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A FAREWELL TO PENSION POLICY: THE IMPACT OF FLEXIBLE IRAs ON CURRENT TAX POLICY

Regina T. Jefferson*

INTRODUCTION

Since the establishment of the income tax in 1913, there have been exceptions to the general rule of taxing all income as it is earned.1 Typically, these exceptions attempt to encourage behavior that is believed to benefit not only individual taxpayers but also society as a whole.2 Many critics of the federal income tax system, however, maintain that most preferential tax treatments disproportionately benefit wealthy Americans.3 Thus, some policymakers contend that it is grossly inequitable for the federal government to continue providing such tax benefits to the wealthiest Americans without offering similar incentives to those with modest incomes.4

Having an estimated cost of $64 billion for 1996, one of the country’s most expensive special tax programs is the private pension system.5 In addition to employer sponsored arrangements, the private pension system includes Individual Retirement Accounts (IRAs)6 which provide individual


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2. JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 244-46, 256-60 (1995). For example, excluding interest payments on debt issued by local and state governments is designed to subsidize borrowing by state and local governments. Id. at 244-46. The charitable contribution deduction encourages private sector charities which tend to provide public goods, and generate positive externalities which benefit society as a whole. Id. at 260.


5. CELIA SILVERMAN ET AL., EMPLOYEE BENEFIT RES. INST., EBRI DATABOOK ON EMPLOYEE BENEFITS 19-23, tbl. 2-5 (Carolyn Pemberton & Deborah Holmes eds., 3d ed. 1995).

6. Individual Retirement Accounts (“IRAs”) are technically not considered retirement plans under I.R.C. § 401(a). See JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 51 (2d ed. 1995). When defining the cost of the Private Pension system,
workers with tax incentives to save for retirement.\textsuperscript{7} An IRA can provide two distinct tax benefits. First, under certain conditions, contributions made to an IRA can be deducted from income.\textsuperscript{8} Second, the investment earnings on the contributions made to an IRA are tax-free until distribution.\textsuperscript{9} By encouraging individuals to save for retirement, two important social goals are accomplished: (1) taxpayers who ordinarily may not be able to save adequately for retirement are encouraged to do so; and (2) aggregate individual savings increases, creating greater national savings and investment capital for American economic growth.\textsuperscript{10}

Notwithstanding federal income tax incentives to foster retirement savings, the individual savings rate is declining in America.\textsuperscript{11} While it may not be surprising that the savings rate among low-income individuals is negligible, it is surprising that the savings rate among middle-income individuals also is dangerously low.\textsuperscript{12} The accumulated savings of middle-income Americans is so low that unless saving patterns change significantly, the bulk of the "baby boom" generation\textsuperscript{13} could experience retirement living standards lower than those of today's retirees.\textsuperscript{14}

\textsuperscript{7} SENATE SUBCOMM. ON LABOR OF THE COMM. ON LABOR \& PUB. WELFARE, 94TH CONG., 2D SESS., 3 LEGISLATIVE HISTORY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT of 1974, pt. 1, at 5554 (Comm. Print 1976) (statement of Rep. Schneebeli) (noting that IRA "allows the fellow who . . . is not covered by a Pension Plan to contribute . . . to a retirement account and receive a deduction for it"); id. at 4809; JOINT COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF TAX PROPOSALS RELATING TO INDIVIDUAL SAVINGS, JCS-3-95, at 2-6 (1995).

\textsuperscript{8} I.R.C. § 219 (1996). The maximum amount allowed to be deducted is the lesser of $2,000 or the amount of compensation received. Id. § 219(b)(1).

\textsuperscript{9} Id. § 219(e)(1).

\textsuperscript{10} See JOINT COMM. ON TAXATION, supra note 7, at 59-65 (noting that IRAs will help middle- and lower-income individuals to save for their retirement while increasing savings rate); Bruce E. Thompson, Jr., Time to Tackle Our Savings Deficit, WASH. TIMES, Apr. 4, 1995, at A19. America's national savings rate is the lowest in the first world. This "savings deficit" contributes to a lack of domestic investment capital in the U.S. economy. Investment capital is essential for economic growth and prosperity. More savings means more money that can be lent to small and large businesses at a lower interest rate. Also, increased savings benefit individual savers by providing a cushion so that they are not living at the edge of an "economic precipice." Id.

\textsuperscript{11} Thompson, supra note 10, at A19. A Merrill Lynch study found that "half of all American families have less than $1,000 net financial assets." Id.; see also Joseph S. Coyle, How to Beat the Squeeze on the Middle Class, MONEY, May 1, 1995, at 106, 112 (noting that Americans save 4% of their after tax income, Germans save 12%, French save 12%, and Japanese save 15%).

\textsuperscript{12} Coyle, supra note 11, at 112-13.

\textsuperscript{13} The cohort of baby boomers is important in determining economic and social policy because of its magnitude. Boomers range in age from 29 to 47 in 1993 [33 to 51 in 1997], and are now in their prime working years, but will soon be entering retirement. RESEARCH DIV., AMERICAN ASS'N OF RETIRED PERSONS, AGING BABY BOOMERS: HOW SECURE IS THEIR ECONOMIC FUTURE? 4 (1994) [hereinafter AARP REPORT].

