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T-95

Statement

Before the

House Ways and Means Committee

Hearing on

Savings and Investment
American Dream Savings Accounts

by

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Washington, D.C.

31 January 1995

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STATEMENT OF PAUL J. YAKOBOSKI
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SUMMARY

The American Dream Savings Account (ADSA) proposal creates a new type of tax-preferred saving vehicle for individuals. As proposed, an ADSA is a less restrictive type of individual retirement account (IRA). While this proposal creates a new saving vehicle for individuals to utilize, I would like to raise a few issues for consideration by the committee. One is the implication of such a saving vehicle for retirement income security, and more fundamentally, whether the objective of ADSAs is increased retirement saving or increased saving in general?

If the objective is increased saving in general, a question to be asked then regards the degree to which individuals are likely to utilize the newly created vehicle, and this feeds into the question of whether it would generate additional saving. The longer the investment horizon of an individual, the more attractive will be saving through an ADSA.

An individual in the 28 percent tax bracket saving $2,000 a year for five years earning 6 percent annually, say toward the down payment on a first home, would have $600 more in an ADSA than if he saved on a non tax-preferred basis ($12,000 versus $11,400). However, given that ADSA account balances cannot fall below $1,000 with a distribution, he would actually have $400 more at his disposal by saving outside the ADSA.

The same individual saving at the same rate for 18 years instead of 5 years, say for a child's education, would have $65,500 in the ADSA compared with $55,100 by saving on a non tax-preferred basis. Given the above, it is not clear how advantageous someone with a relatively short saving horizon would actually find such a saving vehicle, but an investor with a longer saving horizon is likely to find it very attractive.

If the objective is increased saving for the purpose of retirement income, the proposal does increase the incentive to save for retirement through an IRA-type of vehicle by allowing the individual access to money before retirement should it be needed for qualified purposes. Over 90 percent of those eligible to utilize a tax-deferred IRA choose not to do so. It is often speculated that this is due to a lack of money and a reluctance to put saving in a vehicle where it is beyond one's reach (without significant tax penalty) should it be needed before retirement. The ADSA proposal would ease such concerns by allowing access to the money after five years for first time home purchase, education expenses or medical expenses. This should result in increased IRA participation through ADSAs, but again the question is by how much given that money is locked up for five years and then only accessible for certain purposes.

Finally, the ADSA proposal would allow individuals with an existing IRA to roll over their IRA into an ADSA. Income tax would be paid on the rollover amount at the time of rollover, but future earnings would accrue tax free and any distribution would not be taxed if qualified as outlined above. Such a rollover would be permitted whether the source of the IRA money was regular tax deductible contributions or the rollover of a lump-sum distribution from an employment-based retirement plan such as a 401(k). This means that literally hundreds of billions of dollars in "retirement savings" would be eligible for rollover into ADSAs. Over the period 1977-1992, almost 119 million tax filers claimed a deduction for IRA contributions, and the amount claimed for deduction was over $252 billion. Rollover contributions to IRAs are even more significant in terms of dollars. In the 4-year period of 1987-1990 alone, there were 11.2 million rollover contributions made to IRAs, totaling $220 billion.

For some individuals, the tax gain from such a rollover would create a strong incentive to take advantage of the opportunity. However, none of the money rolled over would represent new additions to saving. It would all merely be a shift of existing saving from IRAs to ADSAs. These rollovers would generate tax revenue for the government at the time of rollover but would mean less tax revenue in the future. Therefore, under the proposal, significant sums of money that had been accumulated in tax-preferred vehicles earmarked for retirement income would be made available for other purposes. This would represent a dramatic change in policy objective.

STATEMENT OF PAUL J. YAKOBOSKI
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BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 31, 1995

I am pleased to appear before you this morning to discuss the proposal for creating American Dream Savings Accounts (ADSAs) found in H.R. 6. My name is Paul Yakoboski. I am a research associate at the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health, welfare, and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

The American Dream Savings Account proposal creates a new type of tax-preferred saving vehicle for individuals. As proposed, an ADSA is a less restrictive type of individual retirement account (IRA).[1] Anyone may make a contribution of $2,000 annually, irrespective of income or pension participation status. The contribution is with after tax dollars, but investment earnings accrue tax free subject to conditions. All distributions from such an account are tax exempt if they occur at or after age 59 1/2 or the account has been open for at least five years and the distribution is used for first time home purchase, education expenses, or medical expenses.[2,3] Furthermore, money in an existing IRA (whether the result of regular tax deductible contributions or of the rollover of a lump-sum distribution from an employment-based plan such as a 401(k)) would be eligible for rollover into an ADSA.[4] Income tax would be paid on the rollover amount at the time of rollover, but future earnings would accrue tax free and any distribution would not be taxed if qualified as outlined above.

While this proposal creates a new option for individuals to utilize in saving, both for retirement and other designated purposes, I would like to raise a few issues for consideration by the committee. One is the implication of such a saving vehicle for retirement income security, and more fundamentally whether the objective of ADSAs is increased retirement saving or increased saving in general?

