used for higher education or a first-home purchase.

## Rules for Tax Year 2000

There are two types of IRAs—*traditional* and *Roth*. Income tax is deferred on contributions to a traditional IRA and on investment earnings until funds are withdrawn, at which time all withdrawals are taxable. (Traditional IRAs also may receive taxable (“nondeductible”) contributions, which still accrue *tax-deferred* investment earnings.) Contributions are taxed when contributed to a Roth IRA, but investment earnings may be withdrawn *tax free* if the Roth IRA was opened at least 5 years earlier *and* withdrawals occur after age 59½ (or are otherwise exempt from the 10% early withdrawal tax).

The lesser of \$2,000 or 100% of earnings can be contributed yearly to IRAs. A spouse with little or no earnings also can contribute up to \$2,000, but a couple's combined contributions cannot exceed their joint earnings. An IRA must be a separate trust account held by an approved financial institution. IRA funds can be moved tax-free to a like IRA once a year. Lump-sum distributions from employer plans usually can be transferred tax-free (rolled over) to traditional IRAs without limit.

Contributions to a traditional IRA that qualify for tax deferral are netted from income before computing tax liability. A full \$2,000 contribution can be deferred by an employed person only if the worker (1) lacks coverage by an employer-sponsored plan, or (2) has adjusted gross income (AGI) of \$32,000 or less (\$52,000 for joint filers). Filers may defer some fraction of \$2,000 when AGI falls between \$32,000 and \$42,000 (\$52,000 and \$62,000 for joint filers). A worker's nonworking spouse can defer a \$2,000 contribution if joint AGI does not exceed \$150,000; partial deferral is allowed up to AGI of \$160,000. Up to \$2,000 can be contributed to a Roth IRA by single filers with AGI of \$95,000 or less (\$150,000 or less for joint filers). Roth IRA eligibility phases out at AGI of \$110,000 (\$160,000 for joint filers). The annual sum of an individual's contributions to all IRAs cannot exceed \$2,000.

Withdrawals from an IRA before age 59½ incur a 10% excise tax on taxable amounts withdrawn unless withdrawals are because of: death; disability; conversion of the asset to a lifetime annuity; medical expenses that exceed 7.5% of AGI; the need to pay health insurance premiums while unemployed; higher education expenses; or purchase of a first home. This 10% tax is in addition to any income tax owed on the withdrawal. Withdrawals *must* begin by April 1 of the year after the year that the account holder attains age 70½, at a rate that will consume the IRA over the expected remaining lifespan(s) of the account holder (and beneficiary). A breach of this rule triggers a 50% excise tax on the deficiency. Mandatory withdrawals are not required from Roth IRAs.

A traditional IRA can be converted to a Roth IRA by persons with AGI no greater than \$100,000 (for single or joint filers), but income tax is due on transferred amounts not already taxed. Beginning in 2005, P.L. 105-206 will make it easier for persons over age

70½ to convert traditional IRAs to Roth IRAs by allowing mandatory IRA withdrawal amounts to be netted from AGI when applying the AGI eligibility limit on IRA conversions.

When an account holder dies, a spouse beneficiary may treat an inherited IRA as his/her own, making it subject to the usual IRA rules regarding distribution and taxation. An IRA inherited by a spouse is not subject to the federal estate tax. A nonspouse beneficiary cannot treat an inherited IRA as his/her own and usually must take distributions from it fast enough to liquidate it over either a 5-year period or the beneficiary's life expectancy. The federal estate tax may apply to this beneficiary if the estate's total value including the IRA exceeds an exempt threshold (\$675,000 in 2000).

## Proposals in the 106<sup>th</sup> Congress

**Table 1** lists the IRA proposals found in bills introduced in the 106<sup>th</sup> Congress. H.R. 5203, incorporating the IRA provisions of H.R. 1102, was passed by the House on September 19, 2000. H.R. 1102 was ordered reported (with amendments) by the Senate Finance Committee on September 7, 2000, but it did not reach the Senate floor before the 106<sup>th</sup> Congress adjourned in December 2000.

### Eligibility for IRA Tax Deferrals

Initially, IRA eligibility was limited to workers with no employer pension coverage. Participation rose quickly when all workers became eligible in 1981 but fell sharply after deferrals were curbed in 1986. In 1995, 4.2% of tax filers with wage and salary income made tax-deferred contributions, down from 18.6% in 1985. Contributions in 1995 totaled \$7.6 billion, down 80% from 1985. Also, inflation has shrunk the population eligible for deferral. Had the \$35,000 and \$50,000 AGI deferral limits set in 1986 been indexed for inflation, they would have exceeded \$52,000 and \$74,000, respectively, by 1998.