\textsuperscript{14} Douglas Bernheim, Adequacy of Savings for Retirement and the Role of Economic Literacy, in RETIREMENT IN THE 21ST CENTURY, READY OR NOT 73, 73-78 (Dallas L. Salisbury \& Nora S. Jones eds., 1994). There has been a steep decline in U.S. savings rates; empirical evidence demonstrates that unless baby boomers undergo a dramatic change in their savings pat-
In an effort to improve the individual savings rate, and at the same time respond to charges that too much is being done for the well-off, last year Congress passed legislation aimed at reducing taxes substantially for middle-income Americans. The Tax Fairness and Deficit Reduction Act of 1995 was designed to provide $189 billion worth of tax relief to middle-income taxpayers and included the American Dream Restoration Act. As a method of encouraging individual savings among low- and middle-income Americans, the American Dream Restoration Act created the American Dream Savings Account ("ADSA") which is a more flexible retirement account than the traditional IRA.

As part of the Budget Reconciliation Bill, the ADSA was vetoed by President Clinton last year. However, because increased savings among middle-income Americans remains a number one priority of the President and Congress, an individual retirement expansion proposal like the ADSA, if not the ADSA in its exact form, is expected to be introduced again this year. Thus, it is useful to identify and analyze the goals of the ADSA in order to anticipate and evaluate new legislation in the area of IRA expansion and pension simplification. It is also important to understand the provisions of the ADSA legislation in order to assess the potential impact of similar IRA expansion proposals on existing pension policy.

In a "best case" model, there is a risk that the baby boomer generation will not enjoy the same standard of living as their parents during retirement. Further, based on the "best case" model, they will face a large reduction in their standard of living at retirement. Further, based on a "best case" model, there is a risk that the baby boomer generation will not enjoy the same standard of living as their parents during retirement. Id. But see AARP REPORT, supra note 13, at 20 (claiming that baby boomers may not be able to maintain their working life standards in retirement but may be better off than their parents will be in retirement).


16. The figure of $189 billion is frequently cited in literature concerning the House's tax bill. See, e.g., Wetzstein, supra note 15, at A1. The $189 billion is an estimate of the decrease in federal revenues that will occur over the five-year budget horizon, between 1995 and 2000, because of the Tax Fairness and Deficit Reduction Act's changes in the tax law. See JOINT COMM. ON TAXATION, ESTIMATED REVENUE EFFECTS OF THE TAX PROVISIONS CONTAINED IN THE "CONTRACT WITH AMERICA" (1995), reprinted in BNA, DAILY TAX REPORT (Feb. 2, 1995). It must be noted that there has been criticism of the potential exponential loss in revenue after the initial five-year budget period. See, e.g., ALBERT J. DAVIS, BUDGET IMPLICATIONS OF THE CONTRACT WITH AMERICA TAX CUTS (1995) (noting that in period between years 2000 and 2005, U.S. Treasury Department estimates that revenue losses will increase to $452 billion, and that this will seriously impact efforts to balance the budget). There has also been much debate concerning whether the tax provisions actually will benefit the middle class. See, e.g., 141 CONG. REC. H4213 to H4264 (daily ed. Apr. 5, 1995) (debating effects of Tax Fairness-Deficit Reduction Act on middle-income families). However, while most of the argument centers on whether the benefits will go primarily to the wealthy or to the middle class, few bother to define middle class. The general assumption is that a household income level between $30,000 and $75,000 is middle income. See, e.g., 141 CONG. REC. S9356 to S9363 (daily ed. June 29, 1995) (debate between Sen. Murray and Sen. Dodd on Budget Conference Report).


Accordingly, this Article describes and critiques the objectives of the ADSA. This Article then analyzes the potential social and economic effects of accomplishing the identified goals of the ADSA. Finally, this Article will conclude that the shift in pension policy made manifest by the ADSA, and other similar savings proposals, has potentially dramatic implications for future retirement savings among middle- and low-income Americans.

THE ADSA—AN EXPANDED IRA

A. IRA Expansion

Although recently IRA expansion proposals have received a great deal of attention, expanding the IRA is not a new concept.19 Over the last twenty years, IRAs have gone from being more restrictive to less restrictive, and back to more restrictive, in efforts to stimulate retirement saving equitably.20 When the Employee Retirement Income Security Act of 1974 ("ERISA") was enacted, IRAs were limited to workers not covered by employer-sponsored plans. At that time, however, advocates for IRA expansion argued that because all workers needed supplemental retirement savings, all workers should have access to IRAs.21 In 1981, in response to this concern, Congress expanded the use of IRAs and allowed all wage earners to establish these accounts. At the same time, Congress raised the maximum contribution amount to the lesser of $2,000 or 100% of compensation.22 These two changes caused the number of IRA contributors to more than triple, and the amount of IRA contributions to escalate five-fold in the early 1980s.23


21. See, e.g., H.R. REP. No. 807, 93d Cong., 1st Sess. 521 (1974) (comparing original IRA proposal submitted by Nixon administration with IRA proposal adopted by ERISA, and noting that administration's proposal was broader because it allowed employees covered by employer plans with low benefit levels to establish IRAs) (statement of Rep. Broyhill); see also JAMES R. STOREY, INDIVIDUAL RETIREMENT ACCOUNT ISSUES AND SAVINGS ACCOUNT PROPOSALS 1 (Cong. Res. Serv. Issue Brief No. IB99085, 1995). Storey argues that workers covered by an employer sponsored plan also need supplemental income for retirement. Id. Also, even though an employee may be covered by a pension, that does not mean the employer will receive benefits under the plan since a certain number of years of employment must pass for the benefits to be vested, and thereby legally enforceable. Id.


