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August 2008

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

August 2008

INDIVIDUAL RETIREMENT ACCOUNTS

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

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.

Contents

Letter		1
	Results in Brief	5
	Background	7
	Myriad of Rules Govern IRA Transactions, and IRS Provides Services to Educate Taxpayers	10
	IRS Research and Enforcement Data Show Taxpayers Misreport Millions of Dollars in Traditional IRA Transactions	20
	Complexity Underlies the Challenges That Taxpayers Face in Complying with IRA Rules, and Some Options Could Bolster IRS Service While Other Options Would Require Legislative Change	29
	Conclusions	40
	Recommendations for Executive Action	41
	Agency Comments	41
Appendix I	**Scope and Methodology**	43
Appendix II	**IRS Forms Used to Report Individual Retirement Account Information**	46
Appendix III	**Comments from the Internal Revenue Service**	48
Appendix IV	**GAO Contact and Staff Acknowledgments**	49
Glossary		50
Tables		
	Table 1: General IRA Rules and Associated Penalties by Transaction Type	10
	Table 2: Eligibility for Deduction of Traditional IRA Contributions, Tax Year 2008	12
	Table 3: Eligibility for Roth IRA Contributions, Tax Year 2008	13
	Table 4: Maximum IRA Contribution Limits for IRA Owners by Age, Tax Years 1975–2008	14

Table 5: Total Additional Taxes and Taxpayers Assessed by IRS's Automated Underreporter Program on Select Contribution and Distribution Rules for Traditional IRAs, Tax Years 2001–2004 27
Table 6: Taxpayer Challenges in Complying with Key IRA Rules 30

Figures

Figure 1: Number of Taxpayers Owning IRAs and Fair Market Value of IRAs by IRA Type, Tax Year 2004 8
Figure 2: Number of Taxpayers Contributing to Traditional and Roth IRAs by Age, Tax Year 2004 9
Figure 3: Illustrative Example of Using Form 1040 with Information Reporting to Check Taxpayer Compliance with Traditional IRA Rules 19
Figure 4: Overview of IRS Automated Enforcement Activities for IRA Rules 24

Abbreviations

AGI	Adjusted Gross Income
AUR	Automated Underreporter
IRA	Individual Retirement Account
IRS	Internal Revenue Service
NRP	National Research Program
SEP	Simplified Employee Pension
SIMPLE	Savings Incentive Match Plan for Employees
SOI	Statistics of Income
TE/GE	Tax Exempt and Government Entities
TIGTA	Treasury Inspector General for Tax Administration
W&I	Wage and Investment

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The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

Created over 30 years ago, individual retirement accounts—popularly known as IRAs—are a key tax-preferred vehicle for individuals to save for retirement.[1] According to the Internal Revenue Service's (IRS) latest analysis, about 51 million taxpayers held $3.3 trillion in IRAs at year-end 2004.[2] IRAs also are increasingly important as a way for individuals to roll over savings from pension plans. Total assets in IRAs in 2007 surpassed assets held in either employer-sponsored defined benefit or defined contribution plans.[3]

According to estimates by the Department of the Treasury (Treasury), IRAs cost the federal government an estimated $9.5 billion in forgone revenue for fiscal year 2007.[4] This reflects the revenue losses by the federal government due to the preferential tax treatment of both traditional and Roth IRAs.[5] The traditional IRA allows tax deferral on investment earnings until retirement distribution with an up-front tax deduction from taxable

[1]IRAs were enacted as part of the Employee Retirement Income Security Act of 1974 (Pub. L. No. 93-406). The term IRA, also known as individual retirement arrangement, also includes individual retirement annuities.

[2]Victoria L. Bryant, "Accumulation and Distribution of Individual Retirement Arrangements, 2004," *Statistics of Income Bulletin*, vol. 27, no. 4 (Washington, D.C.: Spring 2008).

[3]Peter Brady and Sarah Holden, "The U.S. Retirement Market, 2007," *Research Fundamentals*, vol. 17, no. 3 (Washington, D.C.: Investment Company Institute, July 2008).

[4]According to estimates by the Joint Committee on Taxation, IRAs cost the federal government $15.5 billion in revenue losses in 2007.

[5]Tax preferences—which are legally known as tax expenditures—result in forgone revenue for the federal government. For more information on revenue loss measurement, see GAO, *Government Accountability and Performance: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

income for contributions by eligible taxpayers.[6] To limit the tax deferral, taxpayers over age 70½ cannot contribute to, and must begin taxable distributions from, their traditional IRAs. In contrast, Roth IRA contributions are not tax deductible and distributions are generally not required for the account owner. Instead, subject to income limitations, taxpayers regardless of age can make after-tax contributions to Roth IRAs with retirement distributions, including investment earnings, generally being tax-free. To limit revenue losses and tax benefits from accruing disproportionately to the wealthy, the law imposes a total annual limit on IRA contributions as well as income limits on the deductibility of traditional IRA contributions and eligibility for Roth IRAs. Contributions exceeding the limits are subject to a 6 percent additional tax to penalize excess contributions.

Even with tax incentives for retirement saving, personal saving in the United States remains near historic lows.[7] To improve personal saving, Congress has changed the IRA rules over the years, for example, by increasing the contribution limits and allowing workers to tap IRA assets for certain nonretirement purposes without the early withdrawal penalty. In addition to the traditional tax-deferred IRA, Congress in 1997 created the after-tax Roth IRA.[8] There are also two kinds of employer-based IRAs—Savings Incentive Match Plans for Employees (SIMPLE) and Simplified Employee Pensions (SEP).[9] Although providing taxpayers with more IRA options, these changes also added complexity to the rules governing IRA contributions and distributions. This complexity coupled with the various penalties on IRA rule violations add to the compliance burden for taxpayers, financial services firms acting as IRA custodians, and financial planners and advisors, as well as the burden for IRS in enforcing the IRA rules.

[6]Taxpayers ineligible for the deduction because of income limitations can make nondeductible contributions to take advantage of the deferral on investment earnings.

[7]See GAO, *National Saving: Current Saving Decisions Have Profound Implications for Our Nation's Future Well-Being*, GAO-06-628T (Washington, D.C.: Apr. 6, 2006), and *National Saving: Answers to Key Questions*, GAO-01-591SP (Washington, D.C.: June 2001), for more information on measuring personal saving. Economists disagree about whether tax incentives have been or could be effective in increasing the overall level of personal saving.

[8]Pub. L. No. 105-34 (1997).

[9]For more information on employer-sponsored IRAs, see GAO, *Individual Retirement Accounts: Government Actions Could Encourage More Employers to Offer IRAs to Employees*, GAO-08-590 (Washington, D.C.: June 4, 2008).

Some taxpayers—whether intentionally or unintentionally—fail to comply with the rules. Some taxpayers may inadvertently contribute more than allowed given their income limits. A taxpayer may have an incentive to lie about the reason for an early withdrawal to avoid penalty. Noncompliance with IRA rules—for example, overstated deductions for contributions and underreported distributions from traditional IRAs—can contribute to the gross tax gap, last estimated at $345 billion for tax year 2001. The gross tax gap is the annual difference between what taxpayers pay in taxes voluntarily and on time and what they should pay under the law. Because of taxpayer noncompliance, the burden of funding the nation's commitments falls more heavily on taxpayers who willingly and accurately pay their taxes.

You asked us to examine taxpayer compliance and challenges with key IRA rules. This report (1) provides an overview of key IRA contribution, distribution, and other rules and describes how IRS educates taxpayers on these rules; (2) describes what IRS knows about the extent of noncompliance for IRA transactions reported on taxpayer returns; and (3) describes the challenges taxpayers face with key IRA rules and some options to strengthen taxpayer compliance. Separately, we issued to you a Limited Official Use Only report detailing the results of our review of IRS enforcement of taxpayer compliance with IRA rules.[10] This report, as negotiated with IRS, provides a public version of material from our earlier report and supplements that report in that it describes more fully the challenges facing taxpayers in navigating IRA rules.

To provide an overview of key IRA rules, we relied primarily on IRS Publication 590, which explains the rules that taxpayers are to follow in contributing to, and receiving distributions from, an IRA. Specific rules depend on account type. This report focuses on traditional and Roth IRAs set up by individuals to save on their own.[11] We also spoke with IRS and Treasury officials and reviewed reports from the Congressional Research Service, the Congressional Budget Office, the Investment Company

[10]GAO, *Individual Retirement Accounts: IRS Enforces Some but Not All Rules, and Opportunities Exist to Strengthen Taxpayer Compliance*, GAO-07-1059SU (Washington, D.C.: Sept. 19, 2007). Designated by IRS as Limited Official Use Only, our September 2007 report contains two additional recommendations to improve IRS enforcement and research related to IRA rules.

[11]This report does not address employer-based individual retirement arrangements, such as SEPs or SIMPLEs; SEP and SIMPLE IRAs are subject to different rules and guidance than traditional and Roth IRAs.

Institute, and others. To describe how IRS educates taxpayers on these rules, we also interviewed IRS officials conducting IRA service activities and reviewed other guidance, such as the IRS Web site and various IRS publications.

To describe what IRS knows about the extent of taxpayer misreporting of IRA transactions on their tax returns, we reviewed publications and documents, interviewed IRS officials, and used the 2001 National Research Program (NRP)—IRS's most recent research study of individual taxpayer compliance—to estimate the extent of taxpayer misreporting. Specifically, taxpayers report deductible contributions to and taxable distributions from traditional IRAs on the Form 1040 individual income tax return.[12] We provide the margin of error based on 95 percent confidence for estimates from the NRP samples of individual tax returns. We also used enforcement data supplied by two IRS compliance programs, the Math Error program and the Automated Underreporter (AUR) program. The Math Error program electronically checks for obvious math errors as tax returns are processed, and the AUR program matches taxpayer returns with IRA custodian-reported information.[13] We determined that the IRS research and enforcement data we used were sufficiently reliable for the purposes of this report.

To describe the challenges taxpayers face with key IRA rules and some options to strengthen taxpayer compliance, we reviewed documents from IRS's enforcement and service programs that address IRAs. We also interviewed IRS officials, as well as representatives knowledgeable about IRAs from financial industry organizations and advisor representatives, including the Securities Industry and Financial Markets Association, American Bankers Association, and American Institute of Certified Public Accountants. We conducted two rounds of interviews with financial industry organizations and advisor representatives. In the first round, we asked open-ended questions about the challenges and options for strengthening compliance. In the second round, we used a standard set of questions in the interviews with the representatives to try to verify

[12]For Roth IRAs, contributions are not deductible, and distributions are generally tax-free and are not reported on the 1040 tax return.

[13]The discussion of these two programs is a public version of the discussion in our more comprehensive September 2007 report that contained sensitive tax enforcement information. Specific details regarding the nature of these automated enforcement programs that IRS considered sensitive were removed.

responses and obtain additional context for the challenges and options mentioned. We limited our discussion of the challenges and options identified to include only those related to the key IRA rules reviewed in this report. These challenges and options are not exhaustive nor are the trade-offs associated with each option. (See app. I for further discussion of our scope and methodology.) We conducted this performance audit from March 2008 through August 2008 in accordance with generally accepted government auditing standards.[14] Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Results in Brief

Taxpayers face a myriad of tax rules governing contributions to, distributions from, and rollovers between accounts for traditional and Roth IRAs. Taxpayers who fail to comply can face added taxes and penalties, which may reduce their retirement savings. Both traditional and Roth 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. Taxpayers who do not qualify for a traditional IRA deduction can make nondeductible contributions, which come with additional reporting rules. Tax rules for distributions diverge for traditional and Roth IRAs. Whereas traditional IRA distributions are fully taxable for a taxpayer who made only deductible contributions, Roth IRA distributions are generally tax-free. For both IRA types, distributions before age 59½ are generally subject to a 10 percent early withdrawal penalty, with some exceptions, such as buying a first home. Whereas Roth IRA owners are not required to take distributions during their lifetime, taxpayers over age 70½ are required to take minimum distributions from traditional IRAs or face a 50 percent penalty on the required distribution amount. Rollovers, where a taxpayer moves money from a pension plan or another IRA into an IRA, must be completed within 60 days of the taxpayer receiving the money, or the amounts are taxable and subject to penalty. To assist taxpayers in

[14] This reflects the additional audit work performed for this report since our September 2007 report.

voluntarily complying with IRA rules, IRS offers special publications, notably Publication 590, and telephone assistance for taxpayers with IRA questions.

