Eight Ways to Simplify Retirement Accounts

By Editor Test *Wed, Sep 15, 2010*

The government “spends” $118 billion a year on tax-deferred accounts whose complexities discourage many people from using them, according to the President's Economic Recovery Advisory Board.

The sections of the tax code that cover tax-deferred and tax-exempt savings programs are a mess—well intentioned perhaps, but a mess. Stop somebody on the street and ask him to explain the tax treatment of Roth IRA withdrawals. You might as well ask directions to Maracaibo.

People in high places have been thinking about cleaning up this mess. A thick new whitepaper called “The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation,” includes at least eight ways to rationalize the rules governing the hodge-podge of programs that we know as IRAs, FSAs, HSAs, 401(k)s, 403(b)s, 529s, SIMPLE-IRAs, SARSEPs, etc.

The report contains both good and bad news. The good news is that lots of interesting alternatives to the status quo exist—like making contribution limits the same for on IRAs and 401(k)s, or letting half the people skip their Required Minimum Distributions.

The bad news is that any change the tax law will inevitably gore somebody’s ox. What one person sees as the elimination of a wasteful and ineffective tax incentive will strike other people as a confiscatory tax hike. And no matter what happens, unintended consequences are likely follow.

But something apparently needs to be done. According to the report, the government “spends” $118 billion a year on tax-deferred retirement, health care and education accounts, but the wrong people are using them. Of the $118 billion in uncollected taxes, 84% stays with people who make $100,000 or more a year. That’s not the kind of social engineering this administration is aiming for.

Here are the eight suggestions:

1. **Consolidate Retirement Accounts and Harmonize Statutory Requirements.** There’s currently a hodge-podge of related but distinct tax-deferred or tax-exempt savings programs in the tax code, from 401(k)s and 403(b)s to 529s, from IRAs to FSAs and HSAs, and from SIMPLE plans to SARSEPs. They have different rules regarding eligibility, contribution limits, and withdrawals.
2. **Integrate IRA and 401(k)-type Contribution Limits and Disallow Nondeductible Contributions.** The advisory board suggested raising the limits on deductible contributions to IRAs (currently $5,000 a year) to the same level as the limit on 401(k) plans. This would eliminate a lot of paperwork for people who currently make IRA contributions that exceed the $5,000 limit. On the other hand, it might reduce tax receipts and would disproportionately favor high-earners.
3. **Restrict use of IRA assets for non-retirement purposes.** One of the redundancies of the current system is that people can use the money in their IRAs for certain medical or educational expenses instead of retirement. The advisory board recommends imposing strict limits on the use of funds in retirement saving accounts for non-retirement purposes. Taxpayers would instead be encouraged to use 529 Plans for college savings and HSAs or FSAs for medical bills.

4. **Clarify and Improve Saving Incentives.** The report proposes an expansion of the existing Saver's Credit to a match from the government as an incentive to low-income workers to save. The existing credit offers a tax deduction, which doesn't help low-income workers. The report also proposes an "automatic IRA" rule, which would require employers in business for at least two years and with more than ten employees to default their employees into an IRA and start deducting contributions from their payroll. Employees could drop out of the program if they wished.
5. **Reduce Retirement Account Leakage.** Under current rules, it's relatively easy for people to squander their tax-deferred savings by spending them when they change jobs or by borrowing against them and not re-paying the loans before they change jobs. The report suggested restricting access to 401(k) and IRA money, but acknowledged that restrictions would create paperwork for employers and hardship for some employees.
6. **Relax non-discrimination rules for small plans.** Many owners of small companies are discouraged from offering their workforce a 401(k) plan because the rules limit their ability to discriminate in favor of their most-valued employees by contributing more for them than for rank-and-file workers. One solution would be to replace existing non-discrimination rules and apply the rules associated with SIMPLE 401(k) plans.
7. **Eliminate RMDs for small accounts.** Eliminating the distribution requirement for those with tax-deferred savings under $50,000 relieve would eliminate the burden of calculating RMDs for half of retirement account owners over age 70½, while exempting only 6% of retirement assets from taxation each year. Today, retirees over age 70½ must multiply their tax-deferred assets by an age-specific factor to determine the amount of savings they must remove from their tax-deferred account(s) and pay taxes on. For people with several tax-favored accounts, the calculation and the decision regarding which account to tap for the distribution can be complicated. One caveat: People with small accounts are the ones most likely to be in circumstances that force them to take distributions each year, whether required or not.
8. **End the 'Curse of the MAGI.'** Today, retirees must fill out an 18-line worksheet to calculate the percentage of their benefits is subject to income tax. Much of the complexity comes from having to determine whether zero, 50% or 85% of benefits should be included in modified adjusted taxable income (MAGI). The panel suggested a return to pre-1993 system of taxing Social Security benefits and other income separately.

Conservatives might bridle at the suggestion that people in higher tax brackets shouldn't reap most of the benefits of tax deferral or exemption, or that a tax break is a "cost" and that a failure to collect taxes is equivalent to an expense for the American people. As we've seen in the debate over extending the Bush tax cuts, they regard the closure of a tax break as a tax hike.

But there's a Democrat in the White House, and his administration holds the liberal viewpoint that tax breaks should either pay for themselves by helping to achieve a public policy goal—in this case, by encouraging people who make under $100,000 to save more—or be eliminated. It would probably be politically impossible to eliminate popular tax breaks; a judicious pruning or tweaking might be the only option.

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