General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals

Department of the Treasury
May 2009

This document is available in Adobe Acrobat format on the Internet at:
http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf
The free Adobe Acrobat Reader is available at: http://get.adobe.com/reader/

EXPAND THE SAVER'S CREDIT AND PROVIDE FOR AUTOMATIC ENROLLMENT IN IRAS

Expand the Saver's Credit

Current Law

A nonrefundable tax credit is available for eligible individuals who make voluntary contributions to 401(k) plans and other retirement plans, including IRAs. The maximum annual contribution eligible for the credit is $4,000 for married couples filing jointly and $2,000 for single taxpayers or married individuals filing separately, resulting in maximum credits of $2,000 and $1,000, respectively. The credit rate is 10 percent, 20 percent or 50-percent, depending on the taxpayer's adjusted gross income (AGI) (the amount of which is adjusted each calendar year based on the cost-of-living adjustment). In 2009, "eligible individuals" who may claim the credit are

- Married couples filing jointly with incomes up to $55,500;
- Heads of households with incomes up to $41,625; and
- Married individuals filing separately and singles with incomes up to $27,750,

who are 18 or older, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The credit is available with respect to an eligible individual's "qualified retirement savings contributions." These include (i) elective deferrals to a section 401(k) plan, section 403(b) plan, section 457 plan, SIMPLE, or simplified employee pension (SEP); (ii) contributions to a traditional or Roth IRA; and (iii) other voluntary employee contributions to a qualified retirement plan, including voluntary after-tax contributions and voluntary contributions to a defined benefit pension plan. The eligible individual may direct that the amount of any refund attributable to the credit may be directly deposited by the IRS into an IRA or certain other accounts.

The credit is nonrefundable and, therefore, offsets regular tax liability or minimum tax liability. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution.

Reason for Change

The saver's credit should be amended to more effectively encourage moderate- and lower-income individuals to save for retirement. Because it is currently nonrefundable, the saver's credit only offsets a taxpayer's income tax liability and therefore gives no saving incentive to tens of millions of households without income tax liability. In addition, the current three-tier credit rate structure should be simplified, the eligibility income threshold should be raised to increase the number of households eligible for the credit, and the credit rate should be increased for most eligible households. Finally, making the saver's credit more like a matching contribution would enhance the likelihood that the credit would be saved and would increase the salience of the incentive by framing it as a match similar to the familiar employer matching contributions to 401(k) plans.

Proposal

The proposal would make the saver's credit fully refundable and would provide for the credit to be deposited automatically in the qualified retirement plan account or IRA to which the eligible individual contributed. Making the saver's credit more like a matching contribution would enhance the likelihood that the credit would be saved and would increase the salience of the incentive by framing it as a match similar to the familiar employer matching contributions to 401(k) plans. The proposal would offer a meaningful saving incentive to tens of millions of additional households while simplifying the current three-tier credit structure and raising the eligibility income threshold to cover millions of additional moderate-income taxpayers.

In place of the current 10-percent/20-percent/50-percent credit for qualified retirement savings contributions up to $2,000 per individual, the proposal would match 50-percent of such contributions up to $500 per individual (indexed annually for inflation beginning in taxable year 2011). The eligibility income threshold would be increased to $65,000 for married couples filing jointly, $48,750 for heads of households, and $32,500 for singles and married individuals filing separately, with the amount of savings eligible for the credit phased out at a 5-percent rate for AGI exceeding those levels.

The proposal would be effective December 31, 2010.

Automatic Enrollment in IRAS

Current Law

A number of tax-preferred, employer-sponsored retirement savings programs exist under current law. These include section 401(k) cash or deferred arrangements, section 403(b) programs for public schools and charitable organizations, section 457 plans for governments and nonprofit organizations, and simplified employee pensions and SIMPLE IRAs for small employers. Individuals who do not have access to an employer-sponsored retirement saving arrangement may be eligible to make smaller tax-favored contributions to individual retirement accounts or individual retirement annuities (IRAs).

IRA contributions are limited to $5,000 a year (plus $1,000 for those age 50 or older). Section 401(k) plans permit contributions (employee plus employer contributions) of up to $49,000 a year (of which $16,500 can be pre-tax employee contributions) plus $5,500 of additional pre-tax employee contributions for those age 50 or older.