23. STOREY, supra note 21, at 2. The number of participants went from 3.4 million tax filers in 1981 to 12 million in 1982. Id. The number of contributions climbed from $4.8 billion in 1981 to $28.3 billion in 1982. Id. Some of the increase can be attributed to advertising and other active promotional tactics. Id. at 2-3.
The IRA's popularity abruptly ended, however, when the Tax Reform Act of 1986 became law. Congress effectively reduced the tax benefits derived from IRA contributions by lowering individual marginal tax rates. Additionally, in the same Act, Congress restricted the deductibility of IRA contributions to workers not covered by employer-sponsored plans or workers who met certain income tests.

Congress made the 1986 changes because it determined that the expanded availability of IRAs had no discernible impact on aggregate personal savings levels. Congress also made the changes because statistical studies indicated that it was primarily wealthier taxpayers, who presumably would have saved adequately for retirement without savings incentives, who participated in IRA programs. Notwithstanding the findings and conclusions responsible for the 1986 limitations on the deductibility of IRA contributions, however, last year Congress passed new ADSA legislation that would have restored the benefits taken away from IRAs by the Tax Reform Act of 1986.

24. *Id.* at tbl. 1. In 1986, 15.5 million taxpayers claimed an IRA deduction. In 1987, when the Tax Reform Act of 1986 came into effect, 7.3 million taxpayers claimed an IRA deduction. *Id.*

25. In the early 1980s, the effect of the diminished incentive was particularly acute for tax returns reporting adjusted gross income over $50,000. *Id.* at 4-5.

In 1985, about 1 in 12 tax returns with AGI between $10,000 and $20,000 reported IRA contributions, while 58% of returns with AGI over $50,000 reported them. In 1987, IRA contributions fell to 5% of the $10,000-$20,000 income group and 8% of the over-$50,000 group. *Id.* at 5.

26. All taxpayers who contribute to IRAs, even if they cannot claim a deduction, enjoy the tax-free build-up of their investment earnings. Limiting the ability to deduct an IRA contribution was done in an effort to widen the income tax base to help offset the lowering of the marginal tax rates. *Id.; see* Marino, *supra* note 19. For joint tax filing units with one earner, the spousal IRA contribution limit is a combined $2,250. I.R.C. § 219(c) (1996). A two-wage-earning couple in which one spouse has minimal earnings can elect to be taxed as a one-earner couple, and be subject to the $2,250 limit. *Id.* § 219(c)(1)(B)(ii). Two-wage-earner couples may contribute up to $4,000. *Id.* § 219(b).

27. Storey, *supra* note 21, at 6 (concluding from research and prior experience with universal deductibility that effects of IRAs on savings are modest at best and any new savings flowing into IRAs may well have materialized without IRAs).

28. See *id.* at 5-6 (discussing disproportionate use of IRAs among wealthier taxpayers); *Joint Comm. on Taxation, supra* note 7, at 16-17.

29. See Marino, *supra* note 19 (discussing action taken by congress to restore benefits eliminated under Tax Reform Act of 1986). The White House Middle Class Bill of Rights would have expanded the income threshold for full IRA deductions to $50,000 for individuals and $80,000 for families. It would have allowed tax-free access for college, first-time home purchases, medical emergencies and long-term unemployment. Similarly, the Senate's Roth-Breaux Super IRA would have restored full deductibility to everyone regardless of income and allowed the same kind of penalty free early withdrawals. *Id.*
B. The ADSA

Consistent with the treatment of traditional IRAs, investment earnings in the ADSA would accrue tax-free subject to certain conditions. Under traditional IRA rules, deductible contributions are available only to taxpayers not covered by employer sponsored retirement plans, or taxpayers whose annual compensations do not exceed minimum income levels. All distributions from traditional IRAs are taxed upon receipt. In contrast, contributions to an ADSA would be non-deductible, and all distributions from an ADSA occurring after age $59\frac{1}{2}$ would be tax exempt. Distributions prior to age $59\frac{1}{2}$ from an ADSA open for at least five years also would be tax exempt, provided that the funds were used for the purchase of a first-time home, educational expenses, or medical expenses. Distributions from an ADSA prior to age $59\frac{1}{2}$ for non-qualified purchases would be subject to an early distribution excise tax. Additionally, the ADSA legislation would increase the $250 IRA contribution limit for nonworking spouses to $2,000.

By establishing a new IRA that does not incorporate the 1986 restrictions on deductibility, proponents of the ADSA are attempting to recreate the level of popularity that IRAs enjoyed in the early 1980s. By extending the flexibility of IRA usage beyond that of the pre-1986 period, proponents are hoping to attract even greater numbers of low- and middle-income savers than in the early 1980s. ADSA supporters believe that individuals ordinarily reluctant to save in traditional retirement savings arrangements for fear of losing access to their funds would be encouraged to save in the more flexible ADSAs. However, the use of retirement funds for non-retirement purchases redefines established pension policy by shifting the focus away from an exclusive retirement saving goal toward a more general personal savings goal. As a result, the expanded IRA raises numerous equity and social concerns.

