JOINT ECONOMIC COMMITTEE

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A PRIMER ON INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)

This year marks the thirtieth anniversary of Individual Retirement Accounts. While IRAs have provided welcome relief from the tax bite that the government places on saving, they are beginning to show their age. IRAs have become increasingly complicated; there are now two different IRAs with different tax treatments, contribution limits, and withdrawal rules, as well as a plethora of other tax-preferred savings accounts to encourage saving for medical care and education. IRAs add to the complexity of saving, even as they ease the tax burden imposed upon it.

President Bush recently proposed the establishment of Lifetime Saving Accounts (LSAs) and Retirement Saving Accounts (RSAs) to simplify and improve the current system of tax-preferred accounts, and Congress may take up legislation in the near future. To understand these proposals and how the tax code currently treats savings, this report takes a closer look at IRAs. Highlights include:

- **IRAs provide limited relief from the tax burden on saving.** Saving in an IRA incurs only one layer of tax, while two layers of tax are imposed on saving and investment in taxable accounts.
- **IRAs are complex and subject to many restrictions.** IRAs are subject to many rules, including income limits, early withdrawal penalties, and forced withdrawals. These restrictions discourage saving among workers at all income levels.
- **IRAs can be improved to expand participation.** Making withdrawals easier, expanding eligibility, and eliminating forced withdrawals would make IRA-like accounts more attractive saving vehicles.

How is saving typically taxed?

Saving is typically subject to two layers of tax. For instance, a worker who saves part of her paycheck is taxed on that money as soon as it is earned. When the worker then saves a portion of her after-tax earnings, the resulting income is also taxed. The result is a heavy tax burden on saving.

How do IRAs change the taxation of saving?

IRAs are special tax-preferred saving accounts that eliminate a layer of tax on saving. As opposed to the standard two-layer saving tax, income put aside for retirement in an IRA is taxed only once – either when it is earned, or when it is withdrawn from the account.

What's the difference between a Roth IRA and traditional IRA?

The difference between Roth and traditional IRAs lies in when the tax benefit is conferred. A traditional IRA offers tax relief when an individual makes a contribution, while a Roth IRA provides relief when the individual makes a withdrawal. Taxpayers who save in a traditional IRA do not have to pay income taxes on earnings contributed to an IRA; however, taxes are due when the contributions and any investment earnings are withdrawn. Individuals using a Roth IRA, on the other hand, owe the usual income taxes on all earnings contributed to the Roth account but *avoid any future taxation of income earned in the Roth account*.

Which type of IRA offers more tax relief for saving?

It depends. Someone facing the same tax rate at the time of contribution and withdrawal should in theory obtain the same tax relief under Roth and traditional IRAs. However, if that person expects higher tax rates at the time of withdrawal than the time of contribution (either because of a higher income or because Congress raises tax rates), the up-front tax payment of the Roth IRA would be a better deal. Conversely, a lower tax rate at retirement would make deferring taxes until withdrawal – the traditional IRA treatment – the more attractive option.

Unfortunately, this simple comparison of Roth and traditional IRAs is obscured – especially for middle- and lower-income taxpayers – by the interaction of traditional IRAs with Social Security and other tax system features. In particular, withdrawals from a traditional IRA count as income that could increase the tax owed on Social Security benefits. Also, deductions received for contributions to a traditional IRA could lower an individual's tax bracket, reducing the value of other deductions such as the mortgage interest deduction.

Roth IRAs, on the other hand, are not subject to any of the ambiguities plaguing traditional IRAs. For this reason, most taxpayers – especially middle- and lower-income individuals – receive a larger tax benefit from Roth IRAs than from traditional IRAs.[1]

Are there restrictions on who can invest in an IRA?

Yes. Eligibility rules depend on a variety of factors, including age, income, tax filing status, and the type of IRA in question. Traditional IRAs are generally more restricted than Roth IRAs. In 2004, married taxpayers under age 70½ who earn less than $60,000 may contribute up to $3,000 to a traditional IRA. (The income limit is higher if one or both spouses do not have access to an employer plan like a 401(k).) Income limits for Roth IRAs are higher, so couples with incomes up to $150,000 could contribute up to $3,000 to a Roth without regard to age. The annual maximum contribution to an IRA is scheduled to increase to $5,000 by 2008.