Reasons for Change

For many years, until the current recession, the personal saving rate in the United States has been exceedingly low. In addition, tens of millions of U.S. households have not placed themselves on a path to become financially prepared for retirement, and the proportion of U.S. workers participating in employer-sponsored plans has remained stagnant for decades at no more than about half the total work force notwithstanding repeated private-sector and congressional attempts to expand coverage. Participation in employer-sponsored retirement saving plans such as 401(k) plans typically has ranged from two thirds to three quarters of eligible employees, but making saving easier by making it automatic has been shown to be remarkably effective at boosting participation. Automatic enrollment in 401(k) plans (enrolling employees by default unless they opt out) has tended to increase participation to more than 9 out of 10 eligible employees. In contrast, for workers who lack access to a retirement plan at their workplace and are eligible to engage in tax-favored retirement saving by taking the initiative and making the decisions required to establish and contribute to an IRA, the IRA participation rate tends to be less than 1 out of 10.

Numerous employers, especially those with smaller or lower-wage work forces, have been reluctant to adopt a retirement plan for their employees, in part out of concern about their ability to afford the cost of making employer contributions or the per-capita cost of complying with tax-qualification or ERISA (Employee Retirement Income Security Act) requirements. These employers could help their employees save -- without employer contributions or plan qualification or ERISA compliance -- simply by making their payroll systems available as a conduit for regularly transmitting employee contributions to an employee's IRA. Such "payroll deduction IRAs" could build on the success of workplace-based payroll-deduction saving by using the excess capacity to promote saving that is inherent in employer payroll systems, especially those that use automatic enrollment. However, despite efforts a decade ago by Treasury, the IRS, and the Department of Labor to approve and promote the option of payroll deduction IRAs, few employers have adopted them or even are aware that this option exists.

Accordingly, requiring employers that do not sponsor any retirement plan (and that are above a certain size) to make their payroll system available to employees and automatically enroll them in IRAs could achieve a major breakthrough in retirement saving coverage. Many employers may then be more willing to take the next step and adopt an employer plan (permitting much greater tax-favored employee contributions than an IRA plus the option of employer contributions). In addition, the process of saving and choosing investments could be simplified for employees, and costs minimized, through a standard default investment as well as electronic information and fund transfers. Workplace retirement savings arrangements made accessible to most workers also could be used as a platform to provide and promote retirement distributions annuitized over the worker's lifetime.

Proposal

Employers in business for at least two years that have 10 or more employees would be required to offer an automatic IRA option to employees on a payroll-deduction basis, under which regular payroll-deduction contributions would be made to an IRA. If the employer sponsored a qualified retirement plan or SIMPLE for its employees, it would not be required to provide an automatic IRA option for any employee. Thus, for example, a qualified plan sponsor would not have to offer automatic IRAs to employees it excludes from qualified plan eligibility because they are collectively bargained, under age 18, nonresident aliens, or have not completed the plan's eligibility waiting period. However, if the qualified plan excluded from eligibility a portion of the employer's work force or a class of employees such as all employees of a subsidiary or division, the employer would be required to offer the automatic IRA option to those excluded employees.

The employer offering automatic IRAs would give employees a standard notice and election form informing them of the automatic IRA option and allowing them to elect to participate or opt out. Any employee who did not provide a written participation election would be enrolled at a default rate of three percent of the employee's compensation. Employees could opt for a lower or higher contribution rate up to the IRA dollar limits. For most employees, the payroll deductions would be made by direct deposit similar to the direct deposit of employees' paychecks to their accounts at financial institutions.

Payroll-deduction contributions from all participating employees could be transferred, at the employer's option, to a single private-sector IRA trustee or custodian designated by the employer. Alternatively, the employer, if it preferred, could allow each participating employee to designate the IRA provider for that employee's contributions or could designate that all contributions would be forwarded to a savings vehicle specified by statute or regulation.

Employers making payroll deduction IRAs available would not have to choose or arrange default investments. Instead, a low-cost, standard type of default investment and a handful of standard, low-cost investment alternatives would be prescribed by statute or regulation. In addition, this approach would involve no employer contributions, no employer compliance with qualified plan requirements, and no employer liability or responsibility for determining employee eligibility to make tax-favored IRA contributions or for opening IRAs for employees. A national web site would provide information and basic educational material regarding saving and investing for retirement, including IRA eligibility, but, as under current law, individuals (not employers) would bear ultimate responsibility for determining their IRA eligibility.

Employers could claim a temporary tax credit for making automatic payroll-deposit IRAs available to employees. The amount of the credit would be $25 per enrolled employee up to $250 each year for two years. The credit would be available both to employers required to offer automatic IRAs and employers not required to do so (for example, because they have fewer than ten employees).

Contributions by employees to automatic IRAs would qualify for the saver's credit (to the extent the contributor and the contributions otherwise qualified), and the proposed expanded saver's credit would be deposited to the IRA to which the eligible individual contributed.

The proposal would become effective January 1, 2012.