Contributions to an ADSA would not affect a taxpayer's eligibility to make contributions to other saving arrangements, including traditional

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30. To qualify for a full deduction of $2,000, an individual must satisfy one of two conditions: (1) the individual, or her spouse, is not covered by an employer sponsored plan, or (2) the total adjusted income is less than $40,000 for a taxpayer filing a joint return, or less than $25,000 for a single taxpayer. I.R.C. § 219(g)(1)-(3) (1996).
32. Id. (proposing additions to I.R.C. § 408A, at §§ 408A(d)(2)(B), 408A(e)).
33. Id. (proposing additions to I.R.C. § 408A, at § 408A(d)(1)(B)).
36. See Gene Epstein, The Coming Changes in IRAs Will Be Popular, But They Won't Make Americans Save More, BARRON'S, Jan. 16, 1995, at 51, 51 (noting that purpose of IRAs is to provide savings incentive).
IRAs.\textsuperscript{37} Provisions of the ADSA legislation would allow all wage earners to contribute to ADSAs regardless of income, or employer-sponsored plan participation status.\textsuperscript{38} For an interim period,\textsuperscript{39} ADSAs would accept penalty-free rollovers from existing IRAs. At the time of such transfers, an income tax would be assessed against the rolled-over amounts.\textsuperscript{40} Future earnings on rolled-over amounts would accrue tax free and distributions from ADSAs resulting from the rolled-over amounts would be subject to the ADSA distribution rules.

Removing the 1986 restrictions on the tax deferred status of IRAs would most likely increase contributions to the more flexible IRAs. However, the ADSA's flexible distribution rules and its acceptance of IRA roll-overs radically change federal pension policy which historically has been aimed at encouraging individuals who ordinarily could not save for retirement to do so. Furthermore, the ADSA's expansion of the available uses for retirement savings also jeopardizes the retirement security of middle- and low-income Americans because it creates disincentives for them to save adequately for retirement, by permitting the use of retirement funds for current consumption items. Consequently, it is unlikely that expansive distribution provisions like those contained in the ADSA legislation would significantly benefit low- and middle-income taxpayers or bring about the intended result of increasing their aggregate personal savings.

C. Shift in Pension Policy

The United States savings rate is one of the lowest in the developed world.\textsuperscript{41} However, more Americans save for retirement than for any other saving goal.\textsuperscript{42} It is the relative popularity of retirement saving in general that has led to the recent interest in using traditional retirement vehicles to encourage tax-preferred saving for other purposes, such as college education, first-home purchases, and medical emergencies.

The underlying reason for the preferential tax treatment of retirement saving plans, including IRAs, is to encourage retirement saving, which in turn increases economic security in old age. In order to ensure that individuals

\begin{itemize}
  \item \textsuperscript{37} Tax Bill Debate, supra note 34, at 13-15.
  \item \textsuperscript{38} H.R. 1215, 104th Cong., 1st Sess. § 6103 (1995) (proposing addition to I.R.C. § 408A, at § 408A(c)(2)). It is also proposed to increase the $250 IRA contribution limit for nonworking spouses to $2,000. Id. § 6104 (proposing amendment to I.R.C. § 219(c)). While individuals could contribute up to $2,000 annually, married couples filing jointly could contribute up to $4,000 to an ADSA.
  \item \textsuperscript{39} Id. § 6103 (proposing addition to I.R.C. § 408A, at § 408A(c)(5)). Rollovers from existing IRAs would be accepted by ADSAs from December 31, 1996, through January 1, 1998. Id.
  \item \textsuperscript{40} Id. (proposing addition to I.R.C. § 408A, at § 408A(d)(3)). The tax would be assessed ratably over a four year period starting with the taxable year the rollover was made. Id.
  \item \textsuperscript{41} Steve Farkas & Jean Johnson, Promises to Keep: How Leaders and the Public Respond to Saving and Retirement 8 (Public Agenda & Employee Benefit Res. Inst. eds., 1994).
  \item \textsuperscript{42} Id. at 9. The amount saved is very low. Id.
\end{itemize}
actually use their retirement funds for retirement purposes, Congress imposes restrictions on the use of retirement savings. Non-retirement use of retirement funds is discouraged by a 10% excise tax on all early distributions from tax-favored retirement saving arrangements, unless such distributions are made on account of death or disability.43

Historically, IRAs also have been viewed exclusively for the purpose of retirement saving. Therefore, all early distributions from IRAs are also subject to the early distribution excise tax. Notwithstanding the penalty for early withdrawal, however, many individuals continue to take early distributions from their IRAs. Because early distributions enable individuals to spend retirement funds on current consumption, some policymakers have argued that the early withdrawal penalty should be higher to deter individuals from using their retirement assets for non-retirement purposes.44 While some commentators have expressed concern about early distributions, other commentators have speculated that the penalties for such distributions are too severe. They maintain that the reason many who are eligible to utilize tax-deferred IRAs choose not to is because they are hesitant to put savings in vehicles that place their assets beyond their reach, for fear that they will need the funds before retirement.45

The more flexible withdrawal rules of the ADSA address the latter concern by allowing penalty-free access to retirement funds after five years for qualified expenditures. The change in rules not only expands the concept of the private pension system, but also de-emphasizes the importance of retirement saving. Thus, the more flexible distribution rules effectively create a new tax-subsidy for qualified current consumption items.

