IRA -- Borrowing for Education Issue

THE WHITE HOUSE

WASHINGTON

allow IRA & other retirement accounts

can you take $ out without penalty? older people

Ellen Seidman

E X E C U T I V E   O F F I C E   O F   T H E   P R E S I D E N T

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TO: Michael T. Schmidt

FROM: Ellen S. Seidman
National Economic Council

SUBJECT: RE: IRA's and other retirement funds

Mike, my understanding is that you cannot take money out of an IRA before age 59-1/2 without both a tax and a penalty for any purpose, although this may have changed recently. In any event, I'm virtually certain that education and training are not an eligible purpose. With respect to 401(k) plans, the situation is a little better, in that borrowing against your account is allowed by law, and most employers have a system that does allow some borrowing, sometimes for fairly broad purposes. (On the other hand, you can't withdraw from a 401(k) early unless you leave your job.) However, this is considered lousy retirement policy, and many employers restrict borrowing only to hardships. The argument would be that borrowing for education and training is a capital investment, and therefore good retirement policy. If it's for older (over 59-1/2) workers, there's no need for a special rule; clearly the issue is the penalty, not the tax, since I don't think anyone is taking the position that the deferral of the tax on earnings should be permanent if the money is used for specific purposes. The experts at Treasury are Mark Iwry (622-1357) and Randy Hardock (622-0170). They'll both give you straight answers, and will also tell you when this was tried before and what the politics were. Randy is more political, and was with Bentsen on the Hill. Ellen

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REVENUE ACT OF 1992

CONFERENCE REPORT

TO ACCOMPANY

H.R. 11

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person who owns more than 50 percent of the corporation. In addition, a qualified employee is not to include any person who owns more than five percent of the stock of the employer (or if the employer is not a corporation, more than five percent of the capital or profits interests in the employer). Finally, a qualified employee is not to include any individual if the services performed by the individual for the employer involve certain gaming activities or are performed in a building housing such gaming activities.[61]

The Indian employment credit is allowed with respect to full-time and part-time employees. However, if an employee is terminated less than one year after the date of initial employment, the amount of credits previously claimed by the employer with respect to that employee generally is recaptured (unless the employee voluntarily leaves, becomes disabled, or is fired due to misconduct).

An employer's deduction otherwise allowed for wages is reduced by the amount of the credit claimed for the taxable year. The conference agreement also provides that the employment credit is not refundable. Finally, the Indian employment credit is subject to the general business credit limitations of section 38,[62] and, therefore, the credit may not be used to reduce tentative minimum tax.

Effective date

The Indian reservation credit applies to property placed in service after December 31, 1992, and the Indian employment credit applies to wages paid or incurred after December 31, 1992.

II. ECONOMIC GROWTH INCENTIVES

A. Individual Retirement Arrangements (IRAs)

1. Modify IRA deduction

Present Law

Under present law, an individual that is not an active participant in an employer-sponsored retirement plan (and whose spouse also is not an active participant in such a plan) may make deductible contributions to an individual retirement arrangement (IRA) up to the lesser of $2,000 or 100 percent of compensation. The amounts held in an IRA, including earnings on contributions, generally are not included in taxable income until withdrawn.

If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out over certain adjusted gross income (AGI) levels. The limit is phased out between $40,000 and $50,000 for married taxpayers, and between $25,000 and $35,000 for single taxpayers. An individual may make nondeductible IRA contributions (up to the contribution limit) to the extent the individual is not permitted to make deductible IRA contributions.

[61] The limitation applies to class I, II, or III gaming as defined in section 4 of the Indian Regulatory Act (25 U.S.C. 2703), as in effect on the date of enactment of the provision.

[62] No portion of the unused business credit for any taxable year that is attributable to the Indian employment credit may be carried back to a taxable year ending before the date of enactment of the provision.

House Bill

No provision.

Senate Amendment

The Senate amendment increases the income limits on IRA eligibility for active participants in employer-sponsored plans from $40,000 to $120,000 for married taxpayers and from $25,000 to $80,000 for single taxpayers. As under present law, the limits are phased out over $10,000 (so that, initially, active participants in employer-sponsored plans with AGI of $130,000 (married) and $90,000 (single) are ineligible). In addition, the active participant rule is modified so that a person is not considered to be an active participant because his or her spouse is an active participant in an employer-sponsored retirement plan. The income limits are indexed for inflation.