Even with IRS's efforts to support taxpayers, IRS data show that some taxpayers, whether intentionally or unintentionally, fail to comply with rules for reporting contribution deductions and taxable distributions from traditional IRAs. On the basis of the most recent research results available, IRS estimated that in 2001, nearly 15 percent of those who made traditional IRA contribution deductions misreported their deductions on their tax returns, and nearly 15 percent of taxpayers who took taxable distributions from traditional IRAs misreported this information. IRS relies on automated enforcement and examination programs to detect and correct these types of IRA misreporting. The Math Error program, which checks for obvious errors, found that thousands of taxpayers in 2006 tried to deduct contributions over the limit for traditional IRAs. For tax year 2004 (the last full year available), the AUR program, which matches tax returns with information returns, assessed additional taxes of $23.2 million for about 24,000 taxpayers for ineligible traditional IRA contribution deductions or exceeding the deduction limits. The AUR program also assessed $61.1 million in taxes and penalties for about 38,000 taxpayers taking 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. Complexity of IRA rules was cited by IRS officials, IRA custodians, and financial planners we interviewed as the overarching contributor to challenges facing taxpayers in complying with IRA rules. According to interviewees, taxpayers may not understand that the annual contribution limit applies across traditional IRAs and Roth IRAs in combination, and taxpayers with incomes in the phaseout ranges make mistakes in calculating the partial amount for their eligible contributions. On the distribution side, interviewees said that taxpayers get confused over which exceptions for early withdrawals are not subject to penalties, in part because the exceptions differ for employer plans. Older taxpayers may make mistakes in determining when they must start minimum distributions and calculating the correct amounts, and the required minimum distribution rule poses a growing challenge as the population ages and increasing amounts of pension assets are rolled over into IRAs. Representatives of financial firms and advisors we interviewed identified some options for IRS to clarify IRA guidance, such as for the combined contribution limit rule, or develop tools to help taxpayers comply, such as a Web-based calculator for minimum distributions required for older taxpayers. IRS could explore actions such as requiring additional reporting by custodians or simplifying the required minimum distribution rule to help taxpayers to comply with this complicated rule. Other options to reduce the complexity of IRA contribution and distribution rules, such as eliminating income limits, pose trade-offs and could be considered in the context of broader tax reform.

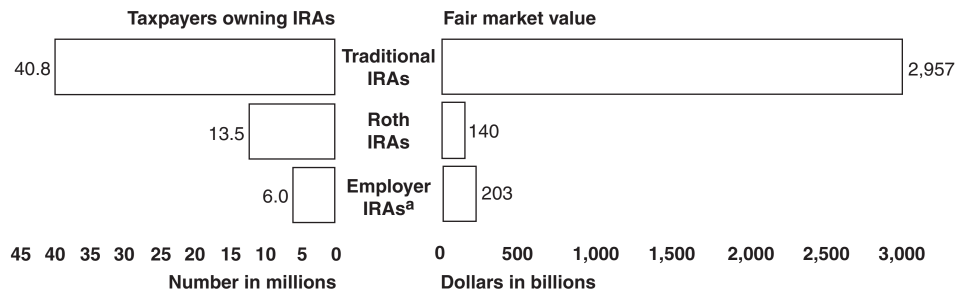
To address the challenges facing taxpayers in complying with current IRA rules, we recommend that IRS (1) clarify guidance to help taxpayers better understand the combined contribution rule and (2) pursue administrative options, including additional taxpayer guidance, and work with Treasury on regulatory or legislative strategies to help taxpayers comply with the required minimum distribution rule. In comments on a draft of this report, IRS agreed to take actions consistent with both of our recommendations. Treasury provided technical comments, which we incorporated as appropriate.

Background

According to IRS's Statistics of Income (SOI) research, of about 51 million taxpayers who owned IRAs as of 2004, nearly 41 million owned traditional IRAs compared to more than 13 million taxpayers who owned Roth IRAs, as shown in figure 1.[15] Of the $3.3 trillion held in IRAs as of 2004, traditional IRAs accounted for almost $3 trillion. Traditional IRAs have grown not only from contributions but also from rollovers from employer pension plans. First introduced in 1998, Roth IRAs totaled $140 billion as of 2004. While Roth IRAs and employer-based SIMPLE and SEP IRAs constitute a small share of IRA assets, the number of taxpayers who own Roth IRAs surpasses the number of those owning employer-based IRAs, as shown in figure 1. IRA assets surpass assets held in either employer-sponsored defined benefit or defined contribution plans.

[15]Some taxpayers may own more than one type of IRA.

Figure 1: Number of Taxpayers Owning IRAs and Fair Market Value of IRAs by IRA Type, Tax Year 2004



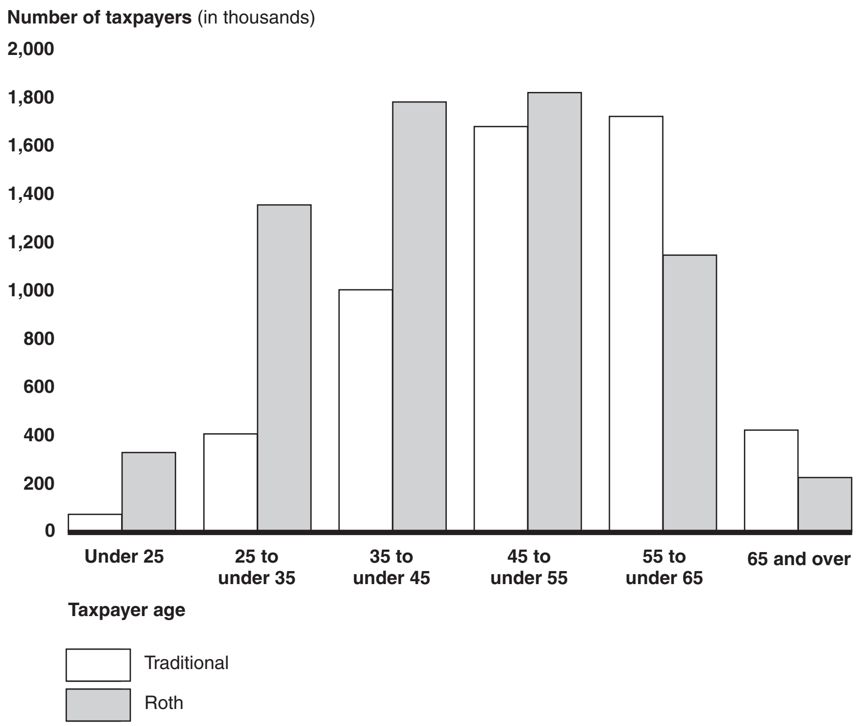
Source: IRS.

[a]Employer IRAs include SEP and SIMPLE IRAs.

According to IRS's SOI analysis, about 5.3 million taxpayers contributed about $12.6 billion to traditional IRAs for tax year 2004, and deductible contributions accounted for over three-quarters of that amount. Also, about 6.7 million taxpayers contributed more than $14.7 billion to Roth IRAs for tax year 2004. Traditional IRA contributions averaged $2,381 and Roth IRA contributions averaged $2,211 for tax year 2004. In addition to contributions, more than 3.6 million taxpayers rolled over about $215 billion into traditional IRAs from employer plans in 2004, according to IRS's SOI analysis.

Taxpayers contributing to Roth IRAs are younger on average than traditional IRA owners, as illustrated in figure 2. On the basis of IRS's SOI analysis for tax year 2004, more taxpayers under age 55 contributed to a Roth IRA than to a traditional IRA, while the reverse is true for taxpayers ages 55 and over. Taxpayers over age 70 may contribute to Roth IRAs, but contributions to traditional IRAs are not allowed after age 70½.

Figure 2: Number of Taxpayers Contributing to Traditional and Roth IRAs by Age, Tax Year 2004



Source: IRS.

Notes: Data are from IRS's SOI. For the category 65 and over, data for taxpayers contributing to traditional IRAs reflect taxpayers not over age 70½. Data for taxpayers contributing to Roth IRAs reflect taxpayers age 70 and over.

Even with the sheer numbers of taxpayers owning IRAs, most taxpayers eligible for IRAs do not take advantage of the opportunity to save for retirement on a tax-preferred basis. According to IRS SOI estimates, only 10 percent of those eligible contributed in 2004.[16]

According to IRS's SOI analysis, about 12.3 million taxpayers withdrew $140 billion—traditional IRA withdrawals accounted for more than 95 percent—during tax year 2004. Based on SOI estimates for tax year 2004,

[16]For more information on IRA participation rates, see Congressional Budget Office, *Utilization of Tax Incentives for Retirement Saving: Update to 2003* (Washington, D.C.: Mar. 2007).

about 54 percent of taxpayers with IRA withdrawals were age 70 and older, withdrawing about $55 billion during 2004.

Myriad of Rules Govern IRA Transactions, and IRS Provides Services to Educate Taxpayers

Individuals face a myriad of tax rules in using tax-advantaged traditional and Roth IRAs, and noncompliance can trigger taxes and penalties that may reduce their retirement savings. As outlined in table 1, rules governing IRAs and associated penalties generally can be categorized into contribution rules, including contribution limits and eligibility; distribution rules; and rollover rules.[17] Taxpayers and IRA custodians must also follow rules for reporting IRA transactions. Publication 590 explains the IRA rules that taxpayers are to follow, and IRS offers additional assistance through its Web site and toll-free phone lines.

Table 1: General IRA Rules and Associated Penalties by Transaction Type

Transaction	Associated rules[a]
Contribution rules for traditional IRA	• Deductible contribution limit for each tax year • Deductible contribution eligibility based on: Having taxable compensation Age: did not reach age 70½ by end of year Whether taxpayer, or spouse, is an active participant in an employer-sponsored retirement plan, and income limits depending on marital filing status for those covered by such plans • Nondeductible contributions allowed regardless of income and pension coverage • Contribution limit for each tax year[a,b] • Excess contributions are subject to a 6 percent tax
Contribution rules for Roth IRA	• Contribution eligibility based on: Having taxable compensation Income limits subject to marital filing status • Contribution limit for each tax year[a,b] • Excess contributions are subject to a 6 percent tax
Distribution rules for traditional IRA	• Distribution is taxable income • Early distributions before age 59½ subject to 10 percent penalty unless taken for specified reasons, such as disability or buying a first home • Required minimum distributions starting at age 70½, subject to 50 percent penalty if not taken • Distribution rules for nondeductible IRAs are based on basis calculations

[17]See glossary for list of IRA terms and app. II for IRS forms related to IRAs. Information in glossary is from IRS Publication 590.

Transaction	Associated rules[a]
Distribution rules for Roth IRA	• Distributions are not taxed if (1) account is at least 5 years old and (2) owner is over age 59½, disabled, or a first-time home buyer, or if distributions are paid to a beneficiary after owner's death • Nonqualified distributions may be subject to tax to the extent that distributions exceed after-tax contributions; nonqualified distributions are subject to 10 percent penalty unless taken for specified reasons, such as qualified higher education expenses • No minimum distributions required during owner's lifetime, but distributions generally required to be taken after IRA owner's death, subject to 50 percent penalty if not taken
Rollover to traditional IRA rules	• Taxpayer has 60 days to roll over assets tax-free from a retirement plan (pension or another traditional IRA) to a traditional IRA, and only one rollover is allowed per year per traditional IRA
Conversion from traditional IRA to Roth IRA rules[c]	• No limit on amount that can be converted • Conversion eligibility subject to income limit and filing status • Generally, conversion amounts are taxable income when converted

Source: GAO analysis of IRS Publication 590.

[a]This is a simplified representation of rules for traditional and Roth IRAs; eligibility and contributions limits, among other rules, have varied from year to year as discussed further below.

[b]In addition to the contribution limit for traditional IRAs, there is a combined annual limit for traditional and Roth IRAs.

[c]Beginning in 2008, amounts from any retirement plan can be converted to a Roth IRA. Beginning in 2010, income limits on conversions are eliminated.

Contribution Rules

Both traditional and Roth IRAs have rules governing eligibility to contribute, and all IRA contributions are subject to an annual limit. For both IRA types, eligibility is limited to taxpayers with taxable compensation.[18] For a traditional IRA in tax year 2008, eligibility for a full or partial deduction from taxable income depends on whether a taxpayer or spouse is covered by an employer-sponsored retirement plan as well as limits on modified adjusted gross income (AGI)[19] and filing status, as shown in table 2. For example, a single taxpayer not covered by an employer plan can take a full deduction regardless of income, and a married taxpayer filing jointly whose spouse is covered by an employer

[18]Eligibility based on taxpayer compensation generally includes wages, salaries, professional fees, bonuses, and other amounts taxpayers receive for providing personal services and from commissions, self-employment income, alimony and separate maintenance payments taxpayers receive, and nontaxable combat pay. Taxable compensation does not include earnings and profits from property, pension or annuity income, deferred compensation received, income from partnerships for which the taxpayer did not provide services that are material income-producing factors, and any amounts excluded from income, such as foreign earned income and housing costs.

