2016

# A Closer Look At The IRAs In State Automatic Enrollment Ira Programs

Kathryn L. Moore

# A CLOSER LOOK AT THE IRAS IN STATE AUTOMATIC ENROLLMENT IRA PROGRAMS

KATHRYN L. MOORE[1]

## I. INTRODUCTION

The United States faces a serious retirement savings funding gap.[2] This gap is due, in part, to the fact that only about half of the American workforce is covered by an employer-sponsored pension.[3]

In theory, workers who are not covered by an employer-sponsored pension can save for retirement through an individual retirement account, or IRA. However, in fact, few workers do.[4]

Recognizing that inertia plays an important role in retirement savings, a new strategy for retirement savings was conceived: automatic

---

[1] Ashland-Spears Distinguished Research Professor of Law, University of Kentucky College of Law. I would like to thank Franklin Runge and Beau Steenken for their research assistance.

[2] *See, e.g.*, Jack VanDerhei, *Auto-IRAs: How Much Would They Increase the Probability of 'Successful' Retirements and Decrease Retirement Deficits? Preliminary Evidence from EBRI's Retirement Security Projection Model*, 36 EMP. BENEFIT RES. INST. NOTES 11, 19 (2015) (estimating retirement savings shortfalls in present value (in 2014 dollars) at age 65 of $36,387 (per individual) for those ages 60-64 and $54,120 for those ages 35-39 for an estimated aggregate national retirement deficit of $4.13 trillion for all U.S. households where the head of household is between 35 and 64 years of age).

[3] *See, e.g.*, Alicia H. Munnell, *Falling Short: The Coming Retirement Crisis and What To Do About It*, CTR. FOR RETIREMENT RES. AT B.C., Apr. 2015, at 4 (noting that "at any given time, only about half of private-sector workers are participating in any employer-sponsored plan, and this share has remained relatively constant over the past 30 years").

[4] *See* THE PEW CHARITABLE TR., HOW STATES ARE WORKING TO ADDRESS THE RETIREMENT SAVINGS CHALLENGE 1 (2016), http://www.pewtrusts.org/en/research-and-analysis/reports/2016/06/how-states-are-working-to-address-the-retirement-savings-challenge (stating that "less than 10 percent of all workers contribute to a plan outside of work"); U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-699 5, AUTOMATIC IRAS: LOWER-EARNING HOUSEHOLDS COULD REALIZE INCREASES IN RETIREMENT INCOME (2013) (noting that about 95 percent of money contributed to traditional IRAs in 2008 was attributable to rollovers, principally from employer-sponsored plans).

enrollment IRAs.[5] Although automatic enrollment IRAs were initially intended to apply at the national level, the strategy failed to gain traction[6] and states have stepped in to fill the breach. Between September 2012 and June 2016, five states enacted state automatic enrollment IRA programs.[7] Moreover, a number of other states are also considering such programs.[8]

This Article takes a closer look at the IRAs in these state automatic enrollment IRA programs.[9] It begins by providing an overview of the state laws creating automatic enrollment IRA programs.[10] It then discusses the requirements that the state programs must satisfy in order to qualify as IRAs for purposes of the Internal Revenue Code and how effective the state programs are in satisfying these requirements.[11] Finally, it concludes by

---

[5] J. MARK IWRY & DAVID C. JOHN, PURSUING UNIVERSAL RETIREMENT SECURITY THROUGH AUTOMATIC IRAS (2006), http://www.heritage.org/research/reports/2006/02/pursuing-universal-retirement-security-through-automatic-iras.

[6] A host of federal bills providing for the creation of a federal automatic enrollment IRA have been introduced since 2006. S*ee, e.g.*, American Savings Account Act of 2016, S. 2472, 114th Cong. (2016); Automatic IRA Act of 2015, S. 245, 114th Cong. (2015); Automatic IRA Act of 2015, H.R. 506, 114th Cong. (2015). Moreover, the President's budget has regularly called for a federal automatic enrollment IRA program. *See, e.g.*, OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017 160 (2016) at Table S-9; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2016 120 (2015) at Table S-9. Nevertheless, an automatic enrollment IRA program has not been enacted at the federal level.

[7] *See infra* Section II.

[8] *See* Juliette Fairley, *Advisors Cry Foul over Mandated Auto-IRAs*, INSURANCENEWSNET (Aug. 19, 2016), http://insurancenewsnet.com/innarticle/advisors-cry-foul-state-mandated-auto-iras (reporting that Vermont, Iowa, Colorado, Georgia, Louisiana, Hawaii, and New York are considering state automatic enrollment IRA programs). *See also Fact Sheet: State-Based Retirement Plans for the Private Sector,* PENSION RTS. CTR.; http://www.pensionrights.org/issues/legislation/state-based-retirement-plans-private-sector (providing general overview of state activity); Alicia H. Munnell, *Could the Saver's Credit Enhance State Coverage Initiatives?*, CTR. FOR RETIREMENT RES. AT B.C., April 2016 at 2 Figure 2 (showing state activity as of March 2016).

[9] For a discussion of other issues raised by the state automatic enrollment IRA programs, see Kathryn L. Moore, *Closing the Retirement Savings Gap: Are State Automatic Enrollment IRAs the Answer?,* GEO. MASON L. REV. (forthcoming 2016).

[10] *See infra* Section II.

[11] *See infra* Section III.

discussing the distinction between Roth and traditional IRAs, and which type of IRA is best suited to serve as the default IRA.[12]

## II. OVERVIEW OF STATE AUTOMATIC ENROLLMENT IRA PROGRAMS

In September 2012, California became the first state to enact legislation creating a state automatic enrollment IRA program. Illinois followed suit in January 2015. By June 2016, Oregon, Connecticut, and Maryland had also enacted such programs.

This section provides an overview of each of these programs.

### A. CALIFORNIA SECURE CHOICE RETIREMENT SAVINGS TRUST

On September 28, 2012, California Governor Jerry Brown signed the California Secure Choice Retirement Savings Trust Act (California Act) into law. The California Act creates the California Secure Choice Retirement Savings Investment Board (California Board)[13] to administer the California Secure Choice Retirement Savings Trust (California Trust) "for the purpose of promoting greater retirement savings for California private employees in a convenient, voluntary, low-cost, and portable manner."[14]

Generally, the California Act requires private-sector employers with five or more employees that do not offer an employer-sponsored retirement plan to establish a payroll deposit retirement savings arrangement that automatically enrolls their employees into the California Program.[15] The California Act provides for covered employees to automatically contribute three percent of their salary to the program unless they affirmatively opt out of participation or elect a different contribution rate.[16] The Board is authorized to adjust the automatic contribution rate to as low as two percent and as high as five percent[17] and may implement an automatic escalation provision.[18]

Employees' payroll contributions are pooled into the California Trust. The California Board is authorized to establish managed accounts invested in United States Treasuries, myRAs, or similar investments for the

---

[12] *See infra* Section IV.
[13] CAL. GOV'T CODE § 100002(a)(1) (2012).
[14] *Id.* § 100004(a).
[15] *Id.* § 100032(a)-(e).
[16] *Id.* § 100032(i).
[17] *Id.* § 100032(j).
[18] *Id.* § 100032(k).

first three years of the Program's operation.[19] During this initial period, the board is directed to develop and implement an investment policy that defines the program's investment objectives and establishes policies and procedures that enable investment objectives to be met in a prudent manner.[20] The policy is to describe investment options which encompass a range of risk and return opportunities and allow for a rate of return that is commensurate with an appropriate level of risk.[21] The board is authorized to develop investment option recommendations that address risk-sharing and smoothing of market losses and gains.[22] Authorized option recommendations may include the creation of a reserve fund or customized investment products.[23]

The California Act provides that the California Program may not be implemented if (1) the IRA arrangements offered under the program fail to qualify for the favorable income tax treatment normally accorded IRAs under the Internal Revenue Code or (2) the Department of Labor determines that the program is an employee benefit plan and State or employer liability is established under ERISA.[24]

The California Act charged the California Board with conducting a market analysis and feasibility study and reporting to the California legislature its recommendations as to whether the legislature should enact further legislation implementing the California Program. [25] The market analysis and feasibility study, which found the program to be "feasible, sustainable, and legally permissible," was issued on January 31, 2016.[26]

---

[19] *Id*. § 100002(e)(1)(A).