Regardless of the restrictions placed on the non-retirement uses of the ADSA, if retirement funds are spent for current consumption they will not be available for retirement.46 The ADSA legislation, therefore, violates Congressional intent and fundamental pension policy by allowing individuals to use retirement funds for purposes other than retirement security.47 As a consequence, if the ADSA or another flexible retirement saving proposal becomes law, millions of Americans who previously were encouraged to save for retirement through the favorable tax treatment of retirement arrangements, and discouraged from using those funds for current consumption by the 10% excise tax on early withdrawals, could choose freely to divert their retirement savings to non-retirement uses.

Because wealthy Americans have sufficient discretionary income to save adequately for retirement, they need no additional incentives to save for this

43. I.R.C. § 72(t) (1996); Langbein & Wolk, supra note 6, at 348.
46. Langbein & Wolk, supra note 6, at 342.
TAX POLICY IMPACT OF FLEXIBLE IRAs

D. Dis-savings for Retirement

ADSAs would be popular because they would provide penalty-free access to tax-subsidized retirement funds before retirement.48 However, it is doubtful that the availability of ADSAs would result in an overall net increase in savings for individual taxpayers, because any projected increase in ADSA savings would likely be accomplished at the expense of traditional retirement savings. This is particularly true for the interim period that the ADSA would permit the transfer of funds from existing IRAs to ADSAs.49 During this period, all prior contributions made to traditional IRAs, including lump sum distributions from employment based pension plans50 previously rolled over into traditional IRAs, would be eligible for penalty-free transfer to ADSAs.51

Rolled-over contributions represent significant amounts of retirement savings.52 From 1987 through 1990, for example, taxpayers made $11.2 million in roll-over contributions to traditional IRAs.53 During the same period, total IRA contributions reached $220 billion.54 Thus, if the roll-over feature of the ADSA legislation ever becomes law, after five years as much as $220 billion of current IRA retirement funds would be available penalty-free for non-retirement purposes. Therefore, not only would the ADSA redefine future pension policy, but it potentially would undermine the success of the existing retirement program by allowing early withdrawals of funds currently earmarked for retirement for non-retirement purposes.55

Proponents of the ADSA are likely to argue that spending for the permitted purposes is not inconsistent with retirement policy and, in fact, en-

48. Murray & Yakoboski, supra note 45, at 3.
49. Although the legislation treated the transfer of funds from an existing IRA to an ADSA as a taxable event, these funds would not have been subject to the I.R.C. § 72(t) penalty tax. H.R. 1215, 104th Cong., 1st Sess. § 6103 (1995) (proposing addition to I.R.C. § 408A, at § 408A(d)(1)).
50. The taxation of certain distributions from qualified plans is deferred if the funds are transferred to an IRA, or to another qualified plan, within 60 days after receipt of the funds. I.R.C. § 402(c) (1996).
52. Id. at 4. See also Prepared Testimony of Martin Jaffe, C.F.P., President, International Ass'n for Financial Planning (IAFP) Before the House Committee on Ways and Means, Jan. 31, 1995 [hereinafter Jaffe Testimony].
53. Murray & Yakoboski, supra note 45, at 4; see also PAUL YAKOBOSKI, RETIREMENT PROGRAM LUMP-SUM DISTRIBUTIONS: HUNDREDS OF BILLIONS IN HIDDEN PENSION INCOME (Employee Benefit Res. Inst. Brief No. 146, 1994).
54. See YAKOBOSKI, supra note 53.
55. STOREY, supra note 21, at 8.
hances future retirement income security. In other words, they will maintain that purchasing a first home, educating children, and saving for medical expenses are socially desirable goals consistent with pension policy and public interest. However, for individuals who use different types of savings vehicles for different savings goals, the limitations placed on the use of ADSA funds could prove meaningless, if taxpayers shift their accumulated savings from traditional retirement saving arrangements to the more flexible ADSA.

The following example illustrates this point. Assume that, some years ago, a taxpayer desired to save for retirement, pay for a child's education, and purchase a new sports car. However, having limited resources, the taxpayer was forced to abandon one of the saving goals. The taxpayer decided to forgo the sports car and save for college tuition and retirement through mutual funds and traditional IRAs, respectively.

Further assume that the ADSA becomes law and the taxpayer rolls over the entire IRA balance into an ADSA in order to have earlier access to the funds. By the time the rollover occurs, the retirement fund has grown to a level that may appear to be a comfortable amount for retirement. However, the appearance of adequate savings may be misleading, given the uncertainty of future inflation, anticipated income increases, and expected investment performance. Several years later the taxpayer's child enters college and tuition becomes due. Notwithstanding years of sacrificing to save for retirement security, the taxpayer decides to take a tax-free distribution from the ADSA to pay for the child's tuition because the taxpayer is unaware that the retirement fund may be insufficient. As a result of this decision, the funds in the mutual fund are now available to purchase the new sports car which the taxpayer initially desired.

