U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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CONTACT Andrew DeSouza (202) 622-2960

TESTIMONY OF TREASURY BENEFITS TAX COUNSEL THOMAS REEDER BEFORE THE HOUSE WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES ON INDIVIDUAL RETIREMENT ARRANGEMENTS

Washington, DC—Chairman Neal, Ranking Member English and Members of the Committee, I appreciate the opportunity to appear today to discuss the issue of individual retirement arrangements (IRAs) and their vital role in generating and maintaining retirement savings of American workers and their beneficiaries.

Background

IRAs are available to all Americans with compensation income (including net earnings from self-employment involving personal services). Certain tax preferences of IRAs, however, are dependent on the individual's level of income and whether the individual is covered by an employer-sponsored retirement plan. There are several types of IRAs, including traditional deductible IRAs, traditional nondeductible IRAs, and Roth IRAs. In addition, there are special types of IRAs available in the employment context referred to as SEP IRAs and SIMPLE IRAs.

Individuals under age 70½ may make contributions to a traditional IRA, subject to certain limits. The contributions are generally deductible. The deduction is phased out, however, for workers with incomes above certain levels who are covered by an employer-sponsored retirement plan. For taxpayers covered by employer plans in 2008, the deduction is phased out for single and head-of-household filers with modified adjusted gross income[1] (AGI) between $53,000 and $63,000, for married couples filing jointly with AGI between $85,000 and $105,000, and for married couples filing separately with AGI between $0 and $10,000. For a married individual filing jointly who is not covered by an employer-sponsored plan, but whose spouse is covered, the deduction is phased out between $159,000 and $169,000 in AGI. IRA earnings are not includible in gross income until distributed. Distributions (including both pre-tax contributions and account earnings) are includible in gross income for income tax purposes.

[1]Modified adjusted gross income for this purpose is adjusted gross income plus income from education savings bonds, interest paid on education loans, employer-provided adoption assistance benefits, IRA deductions, deductions for qualified higher education expenses, and certain other adjustments.

To the extent a taxpayer cannot or does not make deductible contributions to a traditional IRA, a taxpayer under age 70½ may make nondeductible contributions. Distributions representing a return of basis are not includible in gross income, while distributions representing account earnings are includible in gross income. There is no income limit for nondeductible contributions to a traditional IRA.

Individuals of any age with sufficiently low income may make contributions to a Roth IRA. The contributions are not deductible. Allowable contributions are phased out for workers with incomes above certain levels. In 2008, contributions are phased out for single or head-of-household filers with AGI between $101,000 and $116,000, for married couples filing jointly with AGI between $159,000 and $169,000, and for married couples filing separately with AGI between $0 and $10,000. Account earnings accumulate tax free, and qualified distributions (including account earnings) are not included in gross income for income tax purposes. Distributions from Roth IRAs prior to age 59½ or before the individual has had a Roth IRA for 5 years are included in income to the extent they exceed basis, unless the distribution is on account of death or disability or, for an amount up to $10,000, for a first-time home purchase. Distributions are deemed to come from basis first.

The annual aggregate limit on contributions to all of a taxpayer's IRAs (traditional, nondeductible, and Roth) is the lesser of earnings or $5,000 in 2008, and will be indexed for price inflation after 2008. Individuals age 50 and over may make an additional "catch-up" contribution of up to $1,000.

Taxpayers (other than married taxpayers who file separately) with AGI of $100,000 or less can convert a traditional IRA to a Roth IRA. In general, the conversion amount is included in gross income (but not for purposes of determining eligibility to convert). The Tax Increase Prevention and Reconciliation Act of 2005 repealed the income limitation for conversions from a traditional IRA to a Roth IRA made after December 31, 2009. Taxpayers who make such conversions in 2010 may elect to delay half of the income inclusion resulting from the conversion to 2011 and the other half of the income inclusion to 2012. Conversions made on or after January 1, 2011 will result in the full amount of the converted amount not previously included in taxable income to be included in they year of the conversion.

Distributions from traditional IRAs prior to age 59½, or from Roth IRAs prior to age 59½ or 5 years after the first Roth contribution, are generally subject to an additional 10 percent income tax. The tax is imposed on the portion of an early distribution that is includible in gross income. It applies in addition to ordinary income taxes on the distribution. The additional tax does not apply to a rollover to an employer plan or to another IRA, or if the distribution is made in the case of death or disability, certain medical expenses, first-time homebuyer expenses, qualified higher-education expenses, health insurance expenses of unemployed individuals, to a qualified reservist, or as part of a series of substantially equal periodic payments.