[20] *Id*. § 100002(e)(2)(A).

[21] *Id.*

[22] *Id.* § 100002(e)(2)(B).

[23] *Id.*

[24] *Id*. § 100043. In September, 2016, the Department of Labor issued a final regulation, 29 C.F.R. § 2510.3-2(h), providing that a state automatic enrollment IRA program does not constitute an employee benefit plan for purposes of ERISA if it satisfies eleven separate requirements. For a discussion of the regulation, see Moore, *supra* note 9. California law requires the California Program to be structured to meet the requirements of the Department of Labor's regulation. *Id*. § 100043(b)(1)(B).

[25] The provisions imposing these requirements, §§ 100040 and 100042, were repealed when legislation approving the program was enacted in September 2016. S.B. 1234, Gen. Assemb. Ch. 804 (Cal. 2016).

[26] *See* CAL. SECURE CHOICE MKT. ANALYSIS, FEASIBILITY STUDY, & PROGRAM DESIGN CONSULTATION SERV. RFP NO. CSCRSIB03-14, OVERTURE FIN. LLC, FINAL REPORT TO THE CALIFORNIA SECURE CHOICE RETIREMENT SAVINGS INVESTMENT BOARD (2016), http://www.treasurer.ca.gov/scib/.

Legislation approving the program and implementing it as of January 1, 2017, was enacted on September 29, 2016.[27]

## B. ILLINOIS SECURE CHOICE SAVINGS PROGRAM

Illinois Governor Pat Quinn signed the Illinois Secure Choice Savings Program Act (Illinois Act)[28] into law in January 2015. The Illinois Act establishes "a retirement savings program in the form of an automatic enrollment payroll deduction IRA…for the purpose of promoting greater retirement savings for private-sector employees in a convenient, low-cost, and portable manner."[29]

Generally, the Illinois Act requires private-sector employers with 25 or more employees that do not offer an employer-sponsored retirement plan to establish a payroll deposit retirement savings arrangement that automatically enrolls their employees into the Illinois Program unless the employee opts out of the Program.[30] The default contribution level is set at three percent of wages.[31] However, employees may select a different contribution level which may be expressed either as a percentage of wages or a dollar amount up to the I.R.C. § 219(b)(1)(A) limit,[32] which is $5,500 in 2016.[33]

The Act calls for the creation of a trust fund (Illinois Fund) that is separate from the State Treasury.[34] Monies in the Illinois Fund are to consist of the employee contributions to the Illinois Fund, which are accounted for as individual accounts.[35] Amounts held in the Illinois Fund are not to be commingled with State funds and the State is to have no claim to or against, or any interest in, money held in the Illinois Fund.[36]

---

[27] CAL. GOV'T CODE § 100046.

[28] Illinois Secure Choice Savings Program Act, S. Res. 2758, 2014 Leg. (Ill. 2014).

[29] 820 ILL. COMP. STAT. § 80/10 (2015).

[30] *Id.* § 80/60(b).

[31] *Id.* § 80/60(c).

[32] *Id.*

[33] *IRS Announces 2016 Pension Plan Limitations: 401(k) Contribution Limit Remains Unchanged at $18,000 for 2016*, 2015-118 I.R.B. (Oct. 21, 2016).

[34] 820 ILL. COMP. STAT. § 80/15(a).

[35] *Id.*

[36] *Id.* § 80/15(b).

The Illinois Secure Choice Savings Board (Illinois Board)[37] is charged with designing, establishing, and operating the Fund.[38] The Illinois Board is required to engage an investment manager or managers to invest the Illinois Fund.[39] At the minimum, a single investment option must be established and offered: a life-cycle fund with a target date based upon the age of the employee enrolled in the plan.[40] In addition, four other investment options may be established and offered: (1) a conservation principal protection fund; (2) a growth fund; (3) a "secure return" fund;[41] and (4) an annuity fund.[42] The life-cycle fund is to serve as the default investment option for employees who do not elect an investment option unless and until a secure return fund is established and the Board determines that the secure return fund should replace the target date or life-cycle fund as the default investment option.[43]

Employees may select any of the available investment options and may change their investment option at any time, subject to rules promulgated by the Illinois Board.[44] Interest and investment earnings and losses are to be allocated to each individual employee's Program account.[45] Each participant's benefit is equal to the participant's individual Program account balance at the time the participant's retirement savings benefit becomes payable.[46]

The Illinois Act provides that the Illinois Board may not implement the Illinois Program if (1) the IRA arrangements offered under the Illinois Program fail to qualify for the favorable income tax treatment normally accorded IRAs under the Internal Revenue Code or (2) the Department of

---

[37] The composition of the Board is set forth in 820 ILL. COMP. STAT. § 80/20.

[38] 820 ILL. COMP. STAT. § 80/30.

[39] *Id.* § 80/40.

[40] *Id.* § 80/45(a).

[41] A "secure return" fund is a fund "whose primary objective is the preservation of the safety of principal and the provision of a stable and low-risk rate of return." If the Board elects to establish a secure return fund, the Board is authorized to procure any insurance, annuity, or other product to insure the value of the individuals' accounts and guarantee a rate of return. The cost of such a funding mechanism must be paid out of the Fund and under no circumstances is the Board, Program, Fund, State, or participating employer to assume any liability for investment or actuarial risk. *Id.* § 80/45(b)(3).

[42] *Id.* § 80/45(b).

[43] *Id.* §§ 80/45(a), (c).

[44] *Id.* § 80/60(d).

[45] *Id.* § 80/50.

[46] *Id.*

Labor determines that "the Program is an employee benefit plan and State or employer liability is established under [ERISA]."[47]

### C. OREGON RETIREMENT SAVINGS PLAN

On June 25, 2015, Oregon Governor Kate Brown approved legislation establishing the Oregon Retirement Savings Board (Oregon Board). The Oregon Board is charged with developing the Oregon Retirement Savings Plan (Oregon Plan) for Oregon employees who do not have access to a retirement savings plan at work.[48]

The Oregon statute broadly outlines the requirement for the Oregon Plan. It calls for mandatory participation by employers that do not otherwise offer an employer-sponsored retirement plan.[49] It provides for automatic enrollment by employees but permits employees to opt out of participation.[50] It does not set a default contribution rate but instead leaves it to the Oregon Board to establish the default contribution rate[51] and authorizes the Board to provide for automatic escalation of contributions.[52]

The Oregon statute requires that the Oregon Plan be professionally managed[53] and permits the Oregon Board to use private-sector partnerships to administer and invest the contributions to the plan under the supervision and guidance of the Oregon Board.[54] It requires that separate records and accounting be maintained for each plan account[55] but provides for the pooling of accounts for investment purposes.[56]

The Oregon statute provides that if the Oregon Board finds that the Oregon Plan would qualify as an employee benefit plan under ERISA, the Oregon Board may not establish the Oregon Plan.[57] Otherwise, the Oregon Board is directed to establish the Oregon Plan so that individuals may begin to contribute to the plan by July 1, 2017.[58]

---

[47] *Id.* § 80/95.
[48] 2015 Or. Laws, ch. 557, H.B. 2960, § 2(1).
[49] *Id.* § 3(1)(b).
[50] *Id.* § 3(1)(c).
[51] *Id.* § 3(1)(d).
[52] *Id.* § 3(1)(e).
[53] *Id.* § 3(1)(m).
[54] *Id.* § 3(1)(r).
[55] *Id.* § 3(1)(i).
[56] *Id.* § 3(1)(l).
[57] *Id.* § 15(2).
[58] *Id.* § 15(1).

