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Turning Roth IRAs into Universal Savings Accounts

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In recent years, Congress has reduced taxation on personal savings by cutting the capital gains tax rate and liberalizing rules on pensions and savings vehicles. But large tax barriers to saving remain, including restrictive rules on eligibility, contributions, and withdrawals for savings vehicles such as the Roth Individual Retirement Account.

Roth IRAs allow eligible individuals to make limited deposits from after-tax income into accounts with tax-free earnings and withdrawals. Roth IRAs were created in 1997 and modestly liberalized in 2001. They should be expanded further to create "universal savings accounts," or USAs, that all families could use for all types of savings. Indeed, the Bush administration is currently considering options to expand personal savings accounts to encourage more families to save, simplify the tax code, and boost U.S. economic growth.

Advantages and Limitations of Roth IRAs

Roth IRAs have become an important family savings tool, supported widely by financial planning experts. Annual contributions of up to $3,000 (rising to $5,000 by 2008 under current law) from after-tax earnings may be made to the accounts. Because income used for contributions has already been taxed, no tax is imposed on qualified distributions from Roth IRAs. That equalizes the tax treatment of saving and consumption, because after-tax income used for consumption does not face further taxation either. Thus Roth IRAs remove the income tax bias that dissuades Americans from setting aside enough money for the future.

Like Roth IRAs, regular IRAs and 401(k)s eliminate the double taxation of savings. Those vehicles allow an up-front deduction for contributions, but subject withdrawals to tax. However, unlike those accounts Roth IRAs create little federal revenue loss in the near term, and they are less complicated. For example, Roth IRAs do not have the minimum distribution rules that kick in at age 70½ that regular IRAs do.

However, Roth IRAs have important restrictions that reduce their attractiveness, including low contribution limits and tight restrictions on distributions (see table). For earnings to be free of income tax and a punitive 10 percent penalty, accounts must be held for five years and distributions may not take place before age 59½, subject to a few exceptions such as first-time home purchase. Those restrictions discourage savings by reducing liquidity and locking up investment earnings for decades. Millions of families choose not to use the Roth IRA or other savings vehicles at all because of such restrictions and because of confusion regarding the complex limitations (e.g., the IRS taxpayer guide to IRA rules is 90 pages long).

Roth IRA vs. Proposed USA

Feature	Roth IRA	Proposed USA
Purpose of account	Retirement, but with some exceptions chosen by Washington	A tool for all families to save for all purposes
Eligibility	Income less than $110,000 (single) or $160,000 (married)	All Americans may participate
Annual contribution limits	$3,000, but rising to $5,000 by 2008	The greater of $10,000 and 50% of taxable income
Withdrawal restrictions	Distributions before 5 years or age 59½ are subject to tax and a 10% penalty, with some exceptions	All distributions after 3 years are free of taxes and penalties

Roth IRAs Are Ready-Made for Expansion

Eleven percent of U.S. households hold a Roth IRA with a median account balance of $6,000.[1] The participation rate and amounts saved in Roth IRAs are very small compared to the potential, because of the restrictions on eligibility, contributions, and withdrawals.

However, the Roth IRA is based on the sound economic principle that the returns to saving should be taxed only once, not twice as is usually the case under the income tax. On this sound footing, the Roth IRA is a ready-made vehicle for Congress to expand into USAs. By turning Roth IRAs into USAs, all families would have a simple and flexible method to structure nearly all of their savings. USAs would greatly simplify financial planning and help families build economic security free from the risks of pensions tied to companies and the insolvent Social Security system.

Moving to USAs in Three Steps

Congress could convert Roth IRAs into USAs by expanding eligibility to all Americans, liberalizing contribution limits, and allowing families to save for all purposes (not just retirement) by repealing current distribution restrictions.

Roth IRA eligibility is limited to taxpayers with incomes of less than $110,000 (single) and $160,000 (married), with those near the limits required to calculate a phase-out of their contribution. Such limits cause confusion since they differ from limits on other savings plans. All eligibility rules should be repealed to simplify the tax code, increase fairness, and maximize the nation's personal savings rate.

Next, current contribution limits on Roth IRAs should be repealed. Annual contributions to USAs would be limited to 50 percent of taxable income or $10,000, whichever is greater. Some lawmakers oppose expanding contribution limits on regular IRAs and 401(k)s because that would allow taxpayers to reduce current taxes too much and create a federal revenue loss. But with USAs, deposits come from earnings after taxes are already paid, and near-term revenue losses would be minimal. (Since modest-income families have low or zero taxable income, the USA would have an alternate cap of $10,000 per year). Contributions to USAs would have to be in cash, not stocks or bonds. That would ensure that current savers would have to sell securities and pay tax before they could deposit existing funds into a USA.

The third reform is to repeal rules imposing taxes and a 10 percent penalty on earnings if distributions are made prior to age 59½ or before the end of five years. Instead, saving in USAs would be for all purposes, so families would be able to withdraw their funds tax-free anytime after a three-year holding period. Therefore, families could use the accounts to save for many planned and unplanned expenses, such as retirement, education, unemployment, medical costs, funeral expenses, moving, and other needs.

USAs Would Revolutionize Family Savings

If Roth IRAs were restructured as USAs, they would emerge as a popular and economically powerful financial tool that would foster upward mobility and promote savings for families who do not save enough now. Young families would be able to accumulate wealth and build financial security like never before because current limitations, taxes, and penalties would be removed. USAs would work like a brokerage account in which savings could be invested in bank deposits, bonds, or stocks. Interest, dividends, and capital gains within the accounts would be tax-free. USAs would hugely simplify financial planning because there would be no need to pay tax on account earnings, and no need to learn the multiplicity of rules that relate to items such as capital gains or special-purpose accounts, such as education IRAs.

Conclusion

The economy will be faced with severe strains as federal spending on Social Security and other entitlements will explode in cost and impose a huge burden on future taxpayers unless reformed. The solution is increased personal savings to build the economy and allow individuals to pay for more of their own future consumption. Removing tax barriers to saving through USAs could greatly boost personal savings. USAs would complement Social Security reforms that would set up individual accounts funded by the current payroll tax. Social Security private accounts would increase personal financial security and raise retirement income for those opting for the new system. USA accounts would serve as a voluntary add-on to Social Security private accounts, but could be used for family expenses other than just retirement. All Americans would gain as USAs reduced the punitive taxation of savings, simplified family finances, and generated more investment capital to boost the economy.

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[1] Investment Company Institute, "Mutual Fund Fact Book," May 2002, www.ici.org, p. 48.