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INDIVIDUAL RETIREMENT ACCOUNTS

Additional IRS Actions Could Help Taxpayers Facing Challenges in Complying with Key Tax Rules

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Highlights

Highlights of GAO-08-654, a report to the Committee on Finance, U.S. Senate

Why GAO Did This Study

Individual retirement accounts (IRA) allow individuals to save for retirement in a tax-preferred way. Traditional IRA contributions, subject to certain limitations, can be deducted from taxable earnings and taxes on earnings are deferred until distribution. In contrast, Roth IRA contributions are made after tax and distributions are tax-free. Faced with a myriad of rules covering IRA contributions and distributions, taxpayers may fail to comply with the rules. GAO was asked to (1) provide an overview of key rules and describe how the Internal Revenue Service (IRS) educates taxpayers about these rules, (2) describe what IRS knows about the extent of noncompliance with IRA transactions reported on taxpayer returns, and (3) describe challenges taxpayers face with key rules and some options for strengthening compliance. GAO reviewed IRS documents and compliance data. To identify challenges, GAO interviewed officials from the financial industry and advisor representatives.

What GAO Recommends

To strengthen taxpayer compliance, IRS should clarify guidance on the combined traditional and Roth contribution limit and pursue options to improve older taxpayers' compliance with the required minimum distribution rule. IRS agreed to take actions consistent with both recommendations. Technical comments from the Department of the Treasury were incorporated as appropriate.

To view the full product, including the scope and methodology, click on GAO-08-654. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

Taxpayers face a myriad of tax rules governing contributions to, distributions from, and rollovers between accounts for traditional and Roth IRAs. Both types of IRAs have rules governing eligibility to contribute, and all IRA contributions are subject to an annual limit. For example, eligibility to deduct (from taxable income) contributions to a traditional IRA and to contribute to a Roth IRA depends on taxpayer income and filing status, while coverage by an employer-sponsored retirement plan only affects eligibility for deductible contributions to a traditional IRA. Tax rules for distributions diverge for traditional and Roth IRAs, but both types are generally subject to a 10 percent early withdrawal penalty, with some exceptions. Further, traditional IRA owners over age 70½ must take minimum distributions or face a 50 percent penalty on the required distribution amount. Rollovers, where a taxpayer moves money from one account into an IRA account, must be completed within 60 days, or the amounts are taxable and subject to penalty. To assist taxpayers in voluntarily complying with IRA rules, IRS offers special publications and telephone assistance for taxpayers with IRA questions.

Even with IRS's service efforts, IRS data show that some taxpayers fail to comply with rules for reporting contribution deductions and taxable distributions from traditional IRAs. IRS's National Research Program showed that nearly 15 percent of taxpayers who took traditional IRA contribution deductions as well as 15 percent of those who took taxable distributions misreported on them on their tax returns in 2001 (the most recent data available). IRS has automated enforcement programs—matching tax returns with information reported by IRA custodians—to detect and correct these types of IRA misreporting. For tax year 2004, IRS assessed additional taxes of $23.2 million for ineligible traditional IRA contribution deductions or exceeding the deduction limits and $61.1 million in taxes and penalties for early withdrawals from traditional IRAs.

As partly shown by taxpayer misreporting to IRS, taxpayers face challenges in figuring how much they can contribute, navigating the various distribution rules, and rolling over their IRAs between custodians. For example, according to representatives of financial firms and advisors GAO interviewed, taxpayers may not understand that the annual contribution limit applies across traditional IRAs and Roth IRAs in combination. On the distribution side, interviewees said that older taxpayers make mistakes in determining when they must start distributions and calculating the correct amount. Interviewees identified some options for IRS to clarify guidance, such as for the combined contribution limit rule, or develop tools to help taxpayers, such as a Web-based calculator for required minimum distributions. IRS could explore actions such as requiring additional reporting by custodians or simplifying the required minimum distribution rule to strengthen compliance with this complicated rule. Other options to reduce the complexity of IRA rules, such as eliminating income limits on eligibility, pose trade-offs and could be considered in the context of broader tax reform.