Order Code 94-83 EPW
Updated February 22, 2001

CRS Report for Congress
Received through the CRS Web

Individual Retirement Accounts: A Fact Sheet

Paul J. Graney
Analyst in Social Legislation
Domestic Social Policy Division

Background

Individual retirement accounts (IRAs), established by the Employee Retirement Income Security Act of 1974 (P.L. 93-406) to promote retirement saving, were limited at first to workers (and spouses) who lacked employer pension coverage. Income tax was deferred on both contributions and investment earnings. Annual contributions were limited to the smaller of $1,500 or 15% of earnings. Eligibility was expanded to all workers and their spouses by the Economic Recovery Tax Act of 1981 (P.L. 97-34). Annual contributions were limited to the smaller of $2,000 or 100% of earnings. The Tax Reform Act of 1986 (P.L. 99-514) continued tax deferral for IRA *earnings*, but it limited tax deferrals for *contributions* to those from: (1) tax filers with no employer plan (for either spouse); and (2) filers with employer pension coverage but whose adjusted gross income (AGI) is below specified limits. The Taxpayer Relief Act of 1997 (P.L. 105-34) increased these AGI limits, allowed penalty-free early withdrawals for higher education expenses and first-home purchases, and authorized a new "Roth IRA" to provide tax-free income from after-tax contributions and untaxed investment earnings.

Rules for 2001

Employed persons can contribute up to the lesser of annual earnings or $2,000 to an IRA. A worker's nonworking spouse also can contribute up to $2,000. However, for workers with employer pension coverage, a full $2,000 contribution can be deducted from gross income for tax purposes only if AGI does not exceed $33,000 ($53,000 for joint filers). The allowable deduction declines to $0 over the next $10,000 of AGI.[1] The uncovered spouse of a worker with employer coverage may deduct IRA contributions in full if AGI does not exceed $150,000, with deductibility phased out at $160,000. Tax is deferred on an IRA's investment earnings regardless of the taxability of new contributions.

---

[1] The AGI limits for full deductibility were raised by P.L. 105-34 from $25,000 (single filers) and $40,000 (joint filers). Further increases will occur, reaching $50,000 and $80,000, respectively, by 2007. The phaseout interval will increase to $20,000 for joint filers in 2007.

Up to $2,000 a year of after-tax earnings can be contributed to a Roth IRA by tax filers with AGI up to $95,000 ($150,000 for joint filers). This contribution limit is phased out for AGI of $110,000 ($160,000 for joint filers). Qualified withdrawals are not taxed; thus, investment earnings may escape taxation completely.

An IRA's assets must be held in trust at a financial institution and can be invested only in interest-bearing accounts, financial securities, and certain precious metals. Funds can be moved between IRAs once a year tax free if transferred within 60 days. Funds from a tax-qualified pension plan also can be moved tax free to an IRA. Transfer of IRA funds to a Roth IRA requires payment of income tax on funds that have not been taxed, but only filing units (single or joint) with AGI of $100,000 or less can make such transfers.

Withdrawals of *tax-deferred* IRA funds are taxable when received. Taxable withdrawals before age 59½ are assessed a 10% penalty tax except in case of: death; disability; payment of a lifetime annuity; payment for higher education; a first-home purchase; payment of excessive medical expenses; or payment of health insurance premiums by jobless workers. To avoid a 50% penalty tax, withdrawals must begin after age 70½ at a rate that will liquidate an IRA over the life expectancy of the accountholder and a beneficiary deemed to be 10 years younger. A married couple with more than 10 years difference in their ages may use their longer joint life expectancy. This minimum required withdrawal rule does not apply to Roth IRAs.

Trends

Assets held in IRAs have grown steadily, from $85 billion in 1983 to $2.5 trillion at the end of 1999. However, new contributions have not been the main source of this growth. New contributions made up 81% of growth in IRA assets in 1984 but accounted for an estimated 2% of growth in 1997. This shift has been caused by a decline in contributors after deductibility was limited in 1986, a steady stream of asset rollovers from employer pension plans to IRAs, and especially investment earnings. New tax-deferred contributions, which peaked at $38 billion in 1985, fell thereafter, amounting to only $8 billion in 1998. Changes to IRAs made by P.L. 105-34 may have stimulated new contributions since 1997, however.

Besides the 1986 law, another factor in the decline in new IRA contributions has been the lack of inflation indexing. Had Congress indexed the $2,000 contribution limit for inflation since setting it in 1981, the limit would have been $3,789 in 2000. Likewise, income limits on deductibility by workers with employer plans were not changed from 1986 to 1997. Had they been indexed, the $25,000 and $40,000 limits on full deductibility would have been $39,279 and $62,847, respectively, in 2000. P.L. 105-34 increases these limits in steps through 2007 but does not index them for inflation.

Because higher income workers have more discretionary income and higher tax rates, they have contributed relatively more to IRAs than have lower income workers. In 1982, 56% of workers earning over $50,000 contributed to IRAs, compared to only 19% of those with earnings between $20,000 and $25,000. After the 1986 law, participation rates fell for both groups, to 23% and 13%, respectively. A survey by the Investment Company Institute indicated that about 41% or 42.5 million households owned an IRA in June 2000: 33 million households had traditional IRAs, 10.4 million had Roth IRAs, and 7.4 million had IRAs through their employer.