Assuming for the moment an objective of increased saving in general, a question to be asked then regards the degree to which individuals are likely to utilize the newly created vehicle and this feeds into the question of whether it would generate additional saving. If an individual were to save $2,000 a year for five years on a nontax preferred basis, say toward the down payment on a first home, he would have $11,400 (assuming a 6 percent rate of return and a 28 percent tax bracket). If the same saving was done through an ADSA, the individual would have $12,000 at the end of five years in his account, a gain of $600. The question then is whether such gain is sufficient incentive for individuals to tie up their money in an ADSA? If the money is needed before five years, it would be inaccessible without tax penalty. In addition, the individual could actually withdraw only $11,000 from the ADSA since the account balance is not allowed to fall below $1,000 with a withdrawal.[5] Therefore, more money that can actually be used toward a down payment would be available by saving outside the ADSA ($11,400) than within the ADSA ($11,000) in this instance.

However, with a longer investment horizon, such as one may have when saving for a child's college education, the financial advantage of saving through an ADSA would increase. Assume an individual again saves $2,000 per year, only now he saves this amount for 18 years. (Again, he is in the 28 percent tax bracket and earns a rate of return of 6 percent.) In this instance, the individual would have $65,500 in the ADSA after 18 years, compared with $55,100 by saving on a non tax-preferred basis. The advantage of such a saving vehicle becomes more pronounced as the time horizon of the investor increases. Given the above, it is not clear how advantageous someone with a relatively short saving horizon would actually find such a saving vehicle, but an investor with a longer saving horizon is likely to find it very attractive.

Now, instead assume an objective of increased saving for the purpose of retirement income in the future. The proposal does increase the incentive to save for retirement through an IRA-type of vehicle by allowing the individual access to money before retirement should it be needed for qualified purposes. In 1993, among the 53.6 million civilian workers not participating in any type of employment-based retirement plan, only 6.3 percent reported having contributed to an IRA in the previous year. Therefore, 94 percent of those eligible to utilize a tax-deferred IRA choose not to do so. It is often speculated that this is due to a lack of money on the part of lower income workers, but these results hold across different levels of income. Only 2 percent of those eligible for a tax deductible contribution in the lowest earning bracket (under $5,000 annually) contributed to an IRA. While the contribution rate among eligible higher earners is greater, the vast majority still do not participate. Seventy-six percent of those with earnings of $50,000 or more and not participating in an employment-based plan did not contribute to an IRA.

An additional reason hypothesized for low participation rates among those eligible is that individuals, especially lower income individuals, are reluctant to put their saving in a vehicle where it is beyond their reach (without significant tax penalty) should they need it before retirement age. The ADSA proposal would ease such concerns by allowing access to the money after five years for first time home purchase, education expenses, or medical expenses. This should result in increased IRA participation through ADSAs, but again the question is by how much? This is very hard to predict with precision. Again, the fact that individuals are only allowed to withdraw money without tax penalty under a limited number of circumstances, and then only after five years, may still discourage these types of individuals (current eligibles choosing not to participate) from participating in an ADSA.

Any worker is currently allowed to make an after-tax contribution of up to $2,000 to an IRA as now structured. Earnings accumulate tax deferred and income tax is not paid on them until distribution. While hard data on the use of IRAs on an after-tax basis are lacking, it seems that such behavior is relatively rare. The existence of ADSAs would create an increased incentive for such saving as the mechanics are essentially the same with the added bonus that the earnings are not taxed, even at distribution (and there is also the availability to withdraw the money before age 59 1/2 for qualified reasons).

Finally, the ADSA proposal would allow individuals with an existing IRA to roll over their IRA into an ADSA. Income tax would be paid on the rollover amount at the time of rollover, but future earnings would accrue tax free and any distribution would not be taxed if qualified as outlined above. (It is not clear how the rollover of IRAs consisting of after-tax contributions would be treated for tax purposes.) Such a rollover would be permitted no matter what the source of the IRA money, whether the result of regular tax-deductible contributions or of a rollover of a lump-sum distribution from an employment-based retirement plan such as a 401(k). This means that literally hundreds of billions of dollars in "retirement savings" would be eligible for rollover into ADSAs. Over the period 1977-1992, almost 119 million tax filers claimed a deduction for IRA contributions and the amount claimed for deduction was over $252 billion. Rollover contributions to IRAs are even more significant in terms of dollars. In the 4-year period of 1987-1990 alone, 11.2 million rollover contributions were made to IRAs, totaling $220 billion.

For some individuals, the tax gain from such a rollover would create a strong incentive to take advantage of the opportunity. Among those with such an incentive would be individuals who already planned to tap into the IRA in the future for one of the qualifying reasons, for example, a parent who planned to access some of their account in 10 years to finance a child's education. By rolling over into an ADSA, they would avoid the 10 percent penalty tax at the point they took money out for the education expenses.