Beginning at age 70½, minimum distributions gauged to life expectancy of the IRA holder (or the joint life expectancy of the IRA holder and beneficiary) must be taken from a traditional IRA. Roth IRAs are not subject to minimum distribution rules during the account owner's lifetime.

Employers with 100 or fewer employees and no other retirement plan may establish SIMPLE IRAs. Unlike traditional IRAs, participants may defer up to $10,500 and SIMPLE participants aged 50 or over may make additional "catch-up" deferrals of up to $2,500. All contributions are immediately fully vested. In lieu of the nondiscrimination tests applicable to most other employer-sponsored retirement savings plans, SIMPLE IRAs are subject to special contribution rules, including a lower annual elective deferral limit and either a matching employer contribution for each employee up to 3 percent of compensation (which may be reduced to 1 percent under certain circumstances) or non-elective contribution of 2 percent of all eligible employees' compensation.

An employer may contribute to its employees' IRAs under a simplified employee pension (SEP). Under a SEP, the employer must contribute to all employees' IRAs in the same percentage (with certain exceptions). Employee contributions to SEPs are not permitted, except with respect to grandfathered salary reduction SEPs that were in existence on December 31, 1996.

An employer may also establish payroll deduction IRAs under which employees may elect to have a portion of their pay contributed to a traditional or Roth IRA in any amount up to the annual limits for individual traditional or Roth IRAs (plus the catch-up amount, if applicable). Like a SIMPLE IRA, these may be set up on an automatic basis. That is, the employee may be deemed to elect to participate in the program at a certain level unless the employee affirmatively elects not to participate or to participate at a different level. Although a payroll deduction IRA is essentially the same as an individual IRA, there are tremendous advantages to the payroll deduction process. It is generally accepted that employees are more likely to save if the amounts are automatically diverted to an IRA before they reach the employee's hands or checking account.

In summary, IRAs provide a valuable long-term savings tool. They are particularly valuable to those individuals who do not have access to other employer-sponsored savings plans and they are quite useful as a portable entity into which employees can combine the retirement savings they amass over their working careers. With all their retirement assets in a single trust or custodial account, employees can more efficiently and cost-effectively diversify their investments and otherwise manage their retirement savings.

Interpretive and Enforcement Authority over IRAs

The Treasury Department and the Internal Revenue Service (IRS) generally have interpretive and enforcement authority over the establishment and operation of individual IRAs and payroll deduction IRAs. The Employee Benefits Security Administration (EBSA) of the Department of Labor, however, has jurisdiction over various aspects (including fiduciary and disclosure requirements) of SEP IRAs and SIMPLE IRAs, as well as certain payroll deduction IRAs that entail such employer involvement that they constitute an employee benefit plan under Title I of the Employee Retirement Income Security Act of 1974. EBSA also has jurisdiction with respect to the interpretation of the prohibited transaction rules applicable to IRAs and has statutory authority to issue individual and class exemptions from the prohibited transaction rules for transactions involving IRAs.[2]

Treasury Department Activities Promoting Employer-Sponsored Savings Programs

The Administration has long been concerned that the rules of employer retirement savings plans are unreasonably complicated. This complexity imposes substantial compliance, administrative, and enforcement costs on employers, participants, and the government (and hence, taxpayers in general). Moreover, because employer sponsorship of a retirement plan is voluntary, this complexity discourages many employers from offering a plan at all. This is especially true of small employers, which employ a majority of American workers. Complexity is commonly cited as a reason the coverage rate of employer-sponsored plans has not grown above about 50 percent overall and has remained under 25 percent among employees of small firms. Thus, the Administration is dedicated to reducing the complexity through proposed legislation and providing tools for employers – especially small employers – to use in creating and administering plans.

[2] For example, if a non-exempted prohibited transaction occurs, under rules enforced by the IRS, an excise tax would apply. If the prohibited transaction involves the IRA-owner or a beneficiary of the IRA, the balance in the IRA would be subject to income tax.

