Retirement Income
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Details of the Auto-IRA/Saver’s Credit Plan

By Editor Test *Mon, Jun 29, 2009*

David John of the Heritage Foundation, and the Treasury's J. Mark Iwry, hope to see years of work finally bear fruit.

The details of the auto-IRA/Saver’s Credit proposal are still unclear, as are the kinds of opportunities that it might create for payroll companies, banks, or retirement plan providers. But the basic outline of the plan has taken shape.

First, the program is voluntary for individual workers—but not necessarily for employers. Companies with at least 10 employees that that do not offer any retirement plan and have been in business at least two years would have to automatically enroll their employees in an IRA—probably a Roth IRA—and start monthly contributions equal to three percent of pay.

Then there’s the incentive. The next-generation Saver’s Credit would be an updated form of the current Saver’s Credit, now used by about 5.5 million taxpayers. The old version provides a tax credit that accrues only to low- and middle-class workers who pay taxes. The new Saver’s Credit would match 50% (up to $500) of the IRA contributions of low- and middle-income workers whether they owe income taxes or not.

“There are several models for providing auto IRAs,” said David John of the Heritage Foundation, a co-creator of the auto-IRA/Saver’s Credit concept. “In each case the individual company is the nexus. If a small business has a relationship with a bank, the bank might say, ‘We’ll add the auto-IRA to a full range of other services.’ Or, a small business owner could go onto website and, as with Medicare part D, see a list of all the providers who do business with a firm of that size and location.

“Or a business might belong to a multi-employer plan that uses an ‘Auto-IRA’ fund sponsored by XY insurance company,” he added. “If none of that works, a small business might be assigned to a consortium, and an asset manager could aggregate several thousand employees at several hundred companies.”

Each employee’s contributions to the auto-IRA would be deducted from his or her paycheck and be routed to an IRA custodian via the employer’s payroll system. Contributions would likely be invested in inflation-protected U.S. bonds (a special version of the “I-bonds” now sold to individual investors) or into an account with a target date or target-risk balanced mutual fund or fund-of-funds.

At some point, when their account balances become large enough—this part is still fuzzy—the employees could transfer their IRA assets to any financial services firm they choose. Then they would assume their places in the vast, disorganized and under-informed army of American investors.

Who might profit from all of this? Companies who have mastered e-commerce and achieved economies of scale in handling small accounts are expected to latch onto the idea. But it’s not for everyone. “We’ve talked to mutual companies, insurance companies, major banks, to recordkeeping firms and fund administrators, said John. “Some really love it and others say, ‘Who cares?’

"It doesn't break down so much by industry sector as by business model. It takes a business model that's set up to handle large numbers of customers. A payroll services company might handle the deduction from the paycheck, and forward the money to a funds manager. We're seeing strong interest there."

For those interested in the background details, here's the Tax Policy Institute's statement on the new plan:

Under current law, low- and middle-income taxpayers may claim a saver's credit of up to $1,000 ($2,000 for couples) if they contribute to retirement savings plans. The credit equals the credit rate times up to $2,000 of contributions to IRAs, 401(k)s, or certain other retirement accounts by each taxpayer and spouse.

The credit rate for 2008 depends on income and tax filing status as shown in the following table. (For 2009, couples filing jointly must have income below $55,500, heads of household income below $41,625, and other tax filers income below $27,750 to claim any credit.) The credit is not refundable and therefore has limited value for people with little income tax liability.

President Obama proposes to make the saver's credit refundable as a 50% credit up to $500 per individual (indexed for inflation). The full credit would go to families with income below $65,000 ($48,750 for heads of household and $32,500 each for singles and married couples filing separately) and would be automatically deposited into the qualified retirement plan or IRA. The credit would phase out when income exceeds those limits: the maximum credit would be reduced by 5 percent of income over the relevant limit.

The government would effectively pay half the cost of up to $1,000 deposited to a retirement account each year for all eligible households. For example, a family that puts $800 aside in a retirement account would receive a $400 tax credit, lowering the cost of the contribution to $400.

Turning the currently nonrefundable saver's credit into a refundable credit would encourage low-income households to save more by boosting the effective return to their saving. Because the credit would go directly into the saver's retirement account, the default option would augment the amount saved by half and thus further increase the amount saved for retirement. The phase-out of the credit would, however, raise effective marginal tax rates for many middle-income taxpayers with potentially adverse behavioral effects on work effort and saving.

President Obama also proposes to establish automatic enrollment in IRAs and 401(k)s. Currently most employment-based retirement savings plans require workers to make a positive choice to contribute to the plan. The default option is not to contribute. Under the president's proposal, employers in business at least two years and with ten or more workers would have to enroll every worker automatically in a workplace pension plan unless the worker opts not to participate.

Employers who do not currently offer retirement plans would have to enroll employees in a direct-deposit IRA account unless the worker opts out. Research has shown that changing from a default opt-in provision to an opt-out provision markedly increases worker participation. The administration suggests that its proposal would increase the savings participation rate for low- and middle-income workers from the current 15 percent level to around 80 percent.