By shifting saving goals and saving instruments, the taxpayer is indirectly able to use the ADSA funds, which have received tax-free earnings over several years, to purchase a new sports car. Most people would agree that the purchase of the sports car would not be consistent with retirement income security. Yet the transfer of traditional IRA funds to the ADSA facilitated the purchase. Absent the ADSA, the sports car purchase would not have been possible for the taxpayer without either incurring a substantial penalty or forgoing the child's education. Thus, by playing a game of "musical funds," individuals could gain early, penalty-free access to their retirement funds for a first home, education, or a medical emergency, freeing up money that otherwise would have been saved for one of the qualified purchases to

56. See Murray & Yakoboski, supra note 45, at 5.
57. See id.
59. See supra notes 31-40 and accompanying text for a discussion of how ADSAs provide tax-free earnings.
60. See supra notes 44-45 and accompanying text for a discussion of the disadvantages of IRAs for saving purposes.
be spent on unqualified uses. Although the unqualified purchases are likely to be inconsistent with retirement security, the transfer of funds from traditional retirement vehicles could nevertheless, as this example illustrates, make such purchases possible.

E. Adverse Effect on Employer Sponsored 401(k) Plans

In addition to its negative impact on the retirement savings program in general, the ADSA, and similar flexible IRA proposals, threaten the viability of certain employer-sponsored retirement savings arrangements in which the employee is given an option to make elective contributions from current wages. These plans are known as 401(k) plans. Under existing law, there is general consistency in the withdrawal rules for 401(k) plans and IRAs. Therefore, the ADSA's more flexible distribution rules would give the ADSA a competitive advantage over employer sponsored elective contribution plans. This situation ultimately could cause contributions to 401(k) plans to decline, particularly among low-paid individuals who are more likely to value the ADSA's early access feature.

Most employers already have difficulty persuading lower-paid employees to contribute to elective contribution plans. Participation among lower paid employees is necessary to enable qualified plans to meet ERISA’s nondiscrimination tests. Failure to meet the nondiscrimination standards results in a plan losing its preferential tax status. Thus, some employers may refrain from establishing or maintaining 401(k) plans, assuming that low-income employees would prefer saving in more flexible ADSAs. This decision could prove problematic for future retirees because it is generally believed that 401(k) plans are more generous and offer greater retirement security than IRAs.

For example, 401(k) plans often have employer matching features as a way of encouraging participation. Under such options the employer matches a given percentage of every dollar of pay contributed by the employee to the 401(k) plan; accordingly, plan participants receive a greater return from their investments than they would if they saved in an IRA type vehicle.

64. Gordon Williams, Pension Piranhas, FIN. WORLD, May 23, 1995, at 81.
65. See I.R.C. §§ 401(a)(4)-(5) (1996) (detailing non-discrimination requirements); see also id. § 411.
66. Id. § 401(a). One method of avoiding disqualification is for the employer to make contributions on behalf of all non-highly compensated employees. LANGBEIN & WOLK, supra note 6, at 254; see also Treas. Reg. § 1.401(k)-1(b)(5) (as amended in 1993) (stating that qualified nonelective contributions must satisfy nondiscrimination rules); Williams, supra note 64, at 81.
68. LANGBEIN & WOLK, supra note 6, at 252-53. Matching contributions must satisfy special nondiscrimination rules. Id. at 253; see I.R.C. § 401(m) (1996).
More importantly, however, employer-sponsored plans typically are managed by professionals who are more likely to have the expertise to use investment strategies that achieve maximum investment performance. In contrast, the ADSA, like the traditional IRA, would require that investment decisions be made by individual ADSA holders who may have little or no experience in financial management.

F. IRAs Provide Little to Lower-Income Americans

The ADSA was marketed as part of a middle-income tax relief package. However, most of the direct benefits of the ADSA would go to upper-income individuals. The most obvious reason the ADSA disproportionately would benefit wealthier Americans is because of the tax system's progressive tax rate structure. The applicable tax rate increases as individuals earn more income. Thus, the advantage of tax deferral increases as an individual's marginal tax rate increases, making the incentive to save in a tax deferred account greater for high-income taxpayers than for low-income taxpayers.

Flexible retirement savings programs such as the ADSA raise other related concerns about the fairness and merits of a savings program based solely on tax incentives. For example, giving preferential tax treatment to first time home buyers adds to the large tax subsidy already given to homeowners which results from the exclusion of imputed income and the deductibility of interest paid for qualified residential mortgages. Thus, the ADSA would increase the disparate tax treatment between individuals who can afford to own their homes and those who cannot.

Another reason wealthy Americans are likely to benefit more from ADSA type legislation is that households already contributing to IRAs tend to be wealthier than households that do not. The primary reason given by

69. Philip & Anand, supra note 63, at 3; see also Regina T. Jefferson, Rethinking the Investment Risk of Defined Contribution Plans (unpublished manuscript, on file with author).

70. Some employer-sponsored plans, known as self-directed plans, do allow participants to choose their own investments.


72. Gary Belsky, Why Most of the Rich Will Get Richer, MONEY, May 1995, at 134, 134-36; see also Chandler, supra note 71, at A27 (stating that Democrats argue Republican proposals will provide windfall for higher income taxpayers).

73. Section 1 of the Internal Revenue Code imposes a 15% tax on the first $22,100 for unmarried individuals, and a rate of 28% on income between $22,100 and $53,500. Thus, for example, if an unmarried individual with taxable income of $10,000 receives additional income of $100, it would be taxed at 15%. Thus, a deduction of $100 results in a tax savings of $15 to the taxpayer. If however, an individual has taxable income of $50,000, additional income of $100 would be taxed at 28%. Thus, a deduction of $100 results in a tax savings of $28.