### D. MARYLAND SMALL BUSINESS RETIREMENT SAVINGS PROGRAM AND TRUST

On May 10, 2016, Maryland Governor Lawrence Hogan signed the Maryland Small Business Retirement Savings Program and Trust (Maryland Program and Trust)[59] into law. The law establishes the Maryland Small Business Retirement Savings Board (Maryland Board) to implement, maintain, and administer the Maryland Program and Trust to assist Maryland employees without access to employer-sponsored savings arrangements to initiate individual retirement accounts.

Generally, the Maryland law requires private-sector employers that do not offer an employer-sponsored retirement plan to establish a payroll deposit savings program that allows employees to participate in the Maryland Program.[60] Employees will be automatically enrolled in the Maryland Program unless they opt out of participation.[61] The default contribution amount is to be established by the Maryland Board.[62]

The Maryland Board is directed to evaluate and establish a range of investment options, including a default investment.[63] When selecting investment options, the Maryland Board is directed to consider methods to minimize the risk of significant investment losses at the time a participant retires.[64] The Maryland Board is authorized to provide an investment option that provides an assured lifetime income.[65] The Maryland Board is directed to delegate administration of the trust to a third party administrator.[66]

The Maryland Program takes effect on July 1, 2016,[67] but may not be implemented until it is determined that the Maryland Program qualifies for favorable tax treatment under the Internal Revenue Code.[68]

---

[59] MD. CODE, LAB. & EMPL. § 12-401 (2016).
[60] *Id.* § 12-402(a)(1).
[61] *Id.* § 12-402(a)(2).
[62] *Id.* § 12-403(f).
[63] *Id.* § 12-401(c).
[64] *Id.* § 12-401(d).
[65] *Id.* § 12-401(e).
[66] *Id.* § 12-301(b)(2).
[67] 2016 Md. Laws, Chapter 323 § 5.
[68] *Id.* § 3.

### E. CONNECTICUT RETIREMENT SECURITY PROGRAM

On May 27, 2016, Connecticut Governor Dannel Malloy signed the Connecticut Retirement Security Program (Connecticut Program) into law.[69] The law establishes the quasi-public/private Connecticut Retirement Security Authority (Connecticut Retirement Authority)[70] to oversee the Connecticut Program for the purpose of promoting and enhancing retirement savings for private-sector employees in Connecticut.[71]

Generally, the Connecticut Program requires private-sector employers with five or more employees that do not offer an employer-sponsored retirement plan to participate in the program.[72] Employees will be automatically enrolled in the Connecticut Program unless they elect out of participation.[73] The default contribution level is set at three percent of wages, but employees may elect a different contribution level which may be expressed either as a percentage of wages or a dollar amount up to the I.R.C. § 219(b)(1)(A) limit.[74]

The Connecticut Retirement Authority is directed to provide for each participant's account to be invested in an age-appropriate target date fund or other investment vehicle as the authority may provide.[75] Program features are to include the designation of a lifetime income investment intended to provide participants with a source of retirement income for life.[76] At least fifty percent of a participant's account balance is to be invested in the lifetime income investment at retirement.[77]

The Connecticut Program is scheduled to begin operation in 2018.[78]

## III. FEDERAL LAW GOVERNING IRAS

The California Act provides that the California Program may not be implemented if the IRA arrangements offered under the California Program fail to qualify for the favorable income tax treatment normally accorded

---

69 2016 Conn. Acts No. 16-29
70 *Id.* § 2
71 *Id.* § 3(a).
72 *Id.* §§ 1(7), 7(a)(4).
73 *Id.* §§ 7(a)(2)-(3).
74 *Id.* § 1(3).
75 *Id.* § 8.
76 *Id.* § 9(b)(2).
77 *Id.* § 9(b)(3).
78 *Id.* § 7(a)(1).

IRAs under the Internal Revenue Code.[79] The Illinois Act[80] and the Maryland Act[81] contain similar admonishments. Although the Connecticut Act does not include such an express prohibition on implementation, it defines the term IRA for purposes of the Connecticut Act in terms of the Internal Revenue Code's definition of IRA[82] and provides that program assets will be held in trust or custodial accounts that satisfy the requirements of the Internal Revenue Code governing IRAs.[83]

Thus, the California, Illinois, Maryland, and Connecticut Acts all require that their IRAs satisfy the Internal Revenue Code's requirements for IRAs. The Oregon Act does not expressly refer to IRAs. However, material presented by consultants to the Oregon Board states that Oregon must decide which type of IRA to use,[84] and the Oregon Act directs the Oregon Board to obtain legal advice regarding the applicability of the Internal Revenue Code to the plan before establishing the plan.[85]

This section identifies the requirements that the state programs must satisfy in order to qualify as IRAs for purposes of the Internal Revenue Code. It then discusses how effective the state programs are in satisfying each of these requirements.

### A. REQUIREMENTS OF I.R.C. §§ 408(A) AND 408(C)

Section 408(a) of the Internal Revenue Code defines the term "individual retirement account" as a "trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries but only if the written instrument creating the trust meets the following requirements:"

(1) Except in the case of a rollover contribution, no contribution will be accepted unless it is in cash, and the contribution does not exceed the I.R.C. § 219(b)(1)(A) limit;

---

[79] CAL. GOV'T CODE § 100043 (2012).

[80] 820 ILL. COMP. STAT. § 80/95 (2015).

[81] 2016 Md. Laws, Chapter 323 § 3.

[82] 2016 Conn. Acts No. 16-29 § 1(9).

[83] *Id.* § 5(a).

[84] Memorandum from the Ctr. for Ret. Research at Bos. Coll. to Or. Ret. Sav. Plan (May 22, 2016), https://www.oregon.gov/treasury/ORSP/Documents/CRR%20Memo%20-%20Roth%20vs%20Conventional%20IRA%201JUNE16%20-%20BC.pdf [hereinafter *BCCRR Oregon Memo*].

[85] 2015 Or. Laws, ch. 557, H.B. 2960 § 7(b).

(2) The trustee is a bank or other person who demonstrates that the trust will be administered in accordance with the requirements of section 408;

(3) No part of the trust funds will be invested in life insurance contracts;

(4) The individual's interest in his account balance is nonforfeitable;

(5) The trust assets will not be commingled with other property except in a common trust fund or common investment fund; and

(6) Minimum distribution and incidental death benefit requirements are satisfied.

Section 408(c) of the Internal Revenue Code provides that an employer may establish an IRA so long as the six requirements of section 408(a) are satisfied, and there is a separate accounting for the interest of each employee.

### B. STATE LAWS' SATISFACTION OF REQUIREMENTS OF I.R.C. §§ 408(A) AND (C)

All of the state laws, with the exception of Oregon, are clearly intended to satisfy the requirements of I.R.C. §§ 408(a) and (c). By implication, Oregon law also appears to be intended to satisfy the requirements of I.R.C. §§ 408(a) and (c).

#### 1. Introductory Trust Requirements

As noted above, I.R.C. § 408(a) defines the term "individual retirement account" as a "trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries."