IRA participants must commence benefit payments by April 1 of the calendar year following the calendar year in which they reach age 70 1/2. The penalty for failure to make a required distribution of (at least) the correct amount is a nondeductible excise tax of 50 percent of the difference between the minimum required amount and the actual distribution.[6] An individual who did not want the money till a later age would find it to his advantage to roll the money into an ADSA where it would grow tax free (after payment of income tax at the time of rollover) till the time of distribution. There would be no penalty for funds left in the account after age 70 1/2. This is better than taking a distribution at age 70 1/2, paying income tax on it, and then investing it on a non-tax sheltered basis till the money is needed.

There is currently an excise tax of 15 percent on any income from tax-preferred retirement plans combined in excess of $150,000 annually (indexed for inflation). Individuals expecting to be impacted by this excise tax would have the incentive to roll any IRA funds into an ADSA. They could then make withdrawals from the ADSA at their discretion so as to not incur the excise tax on this amount.

Beyond these three scenarios, the advantage of a rollover depends upon what one anticipates happening to their tax rate between now and retirement age. If one expects to be in a lower tax bracket in retirement, then one would be better off leaving the funds in the existing IRA. If, however, one anticipates tax rates increasing over time, then it would make sense to roll over into an ADSA.

None of the money rolled over would represent new additions to saving. It would all merely be a shift of existing saving from IRAs to ADSAs. These rollovers would generate tax revenue for the government at the time of rollover but would mean less tax revenue in the future. Such a shift would have potentially noteworthy implications for retirement income security. After five years, such money would be available tax free for the qualifying purposes. To the extent that such withdrawals occurred, it would be at the price of future retirement income. This represents a dramatic shift of policy objective away from saving for retirement income security to saving in general. Under the proposal, significant sums of money that had been accumulated in tax-preferred vehicles earmarked for retirement income would be made available for other purposes. It can be argued that some of the spending, such as a home purchase or additional education for the owner, would enhance retirement income security; however, the shift in emphasis from retirement saving to generic saving remains important because of the potentially dramatic implications for retirement income in the future.

Conclusion

The American Dream Savings Account proposal creates a new type of tax-preferred saving vehicle for individuals. As proposed, an ADSA is a less restrictive type of individual retirement account (IRA). The longer an individual's investment horizon, the more attractive will be saving through an ADSA. In addition, individuals eligible to make tax-deductible IRA contributions, but who have not done so in the past, may find the ADSA option attractive since it allows access without tax penalty to the savings before retirement if the money is used for a qualifying reason (first time home purchase, education expenses, and medical expenses). Finally, the ADSA proposal would allow individuals with an existing IRA to roll over their IRA into an ADSA, meaning that literally hundreds of billions of dollars in "retirement savings" would be eligible for rollover into ADSAs. This represents a dramatic shift of policy objective away from saving for retirement income security to saving in general, with potentially dramatic implications for retirement income in the future.

Endnotes

[1]Under current law individuals who are not active participants in a qualified employment-based retirement plan can make fully tax-deductible contributions up to a $2,000 maximum per year to an individual retirement account (IRA). Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose adjusted gross income (AGI) does not exceed $25,000 (single taxpayers) or $40,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI falls between $25,000 and $35,000 (single taxpayers) and between $40,000 and $50,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution of less than $2,000 and a nondeductible IRA contribution for the balance, as follows. The $2,000 maximum deductible deduction is reduced by $1 for each $5 of income between the AGI limits. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI is at least $35,000 (single taxpayers) or at least $50,000 (married taxpayers filing jointly) may only make nondeductible IRA contributions of up to $2,000; earnings on the nondeductible contribution are tax deferred until distributed to the IRA holder. IRAs can also be established as rollover vehicles for lump-sum distributions from employment-based pension plans or other IRAs.

[2]Distributions from an ADSA would also be tax exempt in the event of the death or disability of the account owner.

[3]Distributions from IRAs are taxed as ordinary income in the year received, except for the portion of the total IRA distribution that is attributable to nondeductible contributions, which are excludable from gross income. Taxable distributions prior to age 59 1/2 are subject to a 10 percent penalty tax, unless they are taken as part of a series of equal payments made for the life (or life expectancy) of such employee and his or her beneficiary, or the IRA owner dies or becomes disabled.

[4]It is not clear how the rollover of IRAs consisting of after tax contributions would be treated for tax purposes.

[5]H.R. 6 stipulates that for a distribution to be a "qualified special purpose distribution," it shall not include any payment or distribution to the extent such payment or distribution reduces the balance of the amounts in ADS accounts of the taxpayer below $1,000.

[6]The minimum amount that must be paid each year is determined by dividing the account balance by the applicable life expectancy. The applicable life expectancy is the life expectancy of the employee, or the joint life expectancies of the employee and the employee's designated beneficiary, if any. The life expectancy of the employee and/or the employee's spouse can be recalculated annually; however, the life expectancy of a beneficiary other than a spouse cannot be recalculated.