The IRA contribution limit is indexed in increments of $500. In addition, the limit on contributions (deductible and nondeductible) to IRAs is coordinated with the limit on elective deferrals to a qualified cash or deferred arrangement (sec. 401(k) plan), tax-sheltered annuity (sec. 403(b) annuity), simplified employee pension (SEP), or a section 501(c)(18) plan. Under the coordinated limit, IRA contributions cannot exceed the difference (if any) between the limit on elective deferrals and the amount in fact deferred. For purposes of the coordinated limit for IRA deductions and elective deferrals, the limit on elective deferrals to a section 403(b) tax-sheltered annuity is the limit described in section 402(g)(1), as modified under 402(g)(4) ($9,500 in 1992). For example, if the limit were in effect in 1992, a taxpayer who elected to defer $8,000 under a 401(k) plan could contribute only $728 to an IRA, since the limit on elective deferrals to a 401(k) plan is $8,728 in 1992. (A taxpayer who elected to defer $5,000 under a 401(k) plan could still only contribute $2,000 (indexed) to an IRA.)

Effective date.—The provision applies to taxable years beginning after December 31, 1993.

Conference Agreement

The conference agreement follows the Senate amendment, with the following modifications.

The conference agreement increases the income limits on IRA eligibility for participants in employer-sponsored plans from $40,000 to $100,000 for married taxpayers and from $25,000 to $75,000 for single taxpayers. As under present law, the limits are phased out over $10,000 (so that, initially, participants in employer-sponsored plans with AGI of $110,000 (married) and $85,000 (single) are ineligible). The income limits are indexed for inflation in $20,000 increments.

Effective date.—The provision applies to taxable years beginning after December 31, 1994.

2. Special IRAs

PRESENT LAW

Under present law, certain individuals may make deductible contributions to an IRA up to the lesser of $2,000 or 100 percent of compensation. The amounts held in an IRA, including earnings on contributions, generally are not included in taxable income until withdrawn.

Withdrawals from an IRA (other than withdrawals of nondeductible contributions) are includible in gross income. In addition, amounts withdrawn prior to age 59½, death, or disability are subject to an additional 10-percent income tax, unless the withdrawals are in the form of substantially equal periodic payments over the life (or life expectancy) of the IRA owner or over the joint lives (or life expectancies) of the IRA owner and his or her beneficiary.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment permits individuals to establish and maintain new "special IRAs" to which they can make nondeductible contributions. The same eligibility income limits that apply to deductible IRAs also apply to special IRAs. Withdrawals from a special IRA are not includible in income if attributable to contributions that have been held in the special IRA for at least 5 years. The limits on contributions to deductible IRAs and special IRAs are coordinated.

The Senate amendment also permits an individual whose AGI for the taxable year does not exceed the lower end of the income eligibility limits (initially, $80,000 for singles and $120,000 for marrieds) to make transfers from deductible IRAs to special IRAs without imposition of the 10-percent tax on early withdrawals. These limits apply whether or not the individual or his or her spouse are active participants in an employer-sponsored retirement plan. The amount transferred to a special IRA generally is includible in income in the year withdrawn from the deductible IRA. However, in the case of a transfer before January 1, 1994, the transferred amount is includible in income ratably over the 4-taxable year period beginning in the taxable year in which the distribution was made.

Effective date.—The provision generally applies to taxable years beginning after December 31, 1993. However, the provision permitting transfers from deductible IRAs to special IRAs is effective for taxable years beginning after December 31, 1992. Thus, special IRAs can be established and maintained in taxable years beginning before January 1, 1994, only with funds transferred from a deductible IRA.

CONFERENCE AGREEMENT

The conference agreement follows the Senate amendment, with the following modifications.

The conference agreement provides that the same eligibi ity income limits that apply to deductible IRAs also apply to special IRAs. Thus, initially, the income limits on special IRA eligibility for participants in employer-sponsored plans are $100,000 for married taxpayers and $75,000 for single taxpayers (phased out over $10,000 dollars).

The conference agreement permits individuals whose AGI for the taxable year does not exceed the upper end of the new income eligibility limits (initially, $85,000 for single taxpayers and $110,000 for married taxpayers) to make transfers from deductible IRAs to special IRAs without imposition of the 10-percent tax on ly withdrawals. These limits apply whether or not the individual or his or her spouse are active participants in an employer-spc red retirement plan. The AGI limits do not apply to transfers from one special IRA to another special IRA.

The conference agreement also clarifies that a direct trustee-to-trustee transfer from one special IRA to another will not be treated as a distribution, consistent with the treatment of a direct trustee-to-trustee transfer from one deductible IRA to another Rev. Rul. 78-406).

Effective date.—Same as the Senate amendment. The new eligibility income limits, and the coordinated limit on IRA contributions and elective deferrals, apply to special IRAs beginning in 1994. Transfers from deductible IRAs to special IRAs are subject to the income limits applicable to such transfers beginning in 1993.