[19]Modified AGI is calculated by taking AGI and adding back certain items, such as foreign housing deductions and student loan deductions.

plan can take the full deduction if the couple's modified AGI was $159,000 or less for 2008. A taxpayer ineligible for any deduction based on pension coverage or modified AGI can still make nondeductible contributions to a traditional IRA. A taxpayer in the phaseout range who is married and filing jointly or a qualified widower has to figure out the deductible contribution portion and decide whether to contribute the rest on a nondeductible basis.[20]

Table 2: Eligibility for Deduction of Traditional IRA Contributions, Tax Year 2008

Income tax filing status	Modified AGI	Deduction
Individual covered by a retirement plan at work		
Single or head of household	$53,000 or less	Full
	More than $53,000 but less than $63,000	Partial
	$63,000 or more	None
Married, filing jointly or qualifying widow(er)	$85,000 or less	Full
	More than $85,000 but less than $105,000	Partial
	$105,000 or more	None
Married, filing separately	Less than $10,000	Partial
	$10,000 or more	None
Individual not covered by a retirement plan at work		
Single, head of household, or qualifying widow(er)	Any amount	Full
Married, filing jointly or married, filing separately with spouse not covered by a plan at work	Any amount	Full
Married, filing jointly with a spouse who is covered by a plan at work	$159,000 or less	Full
	More than $159,000 but less than $169,000	Partial
	$169,000 or more	None
Married, filing separately	Less than $10,000	Partial
	$10,000 or more	None

Source: IRS.

Note: Data are from IRS Publication 590. Publication 590 includes details on calculating deductions for taxpayers taking partial deductions.

[20]The phaseout range is the range of modified AGI during which the eligible deductible contribution amount phases down from maximum amount to zero.

For a Roth IRA, eligibility also depends on modified AGI and filing status, as shown in table 3. For example, a single taxpayer with modified AGI of less than $101,000 is eligible for a full contribution in 2008, and married taxpayers filing jointly with modified AGI of less than $159,000 also are eligible for a full contribution. A single taxpayer with AGI of at least $116,000 or married taxpayers filing jointly with AGI of $169,000 or more cannot contribute to a Roth IRA for 2008. Taxpayers in the income phaseout range have reduced contribution limits. Coverage by an employer-sponsored retirement plan does not affect eligibility for a Roth IRA.

Table 3: Eligibility for Roth IRA Contributions, Tax Year 2008

Income tax filing status	Modified AGI	Eligibility
Married, filing jointly or qualifying widow(er)	Less than $159,000	Full
	At least $159,000 but less than $169,000	Partial
	$169,000 or more	None
Married, filing separately and lived with spouse at any time during the year	0	Full
	More than zero but less than $10,000	Partial
	$10,000 or more	None
Single, head of household, or married filing separately and did not live with spouse at any time during the year	Less than $101,000	Full
	At least $101,000 but less than $116,000	Partial
	$116,000 or more	None

Source: IRS.

Note: Data are from IRS Publication 590.

Both traditional and Roth IRAs are subject to annual contribution limits. Table 4 shows how the annual limit has changed over time and varies depending on a taxpayer's age. For 2008, taxpayers under age 50 can contribute up to $5,000 and those over the age of 50 and under age 70½ can contribute up to $6,000 to traditional and Roth IRAs. Taxpayers age 70½ and older can contribute to a Roth IRA only. Contributions can be made any time during a year or by the due date for filing a tax return, not including extensions. For example, contributions for 2008 must be made by April 15, 2009. A taxpayer who contributes less than the annual limit cannot make up the difference after that date.

Table 4: Maximum IRA Contribution Limits for IRA Owners by Age, Tax Years 1975–2008

Tax years	Age 49 and below	Age 50 and over[a]
1975–1981	$1,500	$1,500
1982–2001	2,000	2,000
2002–2004	3,000	3,500
2005	4,000	4,500
2006–2007	4,000	5,000
2008[a]	5,000[b]	6,000[b]

Source: Congressional Budget Office.

[a]Catch-up contributions for taxpayers age 50 and older were effective beginning in 2002. Taxpayers age 70½ and older can contribute to Roth IRAs only.

[b]After 2008, increases in contribution limit (excluding additional contributions allowed for ages 50 and over) will be indexed for inflation in $500 increments.

Total contributions to Roth and traditional IRAs in any year cannot exceed the combined contribution limit. Any contribution in excess of the limit or made by an ineligible taxpayer is subject to a 6 percent penalty annually if the excess amount—and any earnings—is not withdrawn by the date the return for the year is due, including extensions. A taxpayer can choose to either withdraw an excess contribution to avoid the penalty or carry the excess forward as a contribution for a later year but still is liable for the excess contribution penalty. For example, if a taxpayer contributes more than allowed in 2008, that taxpayer has until April 15, 2009, to remove the excess, or the taxpayer can pay the penalty for 2008 and apply the excess as contributions for 2009.[21] A taxpayer also can treat a contribution made to one IRA as having been made to a different IRA type; this is known as a recharacterization. For example, a taxpayer ineligible for a Roth IRA could recharacterize a contribution and transfer the amount to a traditional IRA.

Distribution Rules

Whereas both IRA types share a combined contribution limit and have rules limiting eligibility, tax rules for distributions diverge for traditional and Roth IRAs. Traditional IRA distributions are taxable in the year received. Distributions are fully taxable for a taxpayer who made only deductible contributions and partially taxable for a taxpayer who also

[21]In the example, the taxpayer cannot apply the 2008 contributions to an earlier year even if the taxpayer contributed less than the maximum amount in the earlier year.

made nondeductible contributions.[22] In contrast, Roth IRA distributions are tax-free after age 59½ as long as the taxpayer has held the Roth IRA for 5 years.[23] For both traditional and Roth IRAs, early distributions before age 59½ for reasons other than specific exceptions result in 10 percent additional tax.[24]

Another key difference between traditional and Roth IRAs is the required minimum distribution rule to limit tax benefit from earnings accumulating on a tax-preferred basis in an IRA. Taxpayers age 70½ are required to take minimum distributions from tax-deferred traditional IRAs, whereas Roth IRA owners are not required to take distributions during their lifetime. Under 2002 regulations, which simplified the calculation, required minimum distributions for a traditional IRA are calculated using the previous year's fair market value divided by life expectancy based on a uniform table.[25] A taxpayer must begin required minimum distributions by April 1 of the year after turning age 70½. The second distribution must be made by December 31 of the year containing this April 1, and subsequent required minimum distributions must be made by December 31. Failure to take the required minimum is subject to a 50 percent penalty on the required amount not distributed. A taxpayer may request that IRS excuse the penalty if the excess accumulation is due to reasonable error and the taxpayer is taking steps to draw down the excess. Beneficiaries inheriting

[22]Taxpayers are required to complete Form 8606 if they received a distribution from a traditional IRA and have ever made nondeductible contributions to any of their traditional IRAs. Using the form, they figure the nontaxable distributions for that year and their total IRA basis for that and earlier years.

[23]The 5-year period begins with the first taxable year for which a contribution was made to the Roth IRA. Early distributions within 5 years of contributing to the account may be subject to income and additional taxes. Roth IRAs held for 5 years are also tax-free if the distribution is (1) made because a taxpayer is disabled, (2) made to the beneficiary of an estate after the taxpayer's death, or (3) for the purchase or building of a first home.

[24]By law, the nine exceptions for early distributions from a traditional IRA are for (1) unreimbursed medical expenses exceeding 7.5 percent of AGI, (2) cost of medical insurance for the unemployed, (3) the disabled, (4) a beneficiary of a deceased IRA owner, (5) distributions in the form of an annuity or a series of substantially equal payments, (6) qualified higher education expenses, (7) purchase or building of a first home, (8) IRS levy, and (9) qualified military reservist distribution. See IRS Publication 590 for more on these exceptions for traditional and Roth IRAs.

[25]The exception is that a taxpayer with a spouse more than 10 years younger can use a uniform joint life expectancy table. IRS Publication 590 explains the minimum required distribution rule and how to use the life expectancy tables to calculate the minimum distribution.

either IRA type are required to take minimum distributions, and the rules depend on whether the beneficiary is a surviving spouse, other individual, or an entity, such as a trust.

Rollover and Conversion Rules

Rollovers, where a taxpayer moves money from a pension plan or an IRA into another IRA, are also subject to rules specifying that a tax-free rollover must be completed within 60 days of the taxpayer receiving the money and that only one IRA-to-IRA rollover is allowed per traditional IRA during a 1-year period. If a taxpayer does not roll over money within the allowed time or rolls over an IRA too frequently, the transaction does not qualify for tax-free treatment. For a failed rollover, the distribution from the first IRA is taxable and subject to the 10 percent early distribution penalty if the taxpayer is younger than age 59½. Further, amounts contributed in excess of the annual limit to the second IRA are subject to a 6 percent additional tax to penalize excess contributions. IRS has authority to waive the 60-day requirement and extend the rollover period where the failure to do so would be against good conscience, such as in the event of a disaster or an event beyond the taxpayer's reasonable control. The 60-day requirement is automatically waived in the cases of financial institution errors in transferring and depositing the rollover funds. Otherwise, a taxpayer can pay a user fee and apply for a private letter ruling requesting a waiver.[26] A direct transfer between IRA trustees is not considered a rollover and is not subject to the 1-year waiting period. Similarly, a recharacterization of contributions from one type of IRA to another IRA type is not considered a rollover subject to the 1-year waiting period.

Conversions, where a taxpayer pays taxes deferred in a traditional IRA to convert those amounts to a Roth IRA, are subject to income eligibility rules.[27] For tax year 2007, a taxpayer with modified AGI of $100,000 or less and not married filing separately is eligible to make a Roth conversion.[28] If

[26]Before 2006, the fee was $95. Effective February 1, 2006, the fee is $500 for rollovers less than $50,000, $1,500 for those $50,000 to less than $100,000, and $3,000 for $100,000 and larger rollovers.

[27]The Tax Increase Protection and Reconciliation Act of 2005, Pub. L. No. 109-222 (2006), enacted in May 2006, removed the income restriction for Roth IRA conversions after December 31, 2009. The Pension Protection Act of 2006, Pub. L. No. 109-280 (2006), permits conversion to Roth IRAs from any kind of plan beginning in 2008.

[28]This income limit for conversions was enacted in 1997.

a taxpayer is ineligible and the conversion fails, unless recharacterized, amounts distributed from the traditional IRA before age 59½ are subject to a 10 percent penalty, and the Roth IRA contribution in excess of the annual limit is subject to a 6 percent additional tax.

IRS Reporting Rules for Taxpayers and IRA Custodians

Taxpayer reporting rules differ for traditional IRAs and Roth IRAs. For a traditional IRA, a taxpayer reports deductible contributions on line 32 of the individual tax return (Form 1040), and the deduction reduces a taxpayer's current taxable income. A taxpayer is to report taxable traditional IRA distributions—including amounts converted to a Roth IRA—as income on line 15 of the individual tax return.[29] Any taxpayer who makes a nondeductible traditional IRA contribution or receives a distribution from a traditional IRA and ever made nondeductible traditional IRA contributions must also file Form 8606.[30] In contrast to nondeductible traditional IRA contributions, taxpayers do not report Roth IRA contributions to IRS, and Roth IRA distributions are tax-free and generally are not reported on the 1040 tax return.[31] Taxpayers who contributed more than allowed to a traditional or Roth IRA, withdrew money before age 59½, or failed to take required minimum distributions must file Form 5329 to report the associated penalties due.

Custodians, including banks or mutual funds holding account owners' IRA assets, follow the same basic procedures for traditional and Roth IRA contributions and distributions in terms of reporting to IRS. For both traditional and Roth IRAs, the custodian is required to submit a Form 5498 detailing the total contributions, rollovers, recharacterizations, and fair market value for every IRA. For example, for a taxpayer holding one traditional IRA and two Roth IRAs, the custodian should send three Form 5498s to the taxpayer and IRS. Given that taxpayers have until the return filing date to contribute to an IRA, the due date for filing Form 5498 is May 31. Custodians are also to report on Form 5498 whether a taxpayer is subject to required minimum distributions for the coming year but are not required to report to IRS the minimum amount calculated for each

[29]Distributions from a traditional IRA may be partly taxable if a taxpayer has basis with nondeductible contributions that were already taxed.