74. STOREY, supra note 21, at 8; see I.R.C. § 163(h)(2)(D) (1996) (allowing deduction for interest on purchase of qualified residence).

75. See STOREY, supra note 21, at 8.

TAX POLICY IMPACT OF FLEXIBLE IRAs

non-wealthy wage earners for failing to establish IRAs is lack of money. More than 40% of low-income non-IRA-owners reveal that after meeting the cost of their necessities and basic expenses, nothing is left to contribute to an IRA. Seventy-four percent of households with income of less than $40,000 do not save at all because of inadequate income. Therefore, unless Americans earn more in wages, they will continue to lack sufficient disposable income to take advantage of the ADSA, or for that matter, any other savings program.

To the extent that the increased contribution limits for expanded IRAs are expected to increase total savings among low and middle-income individuals, the legislation would have little effect. This prediction can be more fully understood by looking at traditional IRA contribution patterns. In 1987, only 5% of households earning between $10,000 and $20,000 made IRA contributions. At that time, these households were eligible to make fully deductible contributions of $2,000 to their IRAs. Presumably, the low IRA participation rate is attributable to low earnings rather than low contribution limits. Thus, the fact that the ADSA raises the contribution level for single wage earner couples from $2,250 to $4,000 would have little or no effect on couples who cannot afford to contribute $2,250 under current law. Similarly, allowing all wage earners to make contributions up to the $2,000 limit, $4,000 for couples, regardless of income, would not motivate individuals who currently have insufficient disposable income to save.

Thus, the principal beneficiaries of the ADSA’s increased contribution limits would be those who already save and, therefore, require no additional incentive to do so. Such individuals stand to benefit substantially from an expanded IRA because they would be given a more tax-efficient method of saving for education, first home purchases, and medical care expenses which are activities for which there already exists preferential tax treatment.

G. Expanded IRAs May Not Be Effective In Increasing Overall Savings

If the objective of the ADSA legislation is to increase savings in general, then a fair question to ask is whether taxpayers are likely to use ADSAs for savings. The Joint Committee on Taxation estimated that 73% of all tax-

78. Id.
79. Farkas & Johnson, supra note 41, at 14.
80. Storey, supra note 21, at 5 (noting that 8% of those earning over $50,000 made contributions in spite of nondeductibility).
81. But see Joint Comm. on Taxation, supra note 7, at 52-55. Some observers suggest that the heavy marketing of IRAs to the public in the mid-1980s was a large determinant of the high IRA participation rates in the mid-1980s. Accordingly, the decline in IRA contributions after 1986, may be due, in part, to decreased IRA advertising after 1986. Id.
82. See, e.g., I.R.C. § 213(a) (1996) (providing deduction for medical expenses exceeding 7.5% of adjusted gross income); id. § 127(a) (1996) (providing exclusion of up to $5,250 for educational assistance provided by employer); id. § 163(h) (1996) (allowing deduction for interest on qualified residence).
83. Murray & Yakoboski, supra note 45, at 3.
payers with earned income in 1991 were eligible for full tax deferral of IRA contributions, and 9% were eligible for partial deferrals. However, only 2% of the eligible population made contributions to IRAs in 1991. Furthermore, during the peak of IRA participation in the early 1980s, IRA contributions never accounted for more than 1% of disposable income. Therefore, the IRA's history of limited participation suggests that it is very unlikely that the ADSA would do much to improve personal savings in America.

One of the most controversial features of the ADSA is that it is back-loaded. Taxpayers choosing an ADSA over a traditional IRA must be willing to pay current taxes on funds not available to them in reliance on a future tax benefit. If tax rates remain constant, back-loaded and front-loaded savings arrangements provide the same tax benefits. A numerical example can illustrate this point. Assume that a couple invests $4,000 in retirement saving arrangements at a 5% rate of return. The couple's marginal tax rate is 28%, and they plan to retire in fifteen years. If the taxpayers choose to invest in back-loaded ADSAs, they would pay an initial tax of $1,120, which leaves $2,880 to invest. At the end of the fifteen-year-period their total balance would be $5,988, and would be free from tax.

In contrast, if the couple invests $4,000 in front-loaded IRAs, they would pay no taxes initially, leaving the entire $4,000 to invest at 5%. At the end of the fifteen-year-period their total balance would be $8,316. A 28% tax would apply when the funds were distributed, leaving the couple again with $5,998 for their retirement.

If tax rates were expected to increase, the back-loaded feature would encourage increased ADSA contributions because taxpayers would prefer paying taxes determined under the lower tax rate structure. Conversely, if tax rates were expected to decrease, taxpayers would find it more advantageous to invest in traditional IRAs. Thus, the back-loaded feature of the ADSA presents a calculated risk for prospective ADSA savers who may anticipate having future lower marginal tax rates as a result of a rate change, or a decrease in income.