All of the state laws, with the exception of Oregon, expressly provide for the establishment of a trust created or organized in the United States.[86] Oregon law implicitly satisfies the trust requirement by providing

---

[86] *See* CAL. GOV'T CODE § 100004(a) (2016) (establishing retirement savings trust known as California Secure Choice Retirement Savings Trust); 2016 Conn. Acts No. 16-29, § 5(a) (providing that "Program assets shall be held in trust or

that the investment administrator for the plan must be the trustee of all contributions and earnings on contributions to the plan.[87] Thus, all of the state laws satisfy the introductory requirement that there be a trust created or organized in the United States.

In addition, all of the state laws,[88] with the exception of Oregon,[89] require that the trust be operated for the exclusive benefit of the participants and beneficiaries. Thus, all of the state laws, with the exception of Oregon, satisfy the exclusive benefit requirement. The Oregon program, when finalized, must include an express provision requiring that the plan be operated for the exclusive benefit of the participants and beneficiaries in order to satisfy the I.R.C. § 408(a) introductory trust requirements.

2. Limitation on Contributions

As noted above, I.R.C. § 408(a)(1) requires that except in the case of a rollover contribution, no contribution be accepted unless it is in cash, and the contribution must not exceed the I.R.C. § 219(b)(1)(A) limit.

All of the state laws satisfy this provision. Specifically, all of the state laws provide for contributions solely[90] in the form of payroll

---

custodial accounts meeting the requirements of [I.R.C. § 408(a) or (c)]"); 820 ILL. COMP. STAT. § 80/15(a) (providing that Illinois Secure Choice Savings Program Fund is established as trust outside of State treasury); MD. CODE, LAB. & EMPL. § 12-301(a).

[87] 2015 Or. Laws, ch. 557, H.B. 2960, § 3(o).

[88] *See* CAL. GOV'T CODE § 100002(d)(1); 2016 Conn. Acts No. 16-29 § 6(a); 820 ILL. COMP. STAT. § 80/25; MD. CODE, LAB. & EMPL. § 12-203(a).

[89] See 2015 Or. Laws ch. 557, H.B. 2960, § 3(a), 1 (requiring Oregon Board to develop plan that permits eligible employees to contribute to account through payroll deduction).

[90] Connecticut law would also permit rollover contributions in accordance with I.R.C. § 408(a)(1) (2012). *See* 2016 Conn. Acts No. 16-29 § 7(d). Rollover contributions do not need to be in cash. I.R.C. § 408(a)(1).

deductions[91] and expressly or implicitly incorporate the I.R.C. § 219(b)(1)(A) limit.[92]

### 3. Trustee Requirement

I.R.C. § 408(a)(2) requires that the trustee be a bank or other person who demonstrates that the trust will be administered in accordance with the requirements of section 408.

The Connecticut and Illinois laws expressly satisfy this requirement. Specifically, Section 30(b) of the Illinois Act charges the Board with "appoint[ing] a trustee to the I.R.A. Fund in compliance with Section 408 of the Internal Revenue Code."[93] The Connecticut law provides that "Program assets shall be held in trust or custodial accounts meeting the requirements of [I.R.C. § 408(a) or (c)]."[94]

Although the California and Maryland laws do not explicitly satisfy this requirement, they do so implicitly. The California law implicitly satisfies this requirement by providing that the California Board, in its capacity as trustee, has the authority to "[f]acilitate compliance by the retirement savings program or arrangements established under the program with all applicable requirements for the program under the Internal Revenue Code."[95] Similarly, the Maryland law implicitly satisfies this requirement

---

[91] *See* CAL. GOV'T CODE § 100032(h) (providing for default contribution of three percent of employee's salary or wages); 2016 Conn. Acts No. 16-29 § 1(3) (defining "contribution level" in terms of percentage of wages or dollar amount and providing for default contribution of three percent of wages); ILL. COMP. STAT. § 80/60(c) (defining "contribution level" in terms of percentage of wages or dollar amount and providing for default contribution of three percent of wages); MD. CODE, LAB. & EMPL. § 12-403(e); 2015 Or. Laws ch. 557, H.B. 2960, § 3(a) (requiring Oregon Board to develop plan that permits eligible employees to contribute to account through payroll deduction).

[92] *See* CAL. GOV'T CODE § 100010(a)(11) (requiring the California Board to "[s]et minimum and maximum investment levels in accordance with contribution limits set for IRAs by the Internal Revenue Code."); 2016 Conn. Acts No. 16-29 § 5(c) (requiring Connecticut Authority to establish processes to prevent contributions from exceeding I.R.C. § 219(b)(1) limit); 820 ILL. COMP. STAT. § 80/60(c) (limiting "contribution level" to I.R.C. § 219(b)(1)(A) limit); MD. CODE, LAB. & EMPL. § 12-204(a)(11); 2015 Or. Laws, ch. 557, H.B. 2960, § 4(6) (directing the Oregon Board to "[s]et minimum, maximum and default contribution levels in accordance with limits established by the Internal Revenue Code.").

[93] 820 ILL. COMP. STAT. § 80/30(b).

[94] 2016 Conn. Acts No. 16-29 § 5(a).

[95] CAL. GOV'T CODE § 100010(a)(14).

by providing that the Maryland "Board shall adopt regulations and take any other action necessary to implement this title consistent with the Internal Revenue Code and regulations issued in accordance with the Internal Revenue Code to ensure that the Program meets all criteria for federal tax deferral or tax-exempt benefits or both."[96]

The Oregon law, which provides a broad outline for the development of the Oregon Plan, does not address the trustee requirement. When developed, the Oregon plan will need to ensure that the plan's trustee is a bank or other person who demonstrates that the trust will be administered in accordance with requirements of I.R.C. § 408.

#### 4. Prohibition on Investment in Life Insurance Contracts

I.R.C. § 408(a)(3) provides that no part of the trust funds may be invested in life insurance contracts.

None of the state laws expressly prohibit investment in life insurance contracts. In fact, the original California statute authorized investments in insurance agreements[97] and thus could have violated this provision if investments in life insurance were in fact made. The Illinois Act contains similar troubling language authorizing the Illinois Board to "procure *any insurance,* annuity, or other product to insure the value of individuals' accounts and guarantee a rate of return."[98]

In order to ensure satisfaction of the life insurance prohibition, the states should include language prohibiting investments in life insurance contracts in the final implementing provisions governing their programs.

#### 5. Nonforfeitability

I.R.C. § 408(a)(4) provides that the individual's interest in his account must be nonforfeitable.

Although none of the state laws include provisions permitting participants' interests to be forfeited under any circumstances, none of the state laws expressly provide that individuals' interests in their account balances are nonforfeitable.[99] Thus, the state laws' final implementing

---

[96] MD. CODE, LAB. & EMPL. § 12-204(b).

[97] *See* CAL. GOV'T CODE § 100002(e)(3)(G), prior to amendment by S.B. 1234, 2016 Leg. (Ca. 2016).

[98] 820 ILL. COMP. STAT. § 80/45(b)(3) (emphasis added).

[99] Maryland law expressly states that the assets in a participant's individual account are the individual's property. MD. CODE, LAB. & EMPL. §12-403(g). The state law does not, however, expressly state that that interest is nonforfeitable. *See*

language should expressly provide that participants' interests are nonforfeitable.

### 6. Commingling of Assets

I.R.C. § 408(a)(5) provides that trust assets must not be commingled with other property except in a common trust fund or common investment fund.

Illinois law expressly prohibits the commingling of money in the Illinois Fund with state funds.[100] Maryland law implicitly prohibits impermissible commingling of funds.[101] None of the other state statutes expressly prohibit commingling of trust assets with other property except in a common trust fund or common investment fund. Thus, in order to satisfy I.R.C. § 408(c), the state laws' final implementing language should expressly prohibit such commingling.