**Table 1. IRA Proposals Introduced in the 106<sup>th</sup> Congress**

IRA proposal	Bill no.
Increase income limits for deductibility of contributions	H.R. 188, H.R. 876, H.R. 1102, S. 476
End income limits for deductibility of contributions	H.R. 1546, S. 649
Allow partial credit of contribution in lieu of deduction	H.R. 226, H.R. 1102, H.R. 1590, H.R. 2553
End phaseout of deductibility based on spouse pension coverage	H.R. 188
Increase contribution limit	H.R. 188, H.R. 802, H.R. 876, H.R. 1102, H.R. 1322, H.R. 1357, H.R. 1546, H.R. 1840, H.R. 4843, H.R. 5203, S. 593, S. 649, S. 799, S. 1379, S. 2671, S. 2740
Set higher contribution limit for those age 50 and older	H.R. 1102, H.R. 4546, H.R. 4843, H.R. 5203
Index income limits on deductibility for inflation	H.R. 188, H.R. 876

IRA proposal	Bill no.
Index contribution limit for inflation	H.R. 188, H.R. 876, H.R. 1102, H.R. 1322, H.R. 1546, H.R. 1840, H.R. 4843, H.R. 5203, S. 593, S. 649, S. 1013, S. 1379, S. 2671
Coordinate contribution limits with §401(k) plan limits	S. 476
Allow added “trade bonus” contributions for workers	S. 2244
Allow “2 <sup>nd</sup> chance” makeup contributions for years when no contribution was made	H.R. 3620
Allow penalty-free early withdrawal when unemployed	H.R. 188, H.R. 876, H.R. 1590, S. 476
Allow penalty-free early withdrawal for long-term care expense	H.R. 188, S. 476
Allow penalty-free early withdrawal for medical expenses of account holder, lineal ancestors, and descendants	H.R. 188, H.R. 876, S. 476
Allow penalty-free early withdrawal for elementary and secondary education expenses	S. 1013
Allow penalty-free early withdrawal for adoption expenses	H.R. 2282
Allow penalty-free early withdrawal if spouse dies or becomes disabled	H.R. 2826
Allow penalty-free early withdrawals by disaster-area residents to repair property	S. 1714
Allow tax-free withdrawal to buy long-term care insurance	H.R. 275
Allow tax-free withdrawal for charitable donations	H.R. 1102, H.R. 1311, H.R. 1607, H.R. 4433, S. 997, S. 1086
Forgive income tax on penalty-free early withdrawals if repaid to IRA in 5 years	H.R. 188
Allow loan from IRA to buy first home	H.R. 1333, S. 1994
Allow IRA to invest in first home of account holder or family member	S. 1994
Repeal mandatory withdrawal requirement after age 70½	H.R. 252
Increase age when minimum distributions must begin	S. 741, S. 2180
Set standards for coins in which IRA can be invested	H.R. 3052, S. 163
Allow inherited IRA to be held by heir until age 70½	H.R. 188
Exclude inherited IRA from taxable estate	H.R. 188, H.R. 2058
Allow rollover of inherited §401(k) to IRA	H.R. 188
Allow rollover of gain from farm sale to IRA	S. 62
Allow rollover of gain from home sale to IRA	S. 1471

<b>IRA proposal</b>	<b>Bill no.</b>
Allow rollover from §457 plan to IRA	H.R. 554, H.R. 739, H.R. 833, H.R. 1102, H.R. 1213, H.R. 1590, H.R. 3081, H.R. 4843, H.R. 5203, S. 741, S. 1357, S. 2671
Allow rollover of IRA to employer plan	H.R. 739, H.R. 833, H.R. 1102, H.R. 1213, H.R. 3081, H.R. 4843, H.R. 5203, S. 741, S. 1357, S. 2671
Allow rollover of up to \$3,000 from cafeteria plan to IRA	H.R. 3034
Authorize payroll deduction IRAs	H.R. 1102, H.R. 1213, H.R. 1590, H.R. 5203, S. 649, S. 741
Allow "Child Savings Account" within Roth IRA, funded in part by extra child tax credit for contributor	S. 1013
End income limit for eligibility to contribute to Roth IRA	H.R. 1546, S. 649, S. 1013
Raise income limit for eligibility for joint filers to contribute to Roth IRA	H.R. 1102
Allow 4-year averaging of income tax on amount converted from traditional IRA to Roth IRA through 2003	S. 1379
End income limit for conversion of traditional to Roth IRA	S. 1013
Increase income limit for eligibility to convert traditional IRA to Roth IRA	H.R. 1102, H.R. 1546, S. 649, S. 1344
Exempt IRAs from bankruptcy proceeding unless exemption waived by account holder	H.R. 833

