U.S. SENATE COMMITTEE ON

Finance

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Background on the Roth IRA Conversion Proposal in the Conference Agreement on the *Tax Increase Prevention and Reconciliation Act of 2005*
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The conference agreement would allow all taxpayers, regardless of income, to convert their traditional IRAs to Roth IRAs. Under current law, only taxpayers with income below $100,000 per year may do so. The provision is effective for taxable years beginning after December 31, 2009. Taxpayers who convert their IRAs in 2010 would have two years to pay the resulting tax. Taxpayers who convert their IRAs in 2011 and beyond would have one year to pay the resulting tax. The provision does not sunset.

Q. Would the Roth IRA conversion proposal actually make the federal deficit worse over the long-term?

A. No. The proposal generates real federal revenues. The non-partisan Joint Committee on Taxation estimates that allowing all taxpayers to make Roth IRA conversions would generate $6.4 billion in federal revenues over the next 10 years. The conversion proposal would not increase the federal deficit over the long-term. Roth IRA conversions merely change the timing of when individuals must pay tax on their retirement savings, accelerating tax payments in the case of those who convert. The provision does not result in a net change in federal revenues over any long-term period.

In addition, critics choose to ignore a reverse effect of various retirement savings tax incentives. Because congressional budget estimates are done on a 10-year basis, these estimates ignore distant revenue gains as well as losses. Because tax incentives for retirement savings typically are "front-loaded," the ten-year budget estimates generally reflect only large losses of federal revenue, while ignoring the fact that the federal government will recoup the tax on that money (and the associated investment gains) when it is distributed later in retirement.

Q. Is this a tax break or tax cut?

A. No. Allowing taxpayers to execute a Roth IRA conversion is not a tax break or a tax cut. The tax is always paid. If anything, the federal government stands to benefit on a present-value basis from collecting the tax earlier. Also, this provision could increase compliance with IRA-related tax payment requirements. Non-compliance is expected to be a growing problem. Taxpayers who are pro-actively focused on arranging their accounts will pay their taxes. Moreover, Roth vehicles are an important part of a diversified retirement planning strategy, and there is no reason that all Americans should not have access to the best retirement planning tools available. Income levels, tax rates, and tax brackets are all subject to change over the years. A traditional IRA requires the payment of taxes upon distribution. A Roth IRA uses after-tax income, so it requires no tax payment upon distribution. People like the flexibility of different savings vehicles.

Q. Is Congress considering any changes to help taxpayers at lower income levels save for retirement?

A. Yes. The Senate-passed tax reconciliation bill contained an extension of the tax credit to encourage savings by taxpayers below certain income levels. House and Senate negotiators are now considering whether to make the credit permanent, perhaps through the pension bill now under negotiation in conference committee. In Tax Year 2003, 5,486,144 Americans benefitted from the small savers' credit.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 tax act) provided a temporary nonrefundable credit for contributions made by eligible taxpayers to certain qualified retirement plans (e.g., 401(k), 403(b), annuity, SIMPLE, SEP, traditional and Roth IRAs) through the end of 2006. The maximum annual contribution for the credit is $2,000. The credit rate depends on the adjusted gross income of the taxpayer. Only taxpayers with AGI of $25,000 or less ($50,000 for married couples) are eligible for the credit. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. Extending the proposal for five years would cost an estimated $4.1 billion.

Q. Is the Roth IRA conversion proposal a new idea?

A. No. The Senate has a history of strong bipartisan support for allowing Roth IRA conversions for all taxpayers.

In the Senate bill that would become the Taxpayer Relief Act of 1997 (P.L. No. 105-34), the Senate approved Roth IRA conversions for all taxpayers. The Senate bill passed in an overwhelming bipartisan vote of 80-18. The income caps on contributions and conversions were added in conference committee.

In 1998, the Senate passed the IRS Restructuring and Reform Act by a unanimous 97-0 vote. The IRS Reform Act, which was signed into law by President Clinton, included a provision to allow more taxpayers to use Roth IRAs. The change, which Democrats supported, raised $8.028 billion over 10 years – even more than the current estimate of $6.4 billion over 10 years.

In 1999, the Senate-passed Taxpayer Relief and Refund Act included a provision to would allow taxpayers with income of less than $1 million to make Roth IRA contributions. The Act passed the Senate 57-42. President Clinton vetoed the bill.