### 7. Minimum Distribution and Incidental Death Benefit Requirements

I.R.C. § 408(a)(6) provides that minimum distribution and incidental death benefit requirements must be satisfied. The minimum distribution and incidental death benefits requirements are set forth in the Treasury regulations.[102]

None of the state laws expressly include provisions satisfying the minimum distribution and incidental death benefit requirements.[103] Thus, in

---

*also* 820 ILL. COMP. STAT. §80/15(b) (2015) (stating that amounts deposited in the Illinois fund shall not be State property); 2015 Or. Laws ch. 557, H.B. 2960, § 3(n) (providing that "Oregon and employers that participate in the plan have no proprietary interest in the contributions to or earnings on amounts contributed to accounts established under the plan").

[100] 820 ILL. COMP. STAT. § 80/15(b).

[101] MD. CODE, LAB. & EMPL. §12-204(a)(12) (authorizing Maryland Board to "arrange for collective, common and pooled investments of assets of the Program or arrangements, including investments in conjunction with other funds *with which those assets are authorized to be collectively invested* with a view to saving costs through efficiencies and economies of scale") (emphasis added).

[102] Treas. Reg. §§ 1.408-2(b)(6), (7).

[103] *Cf.* 2016 Conn. Acts No. 16-29 § 9(a) & (b) (providing that Connecticut Authority shall establish rules and procedures governing the distribution of funds that allow for such distributions as may be permitted or required by the Internal Revenue Code and directing distributions to begin within ninety days after participant reaches normal retirement age).

order for the state programs to satisfy these requirements, the final implementing language in the state laws should expressly incorporate these requirements.

8. Separate Accounting

I.R.C. § 408(c) requires employers that establish IRAs to provide a separate account for the interest of each employee.

All of the state laws provide for a separate accounting for each employee's interest.[104] Thus, all of the state laws expressly satisfy the I.R.C. § 408(c) separate accounting requirement.

9. Summary

As currently written, the state laws expressly satisfy some, but not all, of the requirements of I.R.C. §§ 408(a) and (c). In order to satisfy I.R.C. §§ 408(a) and (c), the state programs, when implemented, will need to incorporate and expressly satisfy all of the elements of I.R.C. §§ 408(a) and (c).

## IV. TRADITIONAL VERSUS ROTH IRAS

There are two basic types of IRAs: traditional IRAs and Roth IRAs.[105] Traditional IRAs were added to the Internal Revenue Code with

---

[104] *See* CAL. GOV'T CODE § 100008(c) (stating that "individual's retirement savings benefit under the program shall be an amount equal to the balance in the individual's program account on the date the retirement savings benefit becomes payable."); 2016 Conn. Acts No. 16-29 § 4(b)(1) (requiring participants to be provided with a statement no less than quarterly of the account balance in their individual retirement account, including the value in each investment option); 820 ILL. COMP. STAT. §80/15 (stating that Illinois "Fund shall include the individual retirement accounts of enrollees, which shall be accounted for as individual accounts."); 2015 Or. Laws ch. 557 § 3(i) (requiring maintenance of separate records and accounting for each plan account). *Cf.* MD. CODE, LAB. & EMPL. § 12-204(a)(13).

[105] In addition, participants in employer-sponsored pension plans may roll over assets from their employer-sponsored pension into a third type of IRA, a rollover IRA. I.R.C. § 408(d)(3) (2012).

the enactment of ERISA in 1974.[106] Roth IRAs were introduced in legislation enacted in 1997.[107]

The principal distinction between traditional IRAs and Roth IRAs is the timing of taxation. Specifically, individuals may deduct contributions to traditional IRAs from their income when the contributions are made,[108] no tax is imposed on IRA earnings so long as the assets are held by the IRA,[109] and distributions from IRAs are subject to tax when made.[110] In contrast, contributions to Roth IRAs are taxable when made[111] but generally neither the earnings on[112] nor the distributions from Roth IRAs are subject to income tax.[113]

Although the timing of taxation is the most significant difference between traditional and Roth IRAs, there are four other distinctions as well: (1) income limits apply to traditional IRAs in a different manner than to Roth IRAs; (2) there are differences in the contribution limits; (3) there are greater penalties for distributions from traditional IRAs before age 59 ½ than for distributions from Roth IRAs before age 59 ½; and (4) minimum distribution rules apply to traditional IRAs but generally do not apply to Roth IRAs.[114]

---

[106] Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2002(b), (e), 88 Stat. 829, 959-64, 968-69. For a discussion of the history of IRAs, *see* Patricia E. Dilley, *Hidden in Plain View: The Pension Shield Against Creditors*, 74 IND. L.J. 355, 419-24 (1999); Edward Morse, *Travails of the Entrepreneurial Ant: Reforming Tax-Favored Retirement Saving for Small Business Owners*, 50 DEPAUL L. REV. 49, 71-74 (2000).

[107] Taxpayer Relief Act of 1997, Pub. L. No. 105-34 § 302(a), 111 Stat. 788, 825 (1997) (adding new Code § 408A).

[108] I.R.C. § 219(a) (2014). Individuals may also make after-tax contributions to traditional IRAs. I.R.C. § 408(o) (2015).

[109] I.R.C. § 408(e) (2015).

[110] I.R.C. § 408(d) (2015).

[111] I.R.C. § 408A(c)(1) (2010).

[112] I.R.C. § 408A(a) (2010); I.R.C. § 408(e) (2015).

[113] Distributions of contributions to Roth IRAs are never taxable. Moreover, distributions of earnings on Roth contributions are not taxable if they are distributed at least five years after the Roth IRA was established and the distribution (1) was made on or after the owner reaches age 59 ½, (2) the owner is disabled, (3) is made to a beneficiary on account of the owner's death, or (4) the owner uses the money for the first-time purchase of a home. I.R.C. § 408A(d)(2); Treas. Reg. § 1.408A-6 Q & A1(b).

[114] For high-income workers, there are other distinctions between Roth and traditional IRAs. *See, e.g., Medicare premiums a factor in deciding whether to make a deductible contribution to a traditional IRA or a contribution to a Roth IRA,* RIA Pens. Planning 4, 178 (2016). In light of the population targeted by state automatic

By their very nature, state automatic enrollment IRA programs must provide for a default type of IRA. The state legislatures have not been uniform in their choice of default IRA. In its original legislation, California[115] and Maryland[116] chose a traditional IRA. In contrast, Illinois[117] and Connecticut[118] chose Roth IRAs. Oregon did not specify a type of IRA in its legislation; the Center for Retirement Research at Boston College (BCCRR), which has served as a consultant to both the Oregon Board[119] and the Connecticut Board,[120] has recommended that the Oregon legislature select the Roth IRA as the default IRA. [121]

This section considers which type of IRA is best suited to serve as the default IRA in a state automatic enrollment IRA program. It begins by taking a closer look at the distinctions between traditional and Roth IRAs. It then discusses the implications of these distinctions for the selection of a

---

enrollment IRAs, these are not significant distinctions. *See* BCCRR Oregon Memo, *supra* note 85, at 2.

[115] *See* CAL. GOV'T CODE § 100000(e) (defining "IRA" as "an individual retirement account or individual retirement annuity under Section 408(a) or 408(b) of Title 26 of the United States Code.").

[116] MD. CODE, LAB. & EMPL. § 12-101(e) (defining IRA as individual retirement account or individual retirement annuity under I.R.C. §§ 408(a) or (b)).

[117] Ill. Secure Choice Savings Program Act, S. Res. 2758, 2014 Leg § 5 (defining "IRA" as "Roth IRA (individual retirement account) under Section 408A of the Internal Revenue Code.").