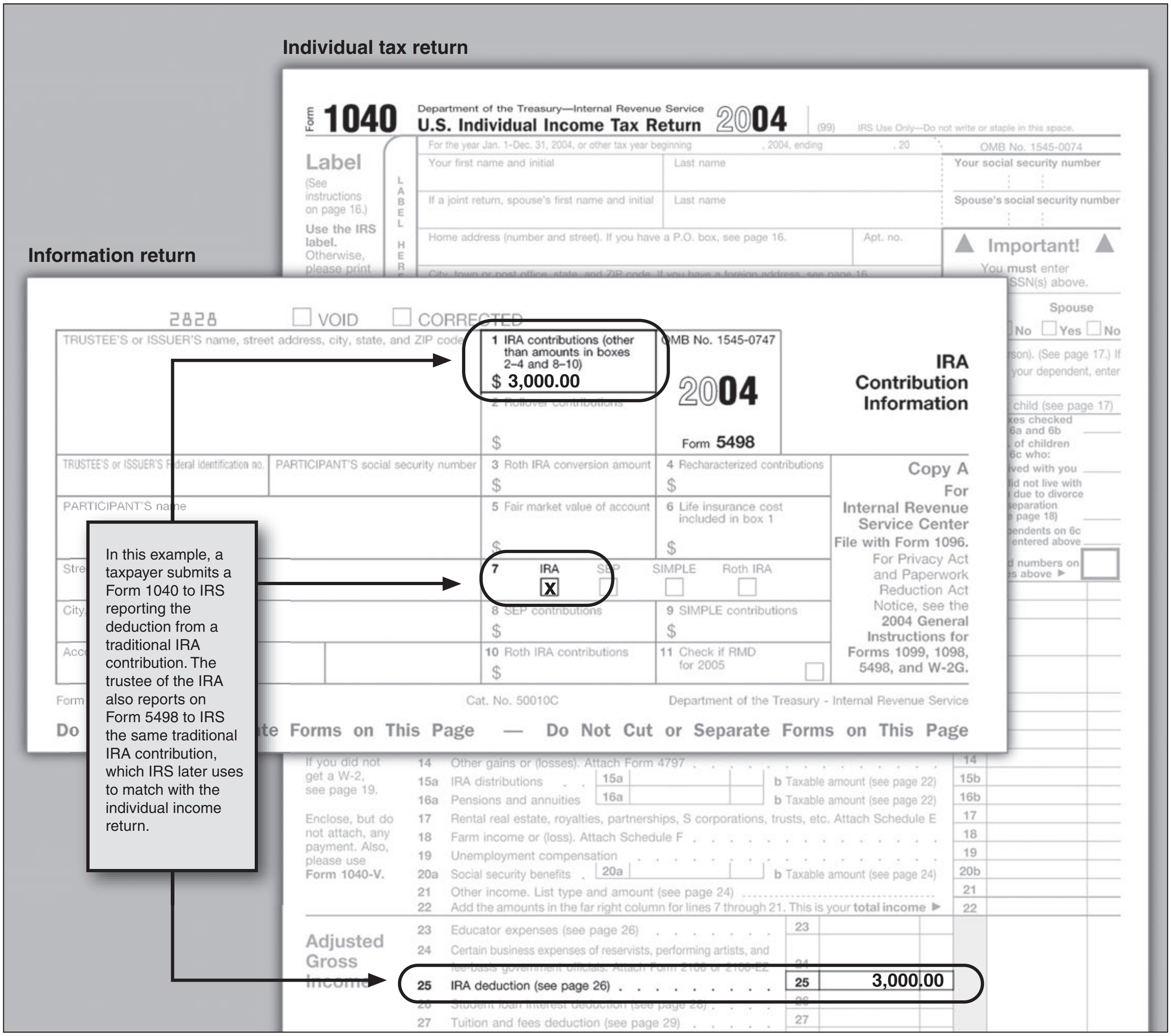
[30]The taxpayer must file Form 8606 even if no tax return was filed for the year, and the penalty for failure to file Form 8606 is $50.

[31]Early distributions within the first 5 years of setting up a Roth IRA and before age 59½, unless an exception applies, are subject to the 10 percent penalty.

account. Instead, the custodians must report the minimum required distribution amount to the taxpayer or at least offer to calculate the amount; the statement or offer must include the date by which the amount must be distributed. For both traditional and Roth IRAs, the custodian is also required to submit a Form 1099-R each year that a withdrawal takes place detailing the total distributions taken from the account during the calendar year and providing some information about the distribution, such as whether the distributions were taken before age 59½ and whether a known penalty exception applies. The due date for filing Form 1099-R with IRS is February 28. Another key information report is the Form W-2 from employers showing compensation and employer pension plan coverage used in determining eligibility for traditional IRA deductions.

Third-party reporting by IRA custodians provides information that taxpayers can use in preparing their tax returns and that IRS can use to identify noncompliant taxpayers. Figure 3 illustrates what taxpayers report for a traditional IRA contribution deduction and what custodians report on Form 5498 about the contribution. Mismatches between these two sources of information can trigger an enforcement response by IRS. Likewise, mismatches between distributions reported by custodians on a 1099-R and taxpayers' individual tax returns can trigger enforcement by IRS.

Figure 3: Illustrative Example of Using Form 1040 with Information Reporting to Check Taxpayer Compliance with Traditional IRA Rules



Source: IRS.

IRS's Service Activities Aim to Increase Taxpayer Understanding of IRA Rules

IRS service activities aim to increase taxpayer understanding of and improve taxpayer compliance with IRA rules for traditional and Roth IRAs. IRS's Media and Publications office offers publications, forms, and forms instructions to help taxpayers complete their tax returns accurately. IRS updated the 2006 Publication 590 to reflect new legislation, permanently raising the IRA contribution limits and indexing them for inflation. IRS also developed procedures and guidance for the new provision effective for tax year 2006, allowing those ages 70½ and older to exclude from gross income an amount that does not exceed $100,000 if it is distributed for charitable purposes directly from their traditional IRAs. For 2007, IRS updated Publication 590 to reflect new provisions for onetime IRA transfers to fund a qualified health savings account and catch-up contributions for pension plan participants whose employers went bankrupt. Financial industry organizations and advisor representatives we interviewed complimented Publication 590 for translating the myriad of complicated IRA contribution and distributions rules into "plain English" to help taxpayers comply.

IRS also provides special publications that include IRA information for taxpayers seeking assistance at IRS walk-in centers or for those consulting the IRS Web site. Further, taxpayers seeking assistance with IRA questions can call the IRS toll-free lines. IRS employees are trained with a probe and response guide to accurately answer questions about IRA rules.

IRS Research and Enforcement Data Show Taxpayers Misreport Millions of Dollars in Traditional IRA Transactions

IRS research and enforcement data show that some taxpayers misreported in aggregate millions of dollars in traditional IRA contributions and distributions on their tax returns.[32] The NRP examination study of tax year 2001 returns, the most recent research results available, showed that nearly 15 percent of those who made traditional IRA contribution deductions misreported their deductions on their tax returns, and nearly 15 percent of taxpayers who took taxable distributions from traditional IRAs misreported this information. IRS relies primarily on automated enforcement to detect misreported IRA contribution deductions and taxable distributions. IRS first checks tax returns for obvious IRA contribution errors and then matches tax returns to custodian-reported information to ensure, among other things, that taxpayers reported taxable

[32]This report focuses on what IRS knows about taxpayer misreporting of IRA transactions on tax returns. Our separate Limited Official Use Only report discusses more fully how IRS enforces key IRA rules.

distributions. For example, the AUR program, in tax year 2004, assessed taxes and penalties totaling about $61 million from almost 38,000 taxpayers who misreported early distributions from traditional IRAs.

Research Shows Taxpayers Misreport Millions in Traditional IRA Transactions

The NRP study of tax year 2001 returns, the most recent research results available, reported numbers of taxpayers who either misreported deductions for their traditional IRA contributions or misreporte95

taxes when taking withdrawals. NRP results for 2001 yield a measure of noncompliance across taxpayers.[33]

- Of taxpayers who made deductible traditional IRA contributions, an estimated 14.8 percent[34] (554,657 taxpayers)[35] did not accurately report the IRA deduction on their individual tax returns—10.4 percent overstated their deductible contributions (that is, exceeded the applicable limit) and 4.4 percent underreported their deductible contributions (that is, reported less on their returns than they actually could deduct).[36] The understated net income due to these misreported traditional IRA contribution deductions was $392 million,[37] including both taxpayers who either overstated or understated their contribution deductions to a traditional IRA. For example, a taxpayer is considered to have overstated a deduction if the deduction reported exceeds the taxpayer's actual contribution or if the deduction is higher than the taxpayer's eligibility allows.
- Of taxpayers who had taxable traditional IRA distributions, an estimated 14.6 percent[38] (1.5 million taxpayers)[39] misreported withdrawals from their traditional IRA distributions—13.7 percent understated (that is, reported

[33]NRP estimates of the number of taxpayers by unique tax returns and not by unique taxpayers. It is possible that within one tax return, two taxpayers are noncompliant.

[34]We are 95 percent confident that from 11.8 percent to 17.8 percent did not accurately report their traditional IRA deductions.

[35]Estimate has a margin of error of less than or equal to (+/-) 124,057.

[36]We are 95 percent confident that from 7.9 percent to 13.3 percent overstated their traditional IRA deductions. We are 95 percent confident that from 2.8 percent to 6.5 percent understated their traditional IRA deductions.

[37]Dollar estimate has a margin of error of less than or equal to (+/-) $192 million.

[38]We are 95 percent confident that from 12.7 percent to 16.6 percent did not accurately report their traditional IRA distributions.

[39]Estimate has a margin of error of less than or equal to (+/-) 220,026.

an amount less than what the taxpayer withdrew) and 0.9 percent overstated IRA distributions (that is, reported an amount greater than what the taxpayer withdrew).[40] The underreported net income due to misreported IRA distributions was $6.3 billion,[41] including taxpayers who failed to report early distributions and the associated tax.

The 2001 NRP data did not provide a measure of noncompliance for some IRA transactions not reported directly on the Form 1040 tax return. For example, because Roth IRA contributions are not reported, the 2001 NRP study did not capture information on taxpayer errors under Roth IRA contribution rules. While NRP does cover misreporting of distributions taken, the 2001 NRP study did not capture estimates of noncompliance for older taxpayers who failed to take required minimum distributions from their traditional IRAs. IRS officials told us that for the upcoming NRP for tax year 2007, they are planning to gather additional information about taxpayer as well as custodian misreporting of IRA transactions.

[40]We are 95 percent confident that from 11.8 percent to 15.7 percent underreported their traditional IRA distributions. We are 95 percent confident that from 0.5 percent to 1.4 percent overreported their traditional IRA distributions.

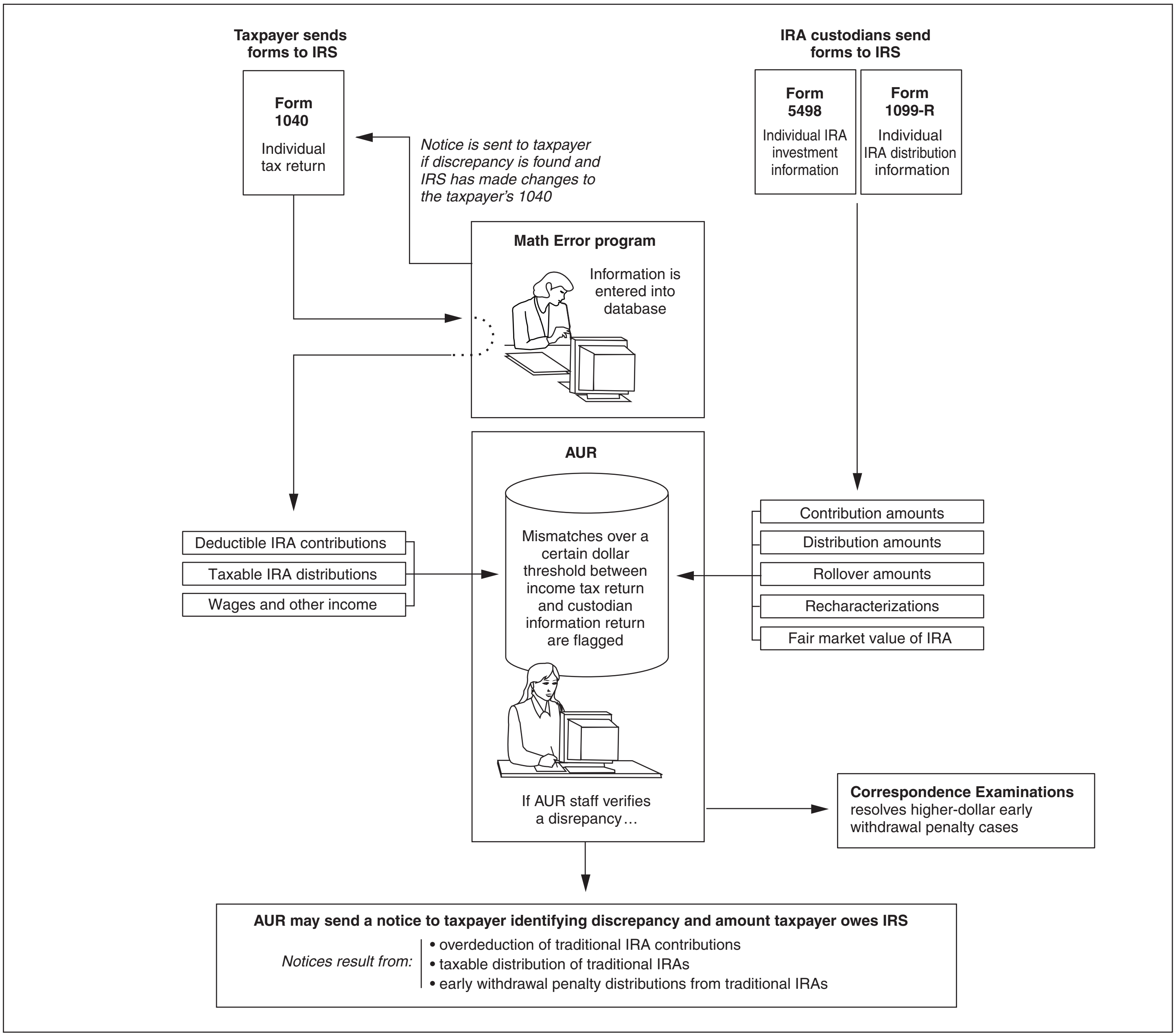
[41]Dollar estimate has a margin of error of less than or equal to (+/-) $2.2 billion.