3. Penalty-free distributions

PRESENT LAW

Under present law, withdrawals from an IRA (other than withdrawals of nondeductible contributions) are includible in gr income. In addition, amounts withdrawn prior to age 59-½, h, or disability are subject to an additional 10-percent income tax, unless the withdrawals are in the form of substantially equal i-odic payments over the life (or life expectancy) of the IRA owner or over the joint lives (or life expectancies) of the IRA owner and his or her beneficiary. The 10-percent additional tax also applies to early withdrawals from tax-qualified retirement plans and tax-sheltered annuities.

There is an exception to the additional 10-percent income tax on early withdrawals for distributions from a tax-qualified retirement plan or tax-sheltered annuity that do not exceed the amount allowable as a deduction for medical care for the year. This exception does not apply to IRAs.

HOUSE BILL

No provision.

SENATE AMENDMENT

First-time home purchasers

The Senate amendment allows withdrawals from an IRA and from amounts attributable to elective deferrals under (1) a cash or deferred arrangement (sec. 401(k) plan), (2) a tax-sheltered annuity (sec. 403(b) annuity), or (3) a section 501(c)(18) plan without imposition of the 10-percent additional income tax on early withdrawals (and without disqualification of the 401(k) plan or 403(b) annuity) to the extent the amount withdrawn is used to pay qualified acquisition, construction, or reconstruction costs with respect to a principal residence of a first-time homebuyer who is the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild.

A first-time homebuyer is any individual (and if married, such individual's spouse) who (1) did not own an interest in a principal residence during the 3 years prior to the purchase of a home and (2) is not in an extended period for rolling over gain from the sale of a principal residence. In the case of certain homebuyers described in Code sec. 143(i)(1)(C) whose family incomes do not exceed $15,000, ownership of land subject to certain contracts for deed described in such section does not disqualify the homebuyer from being considered a first-time homebuyer. In addition, an individual whose principal residence was destroyed or substantially damaged by Hurricane Andrew, Hurricane Iniki, or Typhoon Omar is treated as a first-time homebuyer if the individual rebuilds it or acquires another home to replace it.

Education expenses

The Senate amendment allows withdrawals from an IRA and from amounts attributable to elective deferrals under (1) a cash or deferred arrangement (sec. 401(k) plan), (2) a tax-sheltered annuity (sec. 403(b) annuity), or (3) a section 501(c)(18) plan without imposition of the 10-percent additional income tax on early withdrawals to the extent the amount withdrawn is used to pay qualified higher education expenses of the taxpayer, or the taxpayer's spouse, children or grandchildren.

Medical expenses

The Senate amendment extends to IRAs the present-law exception to the early withdrawal tax for distributions from tax-qualified plans and tax-sheltered annuities for certain medical expenses and expands the exception (as applied both to IRAs and other plans) to apply to medical expenses of the taxpayer's child, grandchild, or ancestor whether or not such person otherwise qualifies as the taxpayer's dependent.

Long-term unemployment

The Senate amendment provides that the 10-percent early withdrawal tax does not apply to withdrawals from IRAs made by an individual after separation from employment if (1) the individual has received unemployment compensation for 12 consecutive weeks and (2) the withdrawal is made during the taxable year during which the unemployment compensation is received or the succeeding taxable year.

American-made automobiles

The Senate amendment exempts withdrawals during 1992 and 1993 from an IRA and from amounts attributable to elective deferrals under (1) a cash or deferred arrangement (sec. 401(k) plan), (2) a tax-sheltered annuity (sec. 403(b) annuity), or (3) a sec. 501(c)(18) plan from the 10-percent additional income tax on early withdrawals to the extent the amount withdrawn is used to purchase a new American-made automobile.

5-year holding period

The Senate amendment provides that the present-law rule permitting penalty-free IRA withdrawals after an individual attains age 59-½ does not apply in the case of amounts attributable to contributions made during the previous 5 years. The provision does not apply to amounts rolled over from tax-qualified plans or tax-sheltered annuities. For purposes of applying the rule, distributions are treated as having been made first from the earliest contributions (and earnings) remaining in the account, and then from other contributions in the order in which made.

Effective dates

The provisions generally are effective for withdrawals after December 31, 1992. The provision requiring a 5-year holding period to avoid withdrawal penalties for distributions from IRAs after age 59-½ applies to contributions (and earnings allocable thereto) made after December 31, 1993.

Conference Agreement

First-time home purchasers

The conference agreement follows the Senate amendment.

Education expenses

The conference agreement follows the Senate amendment.

Medical expenses

The conference agreement follows the Senate amendment.

Long-term unemployment

The conference agreement follows the Senate amendment.

American-made automobiles

The conference agreement does not include the provision in the Senate amendment.

5-year holding period

The conference agreement follows the Senate amendment.

Effective dates

The conference agreement follows the Senate amendment.