[118] 2016 Conn. Acts No. 16-29 § 1(8) (defining individual retirement account as a Roth IRA). The BCCRR, serving as a consultant to the Connecticut Board, recommended the Roth IRA as the default IRA. Center for Retirement Research at Boston College, *Report on Design of Connecticut's Retirement Security Program* 10-11 (Dec. 2015) [hereinafter *BCCRR Connecticut Report*],. The Connecticut Board, in contrast, recommended to the Connecticut legislature that the Connecticut legislature use a traditional IRA as the default IRA. State of Connecticut Retirement Security Board, Report to Legislature 10 (Jan. 1, 2016) [hereinafter *Connecticut Report to Legislature*], http://www.osc.ct.gov/crsb/docs/finalreport/CRSB_January _1_ Report.pdf. The Connecticut legislature selected the Roth IRA as the default IRA but directed the Connecticut Authority to conduct a study of the interests of the participants and potential participants in the Connecticut program in investing in a traditional IRA and report the results of that study to the legislature by January 1, 2019. 2016 Conn. Acts No. 16-29 §§ 1(8) & 12(a).

[119] *See BCCRR Oregon Memo*, *supra* note 85.

[120] *See Connecticut Report to Legislature*, *supra* note 118.

[121] *BCCRR Oregon Memo*, *supra* note 85, at 1-2. It made a similar recommendation to the Connecticut Board. *Connecticut Report to Legislature*, *supra* note 118, at 10-11.

default IRA. Finally, it concludes by explaining why the Roth IRA is the more appropriate default IRA.

### A. ECONOMIC EFFECT OF DIFFERENCE IN TIMING OF TAXATION FOR TRADITIONAL AND ROTH IRAS

If tax rates remain the same, the tax treatment of traditional and Roth IRAs is essentially economically identical. Specifically, for both types of IRAs it is as though the earnings on the contributions were never taxed.

Tax rates, however, do not always remain constant. For instance, some workers, particularly those in their peak earning years, may be subject to higher tax rates during their working years than during retirement. For these workers, a traditional IRA is more favorable than a Roth IRA. Other workers, such as those early in their careers, may face higher tax rates at retirement than during their working years. For these workers, a Roth IRA is more favorable than a traditional IRA.

This section uses examples to demonstrate these economic principles.

#### 1. Economic Equivalence of Traditional and Roth IRAs – Assuming Constant Tax Rate

Suppose that Angela has $1,000 that she can save each year, is taxed at a 20% rate, and earns 10% interest on her contributions each year. If each year she contributes $1,000 to a regular savings account (in which both contributions and earnings are taxed), she will have $2,804.89 at the end of 3 years. In contrast, if she contributes the same amount to a traditional IRA (in which neither contributions nor earnings are taxed but money distributed from the IRA is taxed), she will have $2,912.80 after taxes at the end of 3 years. Finally, if she contributes the same amount to a Roth IRA (in which contributions are taxed but neither earnings nor distributions are taxed), she would again have $2,912.80.[122]

---

[122] The following mathematical formulas illustrate how the tax benefits of a traditional IRA and Roth IRA are virtually identical if tax rates remain constant. (For purposes of the formulas, n = number of years, r = rate of return, and t = tax rate.)

Suppose a worker contributes $1,000 to a traditional IRA. After n years, the IRA will have grown to $\$1{,}000(1 + r)^n$. When the worker withdraws the funds, both the original contribution and earnings on the contribution are taxable. Thus, the after-tax value of the traditional IRA in retirement is $(1 - t)\$1{,}000(1 + r)^n$.

Thus, assuming constant tax rates, contributions to traditional and Roth IRAs are economically equivalent. For both types of IRA, it is as though the earnings were never taxed.

---

In a Roth IRA, the worker pays tax on the original contribution so a worker's after tax contribution to a Roth IRA is $(1 - t)\$1,000$. After n years, the after-tax contribution will have grown to $(1 + r)^n (1 - t)\$1,000$. Since the Roth distribution is not subject to further tax, the after-tax distribution from the traditional IRA is identical to the nontaxable distribution from the Roth IRA: $(1 - t)\$1,000(1 + r)^n = (1 + r)^n (1 - t)\$1,000$. *See BCCRR Oregon Memo*, *supra* note 85, at 1.

| **Contributions to Regular Savings Account** | (20% tax imposed on contributions and 20% tax imposed on earnings) |
|---|---|
| Year One: | |
| $1,000 x 20% = $200 | (tax imposed on $1,000) |
| $1,000 – $200 = $800 | (amount Angela has remaining after taxes to contribute) |
| $800 x 10% = $80 | (earnings on contribution based on 10% interest rate) |
| $80 x 20% = $16 | (tax on earnings) |
| $800 + ($80 – $16) = $864 | (amount at end of Year One after tax on contribution and earnings) |
| Year Two: | |
| $864 + ($1,000 – $200) = $1,664 | (carryover contribution and earnings from Year One plus Year Two after tax contribution of $800) |
| $1,664 x 10% = $166.40 | (earnings on total contributions and past earnings based on 10% interest rate) |
| $166.40 x 20% = $33.28 | (tax on earnings) |
| $1,664 + ($166.40 – $33.28) = $1,797.12 | (amount at end of Year Two after tax on contributions and earnings) |
| Year Three: | |
| $1,797.12 + ($1,000 – $200) = $2,597.12 | (carryover contributions and earnings from Years One and Two plus Year Three after tax contribution of $800) |
| $2,597.12 x 10% = $259.71 | (earnings on total contributions and past earnings based on 10% interest rate) |
| $259.71 x 20% = $51.94 | (tax on earnings) |
| $2,597.12 + ($259.71 – $51.94) = $2,804.89 | (amount at end of Year Three after tax on contributions and earnings) |

| | |
|---|---|
| **Contributions to Traditional IRA** | (tax deferral: no tax imposed on contributions or earnings but 20% tax imposed on distributions) |
| Year One: | |
| $1,000 | (no tax imposed when $1,000 contribution made) |
| $1,000 x 10% = $100 | (earnings on contribution based on 10% interest rate) |
| $1,000 + $100 = $1,100 | (amount at end of Year One – no tax on earnings or contribution) |
| Year Two: | |
| $1,100 + $1,000 = $2,100 | (carryover contribution and earnings from Year One plus Year Two contribution of $1,000) |
| $2,100 x 10% = $210 | (earnings on total contributions and past earnings based on 10% interest rate) |
| $2,100 + ($210) = $2,310 | (amount at end of Year Two – no tax on earnings or contributions) |
| Year Three: | |
| $2,310 + $1,000 = $3,310 | (carryover contribution from Years One and Two plus Year Three contribution of $1,000) |
| $3,310 x 10% = $331 | (earnings on total contributions based on 10% interest rate) |
| $3,310 + $331 = $3,641 | (amount at end of Year Three – no tax on contributions and earnings) |
| $3,641 x 20% = 728.20 | (tax on distribution of $3,641 at end of Year Three) |
| $3,641 – 728.20 = $2,912.80 | (amount remaining after tax on distribution at end of Year Three) |

| | |
|---|---|
| **Contributions to Roth IRA** | (20% tax imposed on contributions; no tax imposed on earnings and no tax imposed on distributions) |
| Year One: | |
| $1,000 x 20% = $200 | (tax imposed on $1,000) |
| $1,000 – $200 = $800 | (amount Angela has remaining after taxes to contribute) |
| $800 x 10% = $80 | (earnings on contribution based on 10% interest rate) |
| $800 + $80 = $880 | (amount at end of Year One after tax on contribution but no tax on earnings) |
| Year Two: | |
| $880 + ($1,000 – $200) = $1,680 | (carryover contribution and earnings from Year One plus Year Two after tax contribution of $800) |
| $1,680 x 10% = $168.00 | (earnings on total contributions and past earnings based on 10% interest rate) |
| $1,680 + $168.00 = $1,848 | (amount at end of Year Two after tax on contributions but no tax on earnings) |
| Year Three: | |
| $1,848 + ($1,000 – $200) = $2,648 | (carryover contributions and earnings from Years One and Two plus Year Three after tax contribution of $800) |
| $2,648 x 10% = $264.80 | (earnings on total contributions and past earnings based on 10% interest rate) |
| $2,648 + $264.80 = $2,912.80 | (amount at end of Year Three after tax on contributions but no tax on earnings) |
| $2,912.80 | (non-taxable distribution available at end of Year Three) |

### 2. Effect of Higher Tax Rate at Time of Contributions

Again suppose that Angela has $1,000 that she can save each year for 3 years. Further suppose that she is taxed at a 20% rate for the first two years when she makes the contributions, earns 10% interest on her contributions each year, and is taxed at a 10% rate in the third year when the contributions are distributed at retirement.