Automated Enforcement Detects and Corrects Millions in IRA Noncompliance

Whereas NRP yields a measure of taxpayer misreporting of traditional IRA transactions, IRS enforcement data reflect cases where IRS pursued taxpayers who appeared to not comply in reporting their IRA deductions or traditional IRA distributions on their tax returns.[42] Through automated checks and document matching, IRS detects and corrects millions of dollars in taxpayer misreporting of IRA transactions. The Math Error program checks for obvious math errors as returns are processed, and the AUR program matches returns with custodian-reported information. Larger early withdrawal matching cases, including failed rollovers, are subject to correspondence examination. Figure 4 provides an overview of IRS's automated enforcement activities for IRA transactions reported on tax returns.

[42]This report uses IRS enforcement data to provide perspective on the types and magnitude of mistakes taxpayers make in reporting IRA transactions on their tax returns. Our separate Limited Official Use Only report discusses more fully how IRS enforces IRA rules.

Figure 4: Overview of IRS Automated Enforcement Activities for IRA Rules



Source: GAO analysis of IRS information.

Math Error Program

As tax returns are processed, the Math Error program reviews traditional IRA deductions claimed by taxpayers for amounts higher than allowable limits. For example, the Math Error program tests whether a taxpayer claimed a deduction greater than the maximum annual contribution limit. The Math Error program adjusts every taxpayer return for which an error is found to reflect any change in the deduction and sends a math error notice to the taxpayer.[43] From tax years 2003 through 2006, IRS issued thousands of math error notices annually to taxpayers misreporting deductions on their traditional IRAs. IRS continues to use the Math Error program because IRA math errors must be resolved to process tax returns and adjust the tax liability so that taxpayers are in compliance.

In May 2007, IRS officials told us that the Math Error program would discontinue age-based tests for traditional IRA contribution deductions because IRS does not have authority to use the Math Error program for IRA age rules.[44] Starting in 2003, IRS used Social Security Administration age data during initial return processing to test taxpayers claiming traditional IRA contribution deductions. This up-front check allowed IRS to implement the higher contribution limit for taxpayers age 50 and over and also to check the lower limit allowed for taxpayers below age 50. For example, for tax year 2004, a taxpayer below age 50 could contribute up to $3,000 and a taxpayer age 50 or over could contribute up to $3,500. For 2007, the Math Error program will test that no taxpayer exceeds the highest limit allowed.

Automated Underreporter Program

Whereas the Math Error program checks for conspicuous errors in the taxpayer's return, the AUR program compares information reported on the individual tax return with third-party information reported by financial institutions for individual taxpayers. The AUR program creates an inventory of potential cases by matching taxpayer return data with the information return file to verify that all income and deductions are reported accurately. An underreporter case results when computer analysis detects a discrepancy between the tax return and the information returns. Because of resource constraints, IRS officials said that they do not

[43]The Internal Revenue Code (I.R.C.) does not provide taxpayers a right to appeal assessments under math error authority because that authority generally applies to obvious errors made by taxpayers on their returns. Instead, the math error notices inform taxpayers that they may file a claim asking for an abatement if they believe IRS erred.

[44]I.R.C. § 6213 grants math error authority for issues such as calculation errors, entries that are inconsistent with or exceed statutory limits, various omissions of information, or incorrect use of an IRS table.

contact taxpayers in all cases where the AUR program finds a mismatch between what was reported on an information return and what was reported on a tax return. If a mismatch occurs over a certain tax threshold, IRS decides if the mismatch warrants a notice, asking the taxpayer to explain the discrepancies, such as when a taxpayer inadvertently fills in the wrong line on the tax return, or pay any taxes assessed. AUR reviewers are directed to consider the reasonableness of the taxpayers' responses to notices but generally do not examine the accuracy of the information in the responses because they do not have examination authority.

For tax year 2001, AUR contacts represented about 2 percent of the noncompliant taxpayers estimated by NRP of either taking an ineligible deduction or overdeducting contributions for traditional IRAs, with about 9,000 taxpayers assessed by the AUR program compared with nearly 555,000 taxpayers estimated by NRP.[45] For tax year 2004, the last full year for which data are available, of 25,000 mismatches for taxpayers potentially ineligible for the contribution deduction, IRS assessed additional taxes of $7 million for nearly 9,000 taxpayers. Of about 85,000 mismatches for taxpayers who potentially overdeducted their traditional IRA contributions, the AUR program assessed additional taxes of $16.2 million for about 15,000 taxpayers for tax year 2004. Table 5 shows the numbers of taxpayers and total additional taxes assessed for misreported traditional IRA deductions for tax years 2001 to 2004. The AUR program does not necessarily work these IRA cases on a stand-alone basis and may pursue potential IRA deduction misreporting along with other discrepancies for taxpayers in the AUR inventory.

[45]For misreported IRA distributions estimated by NRP, we could not estimate the share covered by the AUR program because IRA distribution data are included with distributions from other qualified plans.

Table 5: Total Additional Taxes and Taxpayers Assessed by IRS's Automated Underreporter Program on Select Contribution and Distribution Rules for Traditional IRAs, Tax Years 2001–2004

Dollars in millions

	Ineligible for deduction		Overdeduction of contribution		Early distribution penalty	
Tax year	Amount	Taxpayers assessed	Amount	Taxpayers assessed	Amount	Taxpayers assessed
2001	$4.4	5,792	$3.8	3,218	$20.3	5,517
2002	5.9	5,810	10.9	10,175	79.4	41,962
2003	8.8	12,269	14.6	14,128	71.1	45,582
2004	7.0	8,687	16.2	15,088	61.1	37,900

Source: IRS.

Notes: Data are from the AUR program. Tax year 2005 data are not complete. The AUR program also enforces taxable distributions from traditional IRAs, but those data are included with distributions from other qualified retirement plans. Larger-value early distribution cases for tax years 2001 and beyond were worked by Correspondence Examinations. Tax assessments for each category are independent from each other and are not double counted.

We could not isolate the AUR data on additional taxes assessed on taxpayers who misreported distributions from traditional IRAs because those data are combined with misreporting of taxable distributions from other retirement plans. The AUR program does, however, capture separate data for taxpayers who misreported early distributions from their traditional IRAs. In tax year 2004, of about 420,000 mismatches, the AUR program assessed taxes against about 38,000 taxpayers. As shown in table 5, the AUR program assessed total taxes and penalties of $61.0 million on taxpayers who misreported early distributions from traditional IRAs in that year.[46] In addition to those cases with assessments, the AUR program follows up with taxpayers on some cases where the Form 1099-Rs filed by custodians reported that no known penalty exception applies for an early distribution. According to a financial industry organization representative we interviewed, custodians play a limited role in reporting whether an exception applies because a custodian may not know why a taxpayer took a distribution and is not in a position to validate exceptions reported by the taxpayer.

IRS is considering a new compliance initiative that could alert more taxpayers about their misreported IRA transactions. According to IRS compliance officials, when fully implemented a new AUR "soft notice"

[46]This figure does not include tax assessments involving larger dollar value early distribution cases handled by Correspondence Examinations.

program would send letters to many taxpayers in the AUR inventory asking them to voluntarily fix their noncompliance by filing amended returns, or to not repeat the action the following year. A soft notice requires a taxpayer to take minimal actions and is intended to educate and stimulate compliance without IRS having to invest substantial resources. With phased rollout proposed to begin in fiscal year 2009, many taxpayers detected by the AUR program as misreporting traditional IRA deductions or distributions could ultimately receive soft notices under this proposal.

Correspondence Examinations

For taxpayers who withdraw large amounts from their traditional IRAs before retirement age, a division under Correspondence Examinations handles larger AUR matching cases involving the additional 10 percent penalty and taxes due on early distributions. Through Correspondence Examinations, IRS can determine if taxpayers qualified for a penalty exception using some automated filters. For example, IRS employees can filter out early distribution exceptions for disability using information reported on Form 1099-R or the issuance of Form 1099-SSA. Correspondence Examinations may also ask the taxpayer for further documentation of an exception claimed. In fiscal year 2004, 20,771 taxpayers agreed with the proposed assessments for an average tax change of $1,313.

One aspect of IRA noncompliance detected through the early distribution rule check by Correspondence Examinations is failed rollovers. Taxpayers have the option to withdraw funds from one traditional IRA and roll them over to another traditional IRA. If the taxpayer fails to complete a rollover at all and is under age 59½, Correspondence Examinations will treat the withdrawn funds as an early distribution and the taxpayer is subject to the 10 percent penalty. An examiner may detect a late rollover in a case where a taxpayer provides additional documentation showing the dates of the distribution and the subsequent deposit.

Field Examinations

Beyond systematic checks through its automated programs, IRS can also address IRA noncompliance through its field examination program. According to IRS examination officials, issues related to IRA transactions may surface when an examiner is working an examination case. For example, an examiner could uncover underreported income from an IRA distribution during a probe of a taxpayer's reported income or determine that a taxpayer failed to complete a rollover within the 60-day limit. According to examination officials, an examiner may also revisit traditional IRA eligibility if an examination results in other adjustments to the taxpayer's income.

Complexity Underlies the Challenges That Taxpayers Face in Complying with IRA Rules, and Some Options Could Bolster IRS Service While Other Options Would Require Legislative Change

In using traditional and Roth IRAs to save for their own retirement, taxpayers face challenges in figuring how much they can contribute, navigating the various distribution rules, and moving their IRAs between custodians. Complexity of IRA rules was cited as the overarching contributor to challenges facing taxpayers and IRS in ensuring compliance with IRA rules by IRS officials, IRA custodians, and financial planners we interviewed. Table 6 highlights some challenges that taxpayers face with specific IRA rules. Representatives of financial firms and advisors we interviewed identified some options for IRS to clarify IRA guidance or offer additional IRA service activities.[47] Some options to reduce IRA rule complexity would require changing the laws governing IRA contributions and distributions.

[47]App. I discusses our interview methodology and the various financial groups we contacted.

Table 6: Taxpayer Challenges in Complying with Key IRA Rules

Key IRA rules	Challenges for taxpayers
Contributions	
Annual contribution limit	Some taxpayers may not understand that the annual contribution limit applies across both traditional and Roth IRAs.
Income eligibility for traditional IRA deduction and Roth IRA contribution	Some taxpayers' year-end modified AGI exceeds the income eligibility limit after they already made their contributions. Some taxpayers with modified AGI in phaseout ranges near the income limits make mistakes in calculating the partial amount for their eligible traditional IRA deduction or Roth IRA contribution.
Pension participation rules for traditional IRA contribution deduction	Some taxpayers participating in employer pension plans make mistakes in calculating the deductible portion of any traditional IRA contributions. Some taxpayers are unaware that their employers made contributions to their employer-sponsored retirement plans until they receive their W-2s in January, after having already made their IRA contributions.
Recordkeeping for nondeductible traditional IRA contributions	Some taxpayers fail to track the taxable basis for nondeductible contributions over time, and some could end up paying taxes on their full distributions rather than the taxable portion.
Distributions	
Taxable withdrawals from traditional IRAs	Some taxpayers fail to report traditional IRA distributions, which are generally taxable, on their tax returns.
Early withdrawals subject to penalty	Some taxpayers may get confused over which exceptions for early withdrawals are not subject to penalty, in part because the exceptions differ for IRAs and employer plans. Some taxpayers may make mistakes in figuring out the taxes due on early distributions from Roth IRAs during the 5-year holding period.
Required minimum distribution from traditional IRAs	Some taxpayers make mistakes in determining when they must start minimum distributions and calculating the correct amount.
Rollovers	
Sixty-day rule for tax-free rollover between IRAs	Direct transfers between custodians are not available in all cases, and taxpayers make mistakes in completing indirect rollovers within 60 days.