The Administration continues to be dedicated to educating employers about retirement plan options. Although most large employers sponsor workplace retirement savings programs, such as 401(k), 403(b), or 457 plans, many small employers lack the knowledge or resources to adopt these plans. Along with the Department of Labor, the Treasury Department and the IRS have taken significant steps to publicize the advantages of employer-sponsored IRA-based savings programs and to educate employers and individuals on the ease of setting them up. For example, the IRS has developed model plan documents for SIMPLE IRAs and SEPs and has created the following publications:

- *Retirement Plans for Small Business* (SEP, SIMPLE, and Qualified plans) (Publication 560)
- *Individual Retirement Arrangements* (Publication 590)
- *Choosing a Retirement Solution for Your Small Business* (co-produced by the IRS and EBSA) (Publication 3998)
- *SEP Retirement Plans for Small Businesses* (co-produced by the IRS and EBSA) (Publication 4333)
- *SIMPLE IRA Plans for Small Businesses* (co-produced by the IRS and EBSA) (Publication 4334)
- *SIMPLE IRA Plan Checklist* (Publication 4284)
- *SEP Checklist* (Publication 4285)
- *Have you had your checkup this Year? For SIMPLE IRAs, SEPs and Similar Retirement Plans* (Publication 4405)

In addition to these publications, the IRS operates an extensive on-line resource for IRA-based retirement plans for small employers, "The IRA Online Resource Guide," which is also available as a CD-ROM. There is also video entitled "How to Set up a Retirement Plan for Yourself and Your Employees" available on the IRS online classroom site for small businesses (www.irs.gov/businesses/small). Of particular note is the Retirement Plan Navigator geared to small employers (http://www.irs.gov/pub/irs-tege/online_navigator.pdf), which includes a video and leads small employers through the process of choosing a type of plan and goes through the process of adopting and maintaining the plan.

The Employee Plans division of the IRS participated in over 300 events last year throughout the country, many of which are directed at small employers and their advisors. The IRS has partnered with various groups, including the United States Chamber of Commerce, the National Federation of Independent Business, and the Small Business Administration, in putting together materials and events for small employers.

One of the key features that makes employer-sponsored IRAs attractive to small employers with limited resources is the fact that the employer is not required to file annual reports with the Department of Labor or the IRS. This feature, however, makes it more difficult to determine precisely how many employers are adopting them and how many employees participate. Requiring more reporting would make it harder for employers with limited administrative resources to adopt employment-based IRA programs. But the IRS has data on the level of individual contributions and year-end account balances because those data are reported to the IRS by the IRA custodian. In 2004, contributions were made to the SEP IRAs of 1.6 million taxpayers in an amount of $13.8 billion, or approximately $8,625 per taxpayer. This amount was 28.2 percent of all IRA contributions in 2004. Contributions were made to the SIMPLE IRAs of 1.9 million taxpayers, in the amount of $7.6 billion, or about $4,000 per taxpayer. This amount was 15.6 percent of all IRA contributions in 2004. As of the end of the 2004, 3.5 million taxpayers held $169 billion in SEP IRAs and 2.5 million taxpayers held $34 billion in SIMPLE IRAs. This difference is likely due to the fact that SEP accounts are very common in businesses in which only the owner participates, have much higher contribution limits than SIMPLE IRAs, and have been in existence much longer than SIMPLE IRAs.[3]

Legislative Proposals

Because the Administration has been concerned about the hurdles employers face in trying to establish savings plans for their employees, the Administration's Budget has included for the past several years a proposal (the "Employer Retirement Savings Account" or ERSA) to combine the various types of employer-sponsored savings plans into a single type of plan (with simplified administrative rules for small employers). Of course the Administration would be open to other proposals that decrease the complexity or administrative burden on small employers that want to provide savings opportunities for their employees.

While the Treasury Department and the IRS have been promoting employer-sponsored retirement savings programs and developing new ideas to make plan sponsorship easier, we are concerned about imposing mandatory requirements that could affect the ability of an employer, particularly a small employer, to run its business efficiently and compete effectively in its marketplace. Operating a business already involves a significant amount of investment (typically the employer's time and money) and adding yet another stringent requirement could have an adverse effect, particularly on small employers, which are an essential sector of America's economy. Moreover, mandating a particular benefit on small employers, particularly to the extent such benefits imposes a significant cost on the employer, could affect the employer's decision to offer other employee benefits that may be more relevant for the employer's workforce, particularly health coverage.

Finally, we should not lose sight of the fact that IRAs generally are not as powerful of a retirement savings tool as other tax-qualified retirement plans, such as 401(k), 403(b) and other defined contribution plans and defined benefit plans. This is primarily because the restriction on pre-retirement distributions in such plans avoids much of the pre-retirement leakage that occurs in IRAs. We should not encourage employers to adopt IRA programs if they are instead willing and able to adopt these more sophisticated and flexible retirement plans to benefit their employees.

Conclusion

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear today, and I will be happy to respond to any questions.

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[3] SEPs have been available since 1979, while SIMPLE IRAs have been available only since 1997.