If she contributes to a traditional IRA, she will have $3,267.90 after taxes at the end of 3 years. In contrast, if she contributes to a Roth IRA, she will only have $3,022.80 after taxes at the end of 3 years. Thus, Angela will be better off with a traditional IRA than a Roth IRA if her tax rates are lower at retirement than during her working years.

| **Contributions to Traditional IRA** | (tax deferral: no tax imposed on contributions or earnings but 10% tax imposed on distributions) |
|---|---|
| Year One: | |
| $1,000 | (no tax imposed when $1,000 contribution made) |
| $1,000 x 10% = $100 | (earnings on contribution based on 10% interest rate) |
| $1,000 + $100 = $1,100 | (amount at end of Year One – no tax on earnings or contribution) |
| Year Two: | |
| $1,100 + $1,000 = $2,100 | (carryover contribution and earnings from Year One plus Year Two contribution of $1,000) |
| $2,100 x 10% = $210 | (earnings on total contributions and past earnings based on 10% interest rate) |
| $2,100 + ($210) = $2,310 | (amount at end of Year Two – no tax on earnings or contributions) |
| Year Three: | |
| $2,310 + $1,000 = $3,310 | (carryover contribution from Years One and Two plus Year Three contribution of $1,000) |
| $3,310 x 10% = $331 | (earnings on total contributions based on 10% interest rate) |
| $3,310 + $331 = $3,641 | (amount at end of Year Three – no tax on contributions and earnings) |
| $3,641 x 10% = 364.10 | (tax on distribution of $3,641 at end of Year Three) |
| $3,641 – $364.10 = $3,276.90 | (amount remaining after tax on distribution at end of Year Three) |

| | |
|---|---|
| **Contributions to Roth IRA** | (20% tax imposed on first two years of contributions, 10% tax imposed on third year of contributions; no tax imposed on earnings and no tax imposed on distributions) |
| Year One: | |
| $1,000 x 20% = $200 | (tax imposed on $1,000) |
| $1,000 – $200 = $800 | (amount Angela has remaining after taxes to contribute) |
| $800 x 10% = $80 | (earnings on contribution based on 10% interest rate) |
| $800 + $80 = $880 | (amount at end of Year One after tax on contribution but no tax on earnings) |
| Year Two: | |
| $880 + ($1,000 – $200) = $1,680 | (carryover contribution and earnings from Year One plus Year Two after tax contribution of $800) |
| $1,680 x 10% = $168.00 | (earnings on total contributions and past earnings based on 10% interest rate) |
| $1,680 + $168.00 = $1,848 | (amount at end of Year Two after tax on contributions but no tax on earnings) |
| Year Three: | |
| $1,848 + ($1,000 – $100) = $2,748 | (carryover contributions and earnings from Years One and Two plus Year Three after tax contribution of $900 with 10% tax in Year 3) |
| $2,748 x 10% = $274.80 | (earnings on total contributions and past earnings based on 10% interest rate) |
| $2,748 + $274.80 = $3,022.80 | (amount at end of Year Three after tax on contributions but no tax on earnings) |
| $3,022.80 | (non-taxable distribution available at end of Year Three) |

### 3. Effect of Higher Tax Rate at Time of Distribution

Again suppose that Angela has $1,000 that she can save each year for 3 years. Further suppose that she is taxed at a 10% rate for the first two years when she makes the contributions, earns 10% interest on her contributions each year, and is taxed at a 20% rate in the third year when the contributions are distributed at retirement.

If she contributes to a traditional IRA, she will have $2,912.80 after taxes at the end of 3 years. In contrast, if she contributes it to a Roth IRA, she will have $3,166.90 after taxes at the end of 3 years. Thus, Angela will be better off with a Roth IRA than with a traditional IRA if she is subject to a higher tax rate at retirement than during her working years.

| | |
|---|---|
| **Contributions to Traditional IRA** | (tax deferral: no tax imposed on initial contributions or earnings; 20% tax imposed on distributions) |
| Year One: | |
| $1,000 | (no tax imposed when $1,000 contribution made) |
| $1,000 x 10% = $100 | (earnings on contribution based on 10% interest rate) |
| $1,000 + $100 = $1,100 | (amount at end of Year One – no tax on earnings or contribution) |
| Year Two: | |
| $1,100 + $1,000 = $2,100 | (carryover contribution and earnings from Year One plus Year Two contribution of $1,000) |
| $2,100 x 10% = $210 | (earnings on total contributions and past earnings based on 10% interest rate) |
| $2,100 + $210 = $2,310 | (amount at end of Year Two – no tax on earnings or contributions) |
| Year Three: | |
| $2,310 + $1,000 = $3,310 | (carryover contribution and earnings from Years One and Two plus Year Three contribution of $1,000) |
| $3,310 x 10% = $331 | (earnings on total contributions based on 10% interest rate) |
| $3,310 + $331 = $3,641 | (amount at end of Year Three – no tax on contributions and earnings) |
| $3,641 x 20% = 728.20 | (tax on distribution of $3,641 at end of Year Three) |
| $3,641 – 728.20 = $2,912.80 | (amount remaining after tax on distribution at end of Year Three) |

| | |
|---|---|
| **Contributions to Roth IRA** | (10% tax imposed on first two years of contributions and 20% tax imposed on third year of contributions; no tax imposed on earnings and no tax imposed on distributions) |
| Year One: | |
| \$1,000 x 10% = \$100 | (tax imposed on \$1,000) |
| \$1,000 – \$100 = \$900 | (amount Angela has remaining after taxes to contribute) |
| \$900 x 10% = \$90 | (earnings on contribution based on 10% interest rate) |
| \$900 + \$90 = \$990 | (amount at end of Year One after tax on contribution but no tax on earnings) |
| Year Two: | |
| \$990 + (\$1,000 – \$100) = \$1,890 | (carryover contribution and earnings from Year One plus Year Two after tax contribution of \$900) |
| \$1,890 x 10% = \$189.00 | (earnings on total contributions and past earnings based on 10% interest rate) |
| \$1,890 + \$189.00 = \$2,079 | (amount at end of Year Two after tax on contributions but no tax on earnings) |
| Year Three: | |
| \$2,079 + (\$1,000 – \$200) = \$2,879 | (carryover contributions and earnings from Years One and Two plus Year Three after tax contribution of \$800 – taxed at 20% rate) |
| \$2,879 x 10% = \$287.90 | (earnings on total contributions and past earnings based on 10% interest rate) |
| \$2,879 + \$287.90 = \$3,166.90 | (amount at end of Year Three after tax on contributions but no tax on earnings) |
| \$3,166.90 | (non-taxable distribution available at end of Year Three) |

### B. OTHER DISTINCTIONS IN TREATMENT BETWEEN TRADITIONAL AND ROTH IRAS

In addition to the difference in the timing of taxation, there are four other noteworthy distinctions in the tax treatment of traditional and Roth IRAs. This section discusses those distinctions.