Source: GAO analysis.

Notes: The list of challenges in this table does not represent all challenges mentioned to us during our audit. These challenges were identified through a three-part process. First, we spoke to representatives of financial firms and advisors to identify the range of challenges. We then analyzed the information gathered to identify challenges commonly raised by the interviewees. Using that list, we conducted second round interviews with the same representatives for reactions about the overall list. We analyzed the second round list, and with our knowledge of rules and IRS interviews, we identified key challenges. We also vetted the list with IRS and Treasury.

Challenges with IRA Contribution Rules

Even as IRS works to inform taxpayers about IRA contribution rules, some taxpayers remain confused about whether and how much they can contribute, according to financial industry organization and advisor representatives we interviewed. Some contribution rule challenges span both traditional and Roth IRAs, while other challenges related to whether a traditional IRA contribution is deductible and how to keep records for nondeductible contributions.

Some taxpayers may not understand the annual limits on IRA contributions in part because the limits have changed over recent years and vary by taxpayer age. For example, the 2007 limit for both kinds of IRAs was $4,000 for taxpayers under age 50 and $5,000 for taxpayers age 50 and older, and the 2008 limits are $5,000 and $6,000, respectively. As IRS's math error data show for tax years 2003 to 2006, some taxpayers try to deduct more than their legal limit for traditional IRA contributions. According to the Treasury Inspector General for Tax Administration (TIGTA), taxpayers over age 70½ continue to improperly claim traditional IRA deductions.[48] Financial industry organization and advisor representatives we interviewed agreed that the annual contribution limit rule, with the amount indexed for inflation beginning in 2009, could confuse some taxpayers, but they did not see complying with the contribution limit as a major challenge. According to interviewees, IRS publishes the limits well ahead of when they become effective, and IRA custodians and financial advisors reach out to advise taxpayers on any changes. While custodians typically would not accept a contribution exceeding the annual limit, a custodian would not know if a taxpayer contributed to other IRAs for the same tax year.

According to some interviewees, taxpayers may be confused by the combined limits and some may not understand that the total limit applies across traditional and Roth IRAs and is not a limit for each type. Currently, the 2007 IRS Publication 590 discusses the total contribution limit in the traditional IRA chapter on page 11: "If you have more than one IRA, the limit applies to the total contributions made on your behalf to all your traditional IRAs for the year." Page 11 also has a caution: "Contributions on your behalf to a traditional IRA reduce your limit for contributions to a Roth IRA. See chapter 2 for information about Roth IRAs." On page 60 in the Roth IRA chapter, traditional IRA and Roth IRA contribution limits are discussed, as follows: "If contributions are made to both Roth IRAs and traditional IRAs established for your benefit, your contribution limit for

[48]Taxpayers over age 70½ cannot contribute to a traditional IRA but can contribute to a Roth IRA. TIGTA found that 1,826 taxpayers improperly claimed $4 million in IRA deductions in 2006 for an estimated loss of revenue of $601,423; in 2007, 1,693 older taxpayers improperly claimed more than $3.5 million in IRA deductions with an estimated revenue loss of $530,099.

Roth IRAs generally is the same as your limit would be if contributions were made only to Roth IRAs, but then reduced by all contributions for the year to all IRAs other than Roth IRAs. Employer contributions under a SEP or SIMPLE IRA plan do not affect this limit." Even though the publication explains the rule separately in each chapter, we believe the various statements could be confusing to some taxpayers, particularly those who may not read both chapters. According to IRS officials we interviewed, other options to help clarify the guidance about the rule could include repeating the total contribution limit in the general reminder section up front in Publication 590 as well as on the IRS Web site and in other IRS outreach materials. For example, IRS included a reminder about the total contribution limit in its summer 2008 employer plans newsletter for tax practitioners, and IRS could include a similar reminder in the annual press release announcing the new contribution limits for the upcoming year.

Income eligibility rules are a challenge for both traditional and Roth IRAs. Taxpayers over certain income limits cannot contribute to a Roth IRA and cannot deduct traditional IRA contributions.[49] Interviewees also said that one reason taxpayers may be ineligibly contributing is because their year-end modified AGI exceeds the eligibility limit after they have already made the contribution. In addition, taxpayers must determine their partial deduction amounts if their modified AGI falls within certain phaseout ranges near the income limit for eligibility. The phaseouts, thus, introduce opportunities for some taxpayers to err by overdeducting their traditional IRA contributions or overcontributing to a Roth IRA. IRA contributions errors can contribute to the gross tax gap. For example, for tax year 2004, IRS's AUR program assessed $23.2 million in additional tax on nearly 24,000 taxpayers who overdeducted or ineligibly deducted traditional IRA contributions.

Interviewees generally agreed that the pension participation rule is a major challenge for taxpayers trying to determine their eligibility for a traditional IRA contribution deduction. Taxpayers who are single, heads of households, or qualifying widows/widowers and married couples not covered by any employer retirement plan are eligible for the full deduction regardless of income. Interviewees said that taxpayers might be ineligibly

[49]The maximum income amounts vary across the two IRA types. See table 2 for traditional IRA deduction eligibility and table 3 for Roth IRA contribution eligibility. These tables also show the phaseout ranges for partial eligibility. For both IRA types, eligibility is limited to taxable compensation.

contributing because they are unaware that their employers made contributions to their employer-sponsored retirement plans until they receive their W-2s in January, after having already made their IRA contributions. According to some interviewees, some taxpayers may not understand the definition of "active participant."[50] One representative suggested that the definition for active participant in an employer-sponsored plan could be clarified to reduce confusion among employers and taxpayers and to ensure that employers mark the W-2 correctly. However, an IRS official knowledgeable about employer plans said that the W-2 guidance details how employers are to handle the W-2 checkbox. In turn, individuals need to know their participation status but not the full rule. According to the official, individuals receive a breadth of benefit information when hired, and they simply may not remember that they are enrolled in their new employer's retirement plan until they receive their W-2s.

When a taxpayer contributes to a Roth IRA when he or she is ineligible because of filing status or the modified AGI limits, one way to correct the ineligible contribution and avoid the 6 percent penalty is to recharacterize. However, the recharacterization process—treating a contribution made to an IRA as having been made to a different IRA type and transferring the amount between IRAs—can be confusing for taxpayers, according to representatives we interviewed.[51] To avoid possible errors and the burden of recharacterization, taxpayers could, for example, wait until they receive their 2008 W-2s to check their 2008 income eligibility and retirement plan coverage and then make their eligible 2008 IRA contributions by April 15, 2009. However, some taxpayers may not want to wait until the end of the year to make contributions and forgo the accruals on that year's contribution. Some interviewees suggested basing eligibility on the previous year's modified AGI, which taxpayers would already know and

[50]Active participants for a defined benefit plan include, for example, employees who decline to participate, those who do not perform the minimum service to earn a benefit, and those who are not yet vested.

[51]Taxpayers who overcontribute to any type of IRA can withdraw the excess plus any earnings to avoid the penalty or pay the penalty and apply the excess amount as an IRA contribution for a later year. Recharacterizations, withdrawals, or carryforward to later years of 2008 contributions generally have to be completed by the extended due date (including extensions) of the taxpayer's 2008 income tax return.

could then use to better plan their contributions over the upcoming year and avoid contribution errors.[52]

Nondeductible contributions to traditional IRAs pose their own challenges for taxpayers because of recordkeeping needs. Interviewees said that taxpayers may find it difficult or forget to track the basis of nondeductible contributions over time in part because these contributions do not appear on the Form 1040. They added that taxpayers who did not complete the supplemental Form 8606 to track their nondeductible contributions may find it challenging to determine the taxable amount of their distribution. Some may potentially pay tax on the full distribution amount rather than their taxable basis, while others face the burden of trying to locate the information needed to determine the taxable amount and filing an amended return. Representatives suggested that taxpayers may need more IRS help to understand how to report and track nondeductible contributions to traditional IRAs. Suggested options include clarifying the tax return and Form 8606 and related guidance on tracking the basis for nondeductible contributions, conducting research to determine where taxpayer errors are occurring and developing corrective actions, and implementing a minimum threshold for requiring basis calculation to reduce taxpayer burden in making complicated calculations for small distribution amounts.

Challenges with IRA Distribution Rules

On the distribution end, some taxpayers may be confused about which IRA distributions are taxable or subject to penalty, and older taxpayers in particular may not understand when they must begin required minimum distributions from traditional IRAs. Financial industry organization and advisor representatives we interviewed agreed that IRA distribution rules pose challenges for taxpayers trying to navigate on their own without the help of a tax advisor. As more people contribute and roll over pension amounts to IRAs and the population ages, more taxpayers will have to figure out how to navigate IRA distribution rules. Whereas taxpayers can undo various contribution errors, distribution errors cannot be undone and can trigger taxes and penalties.

IRS's NRP estimates show that about 15 percent of those with traditional IRA distributions misreport their distributions. According to one

[52]Extending the example, a taxpayer could use the 2008 W-2 to determine eligibility for 2009 IRA contributions.

representative we interviewed, some taxpayers initially forget to report traditional IRA distributions to IRS in part because retirement income is not taxable in some states. Other taxpayers make mistakes in determining the taxable portion of their distributions because of their original failure to track the basis for nondeductible contributions. Interviewees viewed Roth IRAs as less challenging for taxpayers because these distributions are generally tax-free in retirement.

Even though many owners plan to hold their IRAs until retirement age, those who take withdrawals before age 59½ face an additional 10 percent penalty unless they qualify for an exception. This can be a costly mistake, and IRS's AUR program assessed 38,000 taxpayers a total of $61.1 million in taxes and penalties on early withdrawals in 2004. As more exceptions have been added, giving individuals more latitude to tap their IRAs before retirement, taxpayers may be challenged to understand what the penalty exceptions are and that IRAs have no general hardship exception.

- According to IRS officials, rule exceptions created through late or retroactive legislation, although meant to benefit taxpayers, can create challenges for IRS to timely prepare guidance and update IRA-related forms and publications.
- Another interviewee said that taxpayers could be easily confused about how allowed exceptions to the early distribution rules differ between IRAs and employer-sponsored retirement plans. Interviewees disagreed on whether IRA early distribution rules should be conformed across different types of retirement plans. Some representatives said that differences among plans made sense, while other interviewees said that the complexity introduced by different rule exceptions for different types of retirement plans confuses taxpayers and conforming the early distribution rules would be beneficial.
- One interviewee said that some taxpayers make mistakes when taking early distributions from Roth IRAs because qualified distributions within the 5-year holding period for a Roth IRA, while not subject to the 10 percent penalty, are still subject to taxation. Moreover, a taxpayer taking an early distribution from a Roth IRA has to calculate the taxable portion of distribution and that requires recordkeeping of all contributions and earnings for the account.
- One interviewee said that taxpayers were sometimes confused about how custodians report reasons for early distributions to IRS on the Form 1099-R. One representative suggested that Publication 590 could better explain to taxpayers that IRA custodians are only obligated to report to IRS whether an early withdrawal was taken, not whether the early withdrawal qualified as an exception to the 10 percent penalty rule. In addition, some IRA custodians suggested that to reduce taxpayer and

custodian confusion about temporary or newly enacted qualified exceptions, IRS could designate a special code, such as for hurricane relief or charitable giving, that custodians could use to complete the Form 1099-R until further guidance could be developed.

Financial industry organization and advisor representatives generally agreed that the required minimum distribution rule for traditional IRAs was particularly challenging for older taxpayers in terms of both determining the timing of the first distribution and calculating the correct amount. For example, the carryover date for the first distribution, April 1, does not coincide with the filing deadline of April 15, and some taxpayers may not realize that subsequent distributions must be done by December 31. To help taxpayers comply with the rule, in 2002 IRS issued uniform tables to simplify the calculation and effective for 2003 required that custodians notify taxpayers through a check box on the Form 5498 that the taxpayers are required to take a distribution in the following year. Even with the added service, the complexity of the required minimum distribution rule is challenging for taxpayers to navigate.