Are there restrictions on withdrawals from an IRA?

Yes. Investors generally cannot take withdrawals from either Roth or traditional IRAs until they reach age 59½. There are some exceptions – withdrawals for certain medical expenses, first-time homebuyer expenses, some higher-education expenses, and health-insurance expenses of unemployed individuals are permitted – but otherwise early withdrawals are hit with a 10% penalty.

Investors in traditional IRAs, but not Roth IRAs, face a second restriction: they are *required* to begin withdrawals (also called "distributions") from their IRA, and to begin paying taxes on those withdrawals by age 70½.

What are the downsides of restrictions on IRAs?

Both participation and withdrawal restrictions add to complexity and discourage workers from saving in IRAs. Paradoxically, income restrictions on IRA participation can mean lower saving at all income levels, as potential savers may be uncertain whether they are eligible to use an IRA. Also, financial institutions that market IRAs may find the marketing effort less worthwhile when IRAs are not an option for many potential investors. Income limits on IRAs thus mean lower participation rates at all income levels – a result observed when income limits were first imposed in 1986.[2]

The various withdrawal restrictions associated with IRAs also discourage IRA participation. Required withdrawals from traditional IRAs at age 70½ could make IRAs costly for some seniors by forcing them to sell assets before they need the money – and sometimes forcing them to sell at a loss. Also, the minimum withdrawal age for both types of IRA makes these saving vehicles a risky bet for some people, especially low-income workers, who could need access to their savings prior to retirement.

Do Roth and traditional IRAs have different effects on the government budget?

Yes, the different IRAs result in a different timing of tax payments. Over the long run, the amount of foregone tax revenue due to a Roth IRA should average out to be about the same as the foregone revenue from a traditional IRA. Yet, because traditional IRAs provide taxpayers an immediate deduction for contributions while Roth IRAs provide tax relief only at withdrawal, the two have significantly different implications for the timing of revenue flows to the government. Within a 10-year budget window in particular, Roth IRAs are considerably less "expensive" in terms of foregone revenue than traditional IRAs.

What is the difference between an IRA and a 401(k) plan?

A 401(k) plan is a employer-sponsored savings account that provides tax relief similar to that offered by a traditional IRA. The primary difference between the two is that the 401(k) can only be administered by an employer and is only available to workers whose employers choose to offer one. Access to an IRAs, on the other hand, does not depend on employer participation.

What other tax-preferred saving vehicles exist?

Congress has created a variety of other tax-preferred saving incentives that are similar to IRAs. In addition to employer-based retirement savings accounts like 401(k)s, there are tax-preferred accounts for dependent care and educational expenses, as well as several types of accounts for medical expenses. These accounts typically resemble a traditional IRA, which provides an immediate tax deduction for contributions.

How would the proposed RSA and LSA accounts affect IRAs and saving behavior?

The president proposed simplifying the system of tax-preferred savings accounts by consolidating existing accounts and easing rules governing how saving in these accounts may be used. Congress is currently considering the specifics of such a program, though no formal legislation currently exists.

Lifetime Savings Accounts (LSAs) would have the tax treatment of Roth IRAs but would allow withdrawals at any time and for any reason. LSAs would likely encourage saving by attracting workers who are reluctant to tie up their money until retirement and who are deterred by the complexity of existing saving options.

Retirement Savings Accounts (RSAs) would be modeled on current Roth IRAs and would replace both Roth and traditional IRAs for tax-preferred retirement saving. Unlike current IRAs, RSAs would have no income limits, no age limits, and no age at which withdrawals are required. Withdrawals from RSAs would be permitted beginning at age 58. RSAs would also likely encourage more workers to save by eliminating confusing saving options and complex rules associated with traditional IRAs and by removing income limits that discourage widespread marketing of IRAs by financial institutions.

[1] Gokhale, Jagadeesh and Laurence J. Kotlikoff, "Who Gets Paid to Save?," published in *Tax Policy and the Economy*, National Bureau of Economic Research, 2003.
[2] Tabulation of IRS Statistics of Income (SOI) data.

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