The Taxpayer Relief Act of 1997 (P.L. 105-34) raises over 10 years the income limits for tax-deferral of IRA contributions (**Table 2**); in 2007, it will widen (from \$10,000 to \$20,000) the phase-out interval for deductibility for joint filers. However, this law does not offset fully the inflationary erosion in these limits. The version of H.R. 1102 reported by the Senate Finance Committee would have speeded up the phase-in of the increases in these limits already in law.

**Table 2. AGI Limits for Full IRA Deductibility Under P.L. 105-34<sup>a</sup>**

<b>Tax year</b>	<b>Single filer</b>	<b>Joint filer</b>	<b>Tax year</b>	<b>Single filer</b>	<b>Joint filer</b>
1987-1998	\$30,000	\$50,000	2003	\$40,000	60,000
1999	31,000	51,000	2004	45,000	65,000
2000	32,000	52,000	2005	50,000	70,000
2001	33,000	53,000	2006	50,000	75,000
2002	34,000	54,000	2007 & later	50,000	80,000

<sup>a</sup> These AGI limits apply to tax filers who have employer pension coverage. Full deductibility is allowed for a filer's uncovered spouse up to a joint AGI of \$150,000 for 1998 and later years.

P.L. 105-34 ended the denial of tax deferrals to those whose spouses have employer plan coverage, if an income limit is met. That is, if only one spouse in a joint filing unit has employer coverage, the uncovered spouse can deduct contributions fully if the filing unit's AGI is below \$150,000. Partial deductions are allowed if AGI is below \$160,000.

Some argue against larger IRA tax deferrals because the revenue lost will benefit mainly higher-income workers, who also are more likely to have employer pensions. In 1985, a year before deferrals were limited, only 8% of tax filers with AGI between \$10,000 and \$20,000 reported IRA contributions compared to 58% with AGI above \$50,000. The Senate version of H.R. 1102 would have offered low- and moderate-income tax filers partial tax credits in lieu of deductions for their IRA contributions, because credits are worth more than deductions to lower-income taxpayers.

### **Annual IRA Contribution Limits**

The \$2,000 IRA limit is not adjusted for inflation. Had the original 1975 limit of \$1,500 been adjusted yearly, it would have exceeded \$5,300 in 2000. Had the \$2,000 limit set in 1981 been adjusted, it would have exceeded \$4,100 in 2000. Both H.R. 1102 and H.R. 5203 would have raised the limit in three steps to \$5,000 and then require yearly inflation adjustments. Even higher limits would apply for filers age 50 and older. Foes argue that expanding IRAs yields little new saving because part of new IRA contributions would be saved anyway in some other form, even without additional tax breaks.

### **Penalties for Early Withdrawals from IRAs**

A 10% tax discourages early use of IRA assets. Some experts advocate tougher rules for early withdrawals, fearing that too many people will use IRA funds before old age and deplete their retirement assets. P.L. 105-34 expanded penalty-free withdrawals, allowing them for higher education costs and first-home purchases (lifetime limit of \$10,000). Proposals would extend penalty-free withdrawals to: long-term care costs, medical expenses of relatives, expenses while jobless for 12 or more weeks, elementary and secondary education costs, adoption expenses, and property repair costs in disaster areas. Tax-free withdrawals are proposed for: the purchase of long-term care insurance; and charitable donations. The latter option was included in the Senate version of H.R. 1102.

### **Inherited IRAs**

An IRA inherited from a spouse can be converted to the heir's own IRA, thereby limiting income taxes. The IRA also qualifies for the spousal exemption from the federal estate tax. However, a nonspouse beneficiary must take distributions from an inherited IRA, and the IRA may be subject to estate taxation. H.R. 188 would have excluded all inherited IRAs from the estate tax and allowed heirs to retain such IRAs until age 70½.

### **Eligibility for Roth IRAs**

The Roth IRA permits tax-free withdrawals of assets that are funded by after-tax contributions and held at least 5 years. To open a Roth IRA, AGI cannot exceed \$110,000 (\$160,000 for joint filers). The Senate version of H.R. 1102 would have raised the joint-filer limit to \$220,000. There is a \$100,000 AGI limit on eligibility to convert a traditional IRA to a Roth. The Senate bill would have set a \$200,000 limit for joint filers.