- Representatives said that the age of 70½ was a confusing concept for taxpayers. Although IRS's tables for calculating each year's minimum distribution were updated in 2002 to reflect current life expectancy, the required beginning age of 70½ has been in place since IRAs were created in 1974. Although some suggested changing the required minimum distribution rule, one representative noted that changing the age, which likely benefits the taxpayer through simplification, would likely create some burden for financial institutions to adjust their information technology systems.
- Interviewees also suggested that IRS could help taxpayers comply with required minimum distribution rules by developing an online tool on IRS's Web site to help taxpayers calculate the correct minimum distribution amounts or directly notifying taxpayers approaching age 70½ that they will be subject to the required minimum distribution rule.
- Some representatives we interviewed expressed concern that the 50 percent penalty on minimum distributions not taken was harsh and that taxpayers may not understand how to request that IRS waive the penalty for reasonable errors. Through tax year 2004, IRS directed taxpayers to pay the penalty first and then request a waiver to get the penalty refunded. In tax year 2005, IRS dropped the requirement for a taxpayer to pay first to request a waiver. For tax year 2007, IRS revised the instructions for Form 5329—the form for reporting additional taxes due on IRAs and other tax-favored accounts—to clarify that a taxpayer is to provide documentation explaining the issue and does not have to pay the penalty in advance to request a waiver.

- Whereas IRA custodians provide educational assistance and notice to the original taxpayer that the required minimum distribution rule applies for the coming year, beneficiaries inheriting IRAs are likely to be less prepared to deal with required distributions. According to interviewees, taxpayers do not always keep beneficiary information up-to-date, and both taxpayers and their advisors are learning the different distribution rules for IRAs inherited by spouses versus other beneficiaries.

Challenges with IRA Rollover Rules

Interviewees said that some taxpayers may face challenges when they periodically rollover their IRAs or transfer money from a pension plan or an IRA into another IRA. Transfers—where IRA funds are shifted directly from one IRA custodian to another—are not always available, and taxpayer mistakes in completing rollovers—where the taxpayer receives a distribution from the first IRA and must contribute the amount to a new IRA—can trigger taxes and penalties. Failed rollovers are subject to the 10 percent early withdrawal penalty if the taxpayer is under age 59½ and the taxpayer's retirement savings would no longer be eligible for tax-preferred treatment. As increasing amounts of pension assets are rolled over into IRAs, more taxpayers may experience challenges when moving money between accounts.

- For transfers between financial institutions, some taxpayers may face a challenge in that not all financial institutions offer this option or are able to systematically handle trustee-to-trustee transfers. The automated system that mutual fund companies use to transfer assets differs from the system brokers use to transfer securities, according to these representatives. They added that system enhancements are being explored, but currently, transfer options may be limited for some taxpayers who wanted to directly transfer IRA assets.
- Interviewees also pointed out that some taxpayers preferred not to directly transfer their IRAs in part because some may want to use the funds as a temporary loan during the 60-day window in which they are to complete a rollover. This situation can be problematic, according to some representatives, because taxpayers might cash out their funds or miss the deadline to complete the rollover. Other interviewees said that the 60-day rollover window benefits taxpayers and may increase savings because it makes assets seem more accessible, which may alleviate some apprehension about setting assets aside in the IRA. Taxpayers who miss the 60-day window may qualify for an automatic waiver for custodian mistakes in depositing funds or providing erroneous advice. Others can pay to request a private letter ruling from IRS to waive the deadline, but IRS has typically not granted waivers for taxpayers who knew or should

have known of the 60-day deadline but had no intention of rolling over the funds by the deadline.

Options Include Enhanced IRS Service to Help Taxpayers Better Understand IRA Rules and Regulatory or Legislative Changes to Simplify Some IRA Rules

To address the various challenges facing taxpayers in complying with IRA rules, options suggested by interviewees and others ranged from improvements in IRS service to help taxpayers better understand the current rules to broader regulatory and legislative changes to simplify the rules governing IRAs.

Enhancing IRS's taxpayer service efforts, such as clarifying and revising IRS Publication 590, could help strengthen compliance with IRA rules by helping taxpayers better understand the rules and avoid unintentional errors. However, these efforts are not easily assessed in terms of their effect on improving compliance. IRS officials said that even though they are able to receive some feedback from customers about how to improve IRA-related forms and publications, they added that it was hard to gather data on their effectiveness, especially when changes are constantly being made. Financial representatives and others we interviewed suggested additional opportunities to clarify guidance and offer new tools to help taxpayers with challenging IRA rules. As recommended by TIGTA, IRS plans to clarify the IRA deduction worksheet to instruct taxpayers over age 70½ that they cannot claim the deduction. As discussed above, IRS could do more to help taxpayers better understand that the total contribution limit applies across traditional and Roth IRAs and is not a limit for each IRA type.

IRS also could explore developing new tools to aid taxpayers in complying with complex IRA rules. For the required minimum distribution rule, interviewees suggested that IRS offer an online calculator. IRS officials cautioned that offering an online calculator is not cost free, estimating that developing the tool could cost about $250,000. Another option could be to expand custodian reporting—beyond simply requiring custodians to notify taxpayers that they are subject to the distribution rule—to requiring that custodians calculate and report the minimum distribution amount per account. Options requiring additional reporting by IRA custodians could improve information available to help taxpayers comply with IRA rules and to help IRS detect noncompliance, but such options pose trade-offs in terms of the added reporting burden for those parties and costs for IRS to use the information.

Beyond improved IRS service to help educate taxpayers about current IRA rules, financial representatives and advisors we interviewed frequently mentioned simplifying IRA rules through legislative changes as an option to strengthen taxpayer compliance. While not an easy task, simplification could help prevent unintentional taxpayer errors and allow fewer opportunities to hide intentional noncompliance. Modifying the IRA rules, while intended to benefit taxpayers, could also create unintended confusion.

- Interviewees said that the Pension Protection Act of 2006 provision allowing charitable contributions of up to $100,000 to be made directly from IRAs to charities as tax-free distributions raised many questions from IRA owners and custodians, as well as charities, about how to implement the transaction, since the provision had become effective before IRS could develop guidance and was due to expire in 2007.
- Another option—basing IRA eligibility on the previous year's modified AGI—may place a burden on taxpayers to track their modified AGI from the previous year, pose a challenge to IRS to match taxpayer information across years through its automated systems, and introduce additional confusion by deviating from other retirement plan rules, which use current year data. While some interviewees favored this option, one interviewee expressed concern that this change could introduce situations where some taxpayers may be unable to contribute to any retirement plan for that year.[53]

Broad IRA legislative options, such as eliminating limits on income eligibility for traditional IRA contribution deductions or Roth IRA contributions or eliminating the required minimum distribution rule, could greatly simplify the rules for some taxpayers, such as older taxpayers who do not need to draw down their IRAs to pay for retirement needs. Such options, however, would certainly reduce federal revenue and with no certainty that more people would take advantage of IRAs to save for retirement.[54]

A full evaluation of options to simplify the taxation of retirement savings is beyond the scope of this report, which focuses on the challenges

[53]Eligibility for traditional IRA contribution deduction is based on pension coverage and marital filing status in addition to income limits.

[54]See also Thomas L. Hungerford and Jane G. Gravelle, *Individual Retirement Accounts (IRAs): Issues and Proposed Expansion* (Washington, D.C.: Congressional Research Service, Updated Mar. 10, 2008), and Thomas L. Hungerford, *Saving Incentives: What May Work, What May Not* (Washington, D.C.: Congressional Research Service, Updated Sept. 27, 2007).

taxpayers face with the current key rules for traditional and Roth IRAs. The National Taxpayer Advocate has suggested simplifying the rules across IRAs and employer pension plans to reduce complexity and encourage participation.[55] In 2004, the National Taxpayer Advocate's Annual Report to Congress recommended that retirement savings provisions be simplified. The report cited that the various types of retirement savings vehicles, while intended to help taxpayers save for retirement, also created complexity and redundancy in the tax law because of their different rules regulating eligibility, contribution limits, withdrawals, and other transactions. Another approach is to reexamine traditional and Roth IRA rules in the context of broader tax reform when considering fundamental decisions about how to make tax investment and saving.[56]

Conclusions

The volume and complexity of IRA rules create a maze where taxpayers may intentionally or unintentionally wander out of compliance with the rules, triggering taxes and penalties. As more taxpayers take advantage of IRAs to contribute funds for retirement or preserve pension rollovers, and with an aging population beginning to tap their retirement savings, taxpayers will encounter growing challenges in complying with the myriad of IRA rules. Sustained attention to taxpayer service and education will be key to helping taxpayers comply with IRA rules and avoid unnecessary penalties on distributions before retirement age or late distributions for older taxpayers owning traditional IRAs. IRS's service efforts, such as Publication 590, have been a positive step toward strengthening taxpayer compliance. Nevertheless, those using IRAs make basic mistakes in figuring out how much to contribute and how much in taxes they may owe on distributions.

To address the challenges taxpayers face with do-it-yourself retirement saving using IRAs, IRS has some opportunities to clarify its IRA guidance and possibly offer new tools to help taxpayers stay on a compliant path. Even with added IRS service for taxpayers, some IRA rules, notably the required minimum distribution rule, may need legislative or regulatory simplification to best help taxpayers navigate their way. Broader options

[55]National Taxpayer Advocate, *2004 Annual Report to Congress* (Washington, D.C.: Dec. 2004).

[56]GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: Sept. 2005).

to simplify IRA contribution and distribution rules have implications for both federal revenue and taxpayer choice for tax-preferred retirement saving, and policymakers could consider IRA rule changes in the context of broader tax reform.

Recommendations for Executive Action

To help address the challenges facing taxpayers in complying with IRA rules, we recommend that the Commissioner of Internal Revenue take the following two actions:

- Clarify guidance and outreach materials to help taxpayers better understand that the combined IRA contribution limit applies across all traditional and Roth IRAs.
- Identify administrative options to improve compliance with the minimum required distribution rule, including additional taxpayer guidance or information reporting, and work in consultation with Treasury on regulatory or legislative strategies to strengthen compliance with the rule.

Agency Comments

In comments on a draft of this report (which are reprinted in app. III), IRS said that our report fairly represents the rules and challenges that apply to IRAs and that IRS is committed to providing clear information to taxpayers about IRA rules. IRS agreed to take actions consistent with both of our recommendations. Specifically, IRS will continue to find opportunities to provide taxpayers with a better understanding of the combined limit rule and explore ways to improve compliance with the required minimum distribution rule, including working with Treasury or seeking legislative options. Treasury provided technical comments on a draft of this report, which we incorporated as appropriate.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Chairman and Ranking Member, House Committee on Ways and Means; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties. We will also make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of

Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

Michael Brostek
Director, Tax Issues
Strategic Issues Team

Appendix I: Scope and Methodology

The objectives of this report are to (1) provide an overview of key individual retirement account (IRA) contribution, distribution, and other rules and describe how the Internal Revenue Service (IRS) educates taxpayers on these rules; (2) describe what IRS knows about the extent of noncompliance for IRA transactions reported on tax returns; and (3) describe the challenges taxpayers face with key IRA rules and some options to strengthen taxpayer compliance. This report focuses on traditional and Roth IRAs set up by individuals to save on their own.[1] Specifically, we relied on key rules governing contributions and distributions for tax-deferred traditional IRAs and after-tax Roth IRAs. Accordingly, we did not review every IRA rule in its entirety. Throughout this engagement, we relied upon IRS Publication 590 as our primary source for understanding traditional IRA and Roth IRA rules.

Objective 1: Provide an Overview of Key IRA Contribution, Distribution, and Other Rules

To provide an overview of key IRA rules, we relied primarily on IRS Publication 590, which explains the rules that taxpayers are to follow in contributing to, and receiving distributions from, an IRA. Specific rules depend on account type. We also spoke with IRS and Department of the Treasury (Treasury) officials and reviewed reports from the Congressional Research Service, the Congressional Budget Office, the Investment Company Institute, and others. We also reviewed laws and regulations related to IRAs. For background about IRAs, we spoke with officials in the Research, Analysis and Statistics unit from Statistics of Income (SOI), reviewed SOI bulletin articles, and compiled statistics from SOI data.

To describe how IRS educates taxpayers in complying with IRA rules, we reviewed relevant documents and interviewed relevant agency officials who were identified for us by IRS, including officials from the following divisions: Wage and Investment (W&I); Tax Exempt and Government Entities (TE/GE); and Research, Analysis and Statistics. In addition, we spoke with the Taxpayer Advocate Service, an independent office within IRS. Within W&I, we spoke with officials from Media and Publications, Stakeholder Partnerships Education and Communication, Accounts Management, and Field Assistance. Within TE/GE, we spoke with officials

[1] Issues related to beneficiaries inheriting IRAs were beyond our scope. Also, this report does not examine employer-based individual retirement arrangements, such as Simplified Employee Pensions (SEP) or Savings Incentive Match Plans for Employees (SIMPLE); with the exception of required minimum distributions, SEP and SIMPLE IRAs are subject to different rules and guidance than traditional and Roth IRAs.

from Employee Plans. We also reviewed other guidance, such as the IRS Web site and various IRS publications.

Objective 2: Describe What IRS Knows about the Extent of Noncompliance for IRA Transactions Reported on Tax Returns

To describe what IRS knows about the extent and types of taxpayer misreporting of IRA transaction on tax returns, we reviewed publications and documents, interviewed IRS officials, and used the 2001 National Research Program (NRP)—IRS's most recent study of individual taxpayer compliance—to estimate the extent of taxpayer misreporting with traditional IRA deductible contribution rules and traditional IRA taxable distribution rules. Specifically, taxpayers report these transactions on the Form 1040 individual income tax return.[2] We provide the margin of error based on 95 percent confidence for estimates from the NRP samples of individual tax returns. We also analyzed data on taxpayer misreporting supplied by the Math Error program and the Automated Underreporter (AUR) program. The Math Error program electronically checks for obvious math errors as tax returns are processed, and the AUR program matches taxpayer returns with IRA custodian-reported information.[3] We followed our guidance for assessing the reliability of computerized databases in using these data sources, and determined that the data are reliable for the purposes of this engagement.

Objective 3: Describe Challenges That Taxpayers Face with Key IRA Rules and Options for Strengthening Taxpayer Compliance

To describe the challenges taxpayers face with key IRA rules and some options for strengthening taxpayer compliance with these rules, we reviewed prior GAO reports, IRS documents from its enforcement and service programs that address IRA rules, and documents from other organizations, such as IRS Publication 590 and reports issued by financial industry organizations and research agencies. We also spoke with IRS officials and financial industry organization and advisor representatives knowledgeable about IRAs who provide tax planning advice or serve as IRA custodians to get their perspectives on challenges related to IRA compliance and how those challenges could be addressed. Specifically, we interviewed representatives from financial industry organizations,

[2]For Roth IRAs, contributions are not deductible, and distributions are generally tax-free and are not reported on the 1040 tax return.

[3]The discussion of these two programs is a public version of the discussion in our more comprehensive September 2007 report that contained sensitive tax enforcement information. Specific details regarding the nature of these automated enforcement programs that IRS considered sensitive were removed.

including the Securities Industry and Financial Markets Association; Investment Company Institute, which represents the mutual fund industry; Financial Planning Association; American Bankers Association; American Institute of Certified Public Accountants; and AARP.[4]

We conducted two rounds of interviews with financial industry organizations and advisor representatives. In our first round of interviews, we asked open-ended questions to obtain information about the range of challenges and options for strengthening compliance. Because we asked open-ended questions, the frequency of our interviewees' responses is not comparable. Therefore, we report responses without reporting the total number of officials or representatives associated with each response. After analyzing the information gathered to identify some common challenges raised by the interviewees, we used a standard set of questions in a second round of interviews with the representatives to try to verify responses and obtain additional context for the challenges and options mentioned, such as whether the challenges were major or frequent or whether an option might impose significant burden on taxpayers or IRA custodians. We also shared the list of challenges with IRS and Treasury to obtain concurrence about taxpayer challenges. Finally, we limited the discussion of challenges and options identified to only those related to the key IRA rules reviewed in this report. These challenges and options are not exhaustive nor are the trade-offs associated with each option. Many of the options are concepts, rather than fully developed proposals with details on how they would be implemented.

We conducted this performance audit from March 2008 through August 2008 in accordance with generally accepted government auditing standards.[5] Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[4]The American Association of Retired Persons officially changed its name to AARP in 1999.

[5]This reflects the additional audit work performed for this report since our September 2007 report.

Appendix II: IRS Forms Used to Report Individual Retirement Account Information

Form number	Prepared by	Submitted to	Copied to	Purpose related to IRAs
1040 & 1040A	Account owner	IRS	NA	To report: • Deductible contributions to a traditional IRA from Form 5498 (1040 line 32, 1040A line 17), • Summary of distribution information from Form 8606 or Form 1099-R (1040 line 15, 1040A line 11), • Additional tax on an IRA (1040 line 60; from Form 5329), • Retirement savings contribution credit from Form 8880 (1040 line 51, 1040A line 32), or • Taxable compensation from Form W-2 (1040 and 1040A line 7).
8606	Account owner	IRS	NA	To report one of four actions taken during the year: • Nondeductible contribution to traditional IRA (Part I). • Distribution from a Simplified Employee Pension (SEP) or Savings Incentive Match Plan for Employees (SIMPLE) IRA or a traditional IRA with basis greater than zero (Part I). • Conversions from traditional, SEP, or SIMPLE IRA to a Roth IRA (Part II). • A distribution from a Roth IRA (Part III). Summary information is reported on 1040 line 15 or 1040A line 11. The penalty for not filing an 8606 when required is $50. The penalty for overstating a contribution is $100.
5329	Account owner	IRS	NA	To report additional tax related to an IRA being paid because of • Early, unexcepted, distribution from an IRA (Part I); • Excess contribution made to a traditional or Roth IRA.(Parts III & IV); or • Excess accumulation in an IRA for account holders subject to minimum required distributions (Part VIII). Summary information is reported on 1040 line 60.
8880	Account owner	IRS	NA	For lower-income taxpayers to claim a tax credit of up to 50 percent of their contribution to a traditional or Roth IRA (8880 line 1). Summary information is reported on 1040 line 51 or 1040A line 32.
W-4P	Account owner	Financial institution	NA	To request no withholding or additional withholding on distributions from a traditional IRA (other than eligible rollover distributions).

Form number	Prepared by	Submitted to	Copied to	Purpose related to IRAs
W-2	Employer	IRS	Wage earner, Social Security Administration, state/local tax department	To document the following: • Earned income (Box 1). Money to be contributed to an IRA must come out of taxable compensation. • Whether the taxpayer is covered by an employer-sponsored retirement plan (Box 13), which affects deductibility for a traditional IRA. Box 1 taxable compensation is reported on 1040 and 1040A line 7.
1099-R	Financial institution	IRS	Account owner, state/local tax department	To report a distribution from an IRA to an account owner. Information reported includes the gross value of the distribution, its taxable amount, and whether any tax was withheld. The form also includes a distribution code that reports the type of distribution (normal, early with qualified exception, early without qualified exception, withdrawn contributions, etc.). If a distribution is taxable, it is reported on 1040 line 15 or 1040A line 11.
5498	Financial institution	IRS	Account owner	To report the fair market value and contribution amounts to an IRA by an account owner. Information reported includes the value of the contribution and its type: normal, rollover, Roth conversion, recharacterization, or Roth contribution. The form also includes a check box that indicates whether a required minimum distribution is due that year. Summary information is reported on 1040 line 32 or 1040A line 17.

Source: GAO analysis of IRS data.

Notes: Data are from IRS Publication 590. NA = not applicable.

Appendix III: Comments from the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY COMMISSIONER

July 30, 2008

Mr. James R. White
Director Tax Issues
Strategic Issues Team
United States Government Accountability Office
Washington, DC 20548

Dear Mr. White:

We appreciate the opportunity to comment on the Government Accountability Office's draft report on: *Individual Retirement Accounts: Additional IRS Actions Could Help Taxpayers Facing Challenges in Complying with Key Tax Rules* (GAO-08-654). The report fairly represents the rules and challenges that apply to Individual Retirement Accounts (IRAs) as well as the size of the IRA universe. Our comments are shown below:

- The Internal Revenue Service (IRS) is committed to providing clear information to taxpayers about the rules that apply to traditional and Roth IRAs. The IRS will continue to look for opportunities to provide taxpayers a better understanding of the combined IRA contribution limit for traditional and Roth IRAs, and the required minimum distribution rule.

- The IRS will consider ways to improve compliance with the IRA minimum distribution rule and consult with the Department of the Treasury to determine whether there are regulatory or legislative changes that can be made that would reduce noncompliance.

Thank you for your interest in this area. If you have questions concerning this response, please contact Steven T. Miller, Commissioner, Tax Exempt and Government Entities, at (202) 283-2500.

Sincerely,

Linda E. Stiff

Linda E. Stiff

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9110 or brostekm@gao.gov

Acknowledgments

In addition to the contact named above, MaryLynn Sergent, Assistant Director; Elizabeth Fan; Evan Gilman; Rob Malone; Donna Miller; Karen O'Conor; Cheryl Peterson; Matthew Reilly; Sam Scrutchins; Walter Vance; and Jennifer Li Wong made key contributions to this report.

Glossary

Active Participant	Status of an individual's participation in an employer-sponsored retirement plan. Typically, the employer will indicate on the individual's Form W-2 if the individual is an active participant by checking the Retirement Plan box.
Basis	The accumulated nondeductible contributions in a traditional IRA.
Compensation	For IRA purposes includes wages/salaries/tips, commissions, self-employment income, alimony, separate maintenance, and nontaxable combat pay. IRA contributions must come from taxable compensation received during the year.
Contribution	An amount, subject to limits, deposited into an IRA.
Deductible Contribution	A contribution that allows tax deferral on investment earnings until retirement distribution with an up-front tax deduction for contributions by eligible taxpayers depending on pension coverage and income. Annual contributions are subject to a total limit.
Nondeductible Contribution	An after-tax contribution to a traditional IRA that is not eligible for up-front tax deduction. Nondeductible contributions are not subject to an income limit but are subject to the total limit.
Roth Contribution	An after-tax contribution to a Roth IRA by eligible taxpayers. Roth IRA contributions are subject to a limit based on a taxpayer's income and filing status.
Excess Contribution	A contribution made in excess of eligible amount for the year, which is subject to a 6 percent additional tax to penalize excess contributions.
Conversion	A specific type of rollover in which funds on deposit in a traditional IRA are transferred to a Roth IRA.
Distribution	An amount paid out from an IRA. Distributions from traditional IRAs are taxable subject to a recovery of basis for a nondeductible IRA, and Roth IRAs are generally tax-free.

Early Distribution	An amount issued to an account owner from an IRA during a year in which the account owner has not reached age 59-½, for reasons such as cost of medical insurance for the unemployed or purchase or rebuilding of a first home.
Eligible Rollover Distribution	A distribution made to an account owner that is eligible to be contributed via rollover to another IRA or qualified plan.
Required Minimum Distribution	The minimum amount that must by distributed to an account owner each year beginning in the year when the account owner reaches age 70-½. The required minimum contribution is calculated uniquely for each account based on account balance and life expectancy.

Excess Accumulation

A condition that occurs when an account owner is age 70-½ or older and does not receive distributions during the year that equal at least the required minimum distribution. Excess accumulations are subject to a 50 percent penalty.

IRA (Individual Retirement Account)

An account for tax-deferred retirement savings that is controlled by individuals, not employers. The term IRA, also known as individual retirement arrangement, also includes individual retirement annuities.

Roth IRA	An IRA that accepts after-tax contributions subject to limits and allows tax-free withdrawals.
SEP IRA	An arrangement for an employer to make deductible contributions to a traditional IRA (a Simplified Employee Pension or SEP IRA) set up for the employee to receive contributions. Generally, distributions from SEP IRAs are subject to the withdrawal and tax rules that apply to traditional IRAs.
SIMPLE IRA	An IRA that is set up to receive contributions to an employee pursuant to a Savings Incentive Match Plan for Employees (SIMPLE), which is available to qualifying small businesses.
Traditional IRA	An IRA that accepts both deductible and nondeductible contributions, subject to limits, and makes taxable distributions.

Modified Adjusted Gross Income (AGI)

The income level referenced to establish eligibility for making contributions to a traditional IRA or a Roth IRA. This amount is calculated via a worksheet that is specific to the plan type to which the taxpayer wants to contribute.

Phaseout Range

The range of modified AGI during which the eligible contribution amount phases down from the maximum amount to zero.

Recharacterization

A process by which an ineligible contribution is moved, before the tax-filing deadline, to an account that is eligible to receive it.

Rollover

The process by which funds on deposit in a qualified employer plan or another IRA are transferred to an IRA.

Direct Rollover

A rollover that is transferred, tax-free, directly from one trustee to another with no distribution being made to the account owner.

Trustee

A financial institution that maintains an account owner's IRA.

Withholding

The amount held back by a trustee when a distribution is made to an account owner; amount of withholding depends on type of distribution.

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