Even in the absence of concern about the possibility of marginal tax rate changes, however, the back-loaded feature of the ADSA alone may render it ineffective as a saving incentive. ADSAs may have less appeal than traditional IRAs simply because the ADSA does not immediately minimize a taxpayer's tax liability. As discussed above, during the early 1980s the IRA program was much more popular than it is today, particularly for middle-

84. See Storey, supra note 21, at 2-3.
85. Chandler, supra note 71, at A27. Back-loaded refers to the fact that the taxpayer pays taxes on the amount contributed initially, but receives a tax benefit at the end when the funds are withdrawn tax-free. Id.
87. Chandler, supra note 71, at A27. Early withdrawal of funds for non-qualified purposes, however, would be subject to an excise tax. Id.
88. Id.
89. Id.
income individuals. Once IRAs were restricted, however, and the tax deductible feature was eliminated for most workers, many individuals discontinued their contributions. Just as the elimination of the immediate deduction contributed to the sharp decline in IRA participation in 1986, the absence of an immediate deduction for ADSAs may significantly minimize their investment appeal today.

An additional reason ADSAs may not have much appeal is the currently low tax rates. IRAs were most popular before the Tax Reform Act of 1986, when tax rates were substantially higher. Consequently, during this period deductions were more valuable than they would be today to taxpayers with higher marginal tax rates.

H. Administrative Difficulties and Adverse Budgetary Implications

The ADSA would introduce substantial administrative complexity. It would be necessary to give taxpayers explanations about the differences in front-loaded and back-loaded IRAs as well as the complicated definitions and requirements for meeting the criteria for qualified expenditures. The ADSA would also be administratively burdensome to taxpayers and the IRS in efforts to account for and accurately measure the five-year holding period necessary for tax-free distributions. Moreover, many taxpayers would have both traditional IRAs and ADSAs, causing great confusion about the inconsistent distribution rules for the two types of accounts. As a result, taxpayers would incur additional reporting requirements, and the Treasury would incur additional costs for the administration of ADSAs and their enforcement.

Budgetary estimates indicate that if the ADSA had become law, not only would there have been significant administrative difficulties, but there also would have been substantial fiscal challenges. For the interim period that ADSA legislation would have permitted rollovers from traditional IRAs, the ADSA would have produced revenue because these transactions would be subject to an income tax. The income tax would be paid on the

90. See Jaffe Testimony, supra note 52.
92. See supra note 73 for an explanation of the effect of a progressive marginal tax rate. On the other hand, relatively low rates may encourage some taxpayers to invest in ADSAs and incur current tax liability because the risk of higher tax rates in the future is greater. JOINT COMM. ON TAXATION, supra note 7.
93. Chandler, supra note 71, at A27 (stating that “many budget experts decry the IRA provisions in the bill as a ‘fiscal time bomb’”).
94. Id. (stating that “converting old accounts and opening new ones would increase revenue in the short term—Republicans project the accounts will generate $4.7 billion in the bill’s first five years”). The Joint Committee on Taxation estimates that the American Dream Savings Account would raise $2.2 billion over the first five years. See H. Jane Lehman, IRA Proposals Could Aid First-Time Buyers: Congress Weighs Waiving Withdrawal Penalty, WASH. POST, Feb. 11, 1995, at E1, E9. However, over the second five years, the committee estimates that the ADSA will lose $23.9 billion. Id. The Treasury estimates that over the first five years, the ADSA will raise closer to $5 billion and will lose $22.7 billion in revenues over the second five
rolled-over amounts over a four-year period beginning with the taxable year in which the transfer was made. Estimates from the Joint Committee on Taxation predicted that $2 to $5 billion would be raised in the first five years of the ADSA program. However, after five years, as individuals became eligible for the tax-free distributions of the investment earnings on their contributions, estimates show that the ADSA would have reduced revenue by approximately $24 billion. Thus, the ADSA would be expected to cause a substantial net revenue loss in its first ten years.

Therefore, in the long run, rather than increasing national savings, the ADSA would increase the federal deficit. Moreover, as taxpayers would continue to withdraw their funds tax-free from their ADSAs, the cost of the program would grow exponentially.

CONCLUSION

The ADSA is an example of an expansive IRA proposal. It represents a dramatic movement away from existing pension policy which provides greater incentives to save for retirement security than for current consumption. This shift in policy potentially has serious implications for future retirement income saving. In particular, to the extent that the ADSA and other flexible IRA proposals would permit penalty-free access for certain non-retirement expenditures, the shift discourages future retirement saving among middle- and low-income individuals who have previously been encouraged to save for retirement through existing retirement saving incentive programs.

Additionally, for the interim period that the ADSA would accept roll-overs from traditional IRAs, many individuals would be encouraged to remove funds from their traditional IRAs and place them in the more flexible accounts in order to have earlier access for non-retirement purposes. As a result of these transfers, increased contributions to ADSAs would not represent additional personal savings at all. Instead, this activity would represent an erosion of existing retirement savings. Therefore, the ADSA would very likely be unsuccessful at accomplishing its goal of increasing aggregate personal savings among non-wealthy Americans. For these reasons, an expanded IRA program could prove to be fiscally irresponsible and economically unsound to the extent that it widens the current deficit without increasing aggregate personal savings or providing tax relief to non-wealthy Americans.

years. Alissa J. Rubin, Tax Cuts, 10 Years down the Road, 53 CONG. Q. WKLY. REP. 345 (Feb. 4, 1995).  
95. Murray & Yakoboski, supra note 45, at 2.  
96. JOINT COMM. ON TAXATION, supra note 7; see also Lehman, supra note 94, at E9.  
97. Chandler, supra note 71, at A27.  