#### 1. Income Limits

Both traditional and Roth IRAs are subject to income limits.[123] The dollar amounts, which are indexed for inflation, are identical, but the dollar amounts apply in a different manner. Specifically, an individual may not contribute to a Roth IRA if the individual's income exceeds the income limit[124] while an individual may contribute to a traditional IRA, regardless of income, but if an individual's income exceeds the income limit and the individual and/or his or her spouse is covered by an employer-sponsored pension plan, the individual may not deduct his or her contribution to a traditional IRA.[125]

Thus, in 2016, single taxpayers who earn $132,000 or more, and married taxpayers filing jointly who earn $194,000 or more are not permitted to contribute to a Roth IRA.[126] Roth contributions are phased out for single taxpayers with earnings between $117,000 and $132,000 and for married taxpayers filing jointly with earnings between $184,000 and $194,000.[127]

The state automatic enrollment IRA programs do not apply to workers who are covered by an employer-sponsored plan. Thus, single taxpayers will not be affected by the income limit on deductible contributions to traditional IRAs. Married workers, however, may be affected by the limit if their spouse is covered by an employer-sponsored plan. Specifically, married workers may not deduct their contributions to a traditional IRA under a state automatic enrollment IRA program if their spouse is covered by an employer-sponsored plan and the couple's income

---

[123] For the definition of income for these purposes, see I.R.C. § 219(g)(3) (2014) (modifying adjusted gross income); I.R.C. § 408A(c)(3) (2014) (incorporating I.R.C. § 219(g)(3) definition of income).

[124] I.R.C. § 408A(c)(3)(A) (2010) (imposing limits); I.R.C. § 408A(c)(3)(D) (2010) (providing for inflation adjustment).

[125] I.R.C. § 219(g) (2014) (imposing limits); I.R.C. § 219(g)(8) (2014) (providing for inflation adjustment).

[126] *See* I.R.S., *supra* note 33.

[127] *Id.*

in 2016 exceeds $194,000.[128] Deductions are phased out in 2016 for incomes between $184,000 and $194,000.[129]

### 2. Contribution Limits

Nominally, the contribution limits for traditional and Roth IRAs are identical for individuals under the age 70 ½.[130] Specifically, the contribution limit for individuals under the age of 50 is $5,500[131] while the contribution limit for individuals age 50 to 70 ½ is $6,500.[132] For individuals who seek to maximize their contributions, however, the contribution limit for Roth IRAs is effectively higher than the limit for traditional IRAs because the Roth limit is an after-tax limit while the traditional limit is a before-tax limit. To illustrate, if an individual in the 10% income tax bracket contributes the maximum $5,500 to a traditional IRA, the $5,500 contribution is equivalent to a $4,950 after-tax contribution ($5,500 – (5,500 x 10% = $550) = $4,950). In contrast, if an individual in the 10% income tax bracket contributes the maximum $5,500 to a Roth IRA, the individual makes an after-tax contribution of $5,500 and may pay the $550 tax with other money. In effect, the individual is contributing an extra $550 to the Roth IRA.

In addition, an age limit applies to contributions to traditional IRAs[133] but not to contributions to Roth IRAs.[134] Specifically, individuals age 70 ½ or older are prohibited from contributing to a traditional IRA[135] but may contribute up to $6,500 to a Roth IRA.

### 3. Excise Tax on Pre-Age 59 ½ Distributions

As discussed above, distributions from traditional IRAs are taxable as income in the year of receipt.[136] In addition, if the recipient is under the

---

[128] *Id.*

[129] *See id.*

[130] *See* I.R.C. § 408A(c)(2) (2015) (Roth IRA provision cross-referencing traditional IRA limit provision I.R.C. § 219).

[131] I.R.C. § 219(b)(5)(A) (2014) (establishing basic limit of $5,000); I.R.C. 219(b)(5)(C) (providing for cost-of-living adjustment). I.R.S., *supra* note 33 (setting limit at $5,500 for 2016).

[132] I.R.C. § 219(b)(5)(B) (2014) (permitting $1,000 catch-up contribution for individuals age 50 or over).

[133] I.R.C. § 219(d)(1) (2014).

[134] I.R.C. § 408(c)(4) (2015).

[135] I.R.C. § 219(d)(1) (2014).

[136] I.R.C. § 408(d) (2015).

age of 59 ½, a ten percent excise tax generally applies.[137] Unlike distributions from traditional IRAs, distributions of Roth contributions are never taxable[138] nor subject to the ten percent excise tax. Pre-age 59 ½ distributions of earnings on Roth contributions, however, may be subject to regular income taxation[139] as well as the ten percent excise tax.[140]

The Internal Revenue Code provides favorable income tax treatment to IRAs primarily to encourage individuals to save for retirement.[141] The ten percent excise tax on early distributions is intended to ensure that funds in tax-favored retirement savings vehicles, such as IRAs, are available for retirement purposes and not withdrawn too early.[142]

Exceptions apply to the excise tax for pre-age 59 ½ distributions from traditional and Roth IRAs.[143] For example, no excise tax applies if the distributions are made for the first-time purchase of a home,[144] qualified education expenses,[145] or certain medical expenses.[146]

#### 4. Minimum Distribution Rules

Minimum distribution rules apply to traditional IRAs[147] but do not apply to Roth IRAs until after the death of the individual who established the Roth IRA.[148]

The minimum distribution rules are intended to ensure that retirement savings are used for retirement savings purposes rather than for

---

[137] I.R.C. § 72(t)(1) (2015).

[138] Treas. Reg. § 1.408A-6 Q&A1(b) (2014).

[139] I.R.C. § 408A(d)(2) (2010). *See also supra* note 113 (discussing rules regarding taxation of distributions from Roth IRAs).

[140] I.R.C. § 72(t)(1) (2015).

[141] *See* U.S. DEP'T OF TREAS., General Explanation of the Administration's Fiscal Year 2004 Revenue Proposals, at 118 (2003) (stating that "Individual Retirement Accounts (IRAs), including traditional, Roth, and nondeductible IRAs, are primarily intended to encourage retirement saving").

[142] *Cf.* STAFF OF J. COMM. ON TAXATION, 112TH CONG., PRESENT LAW AND BACKGROUND RELATING TO THE TAX TREATMENT OF RETIREMENT SAVINGS 28 (Comm. Print 2011) (stating that restriction designed to ensure that qualified plan distributions are "not taken too early so that they are depleted prior to retirement").

[143] I.R.C. § 72(t)(2) (2015).

[144] I.R.C. § 72(t)(2)(F) (2015).

[145] I.R.C. § 72(t)(2)(E) (2015).

[146] I.R.C. § 72(t)(2)(B) (2015).

[147] I.R.C. § 408(a)(6) (2015).

[148] I.R.C. § 408A(c)(5) (2010).

estate planning purposes.[149] The rules require that beginning at age 70 ½, the entire amount of the IRA be distributed over the life expectancy of the individual (or over the lives of the individual and a designated beneficiary).[150]

### C. IMPLICATIONS OF DISTINCTIONS FOR SELECTING DEFAULT IRAS

In considering which type of IRA should serve as the default IRA, it is important to take into account the characteristics of the individuals most likely to be covered by the state automatic enrollment IRA programs. Thus, this section begins by discussing those characteristics. It then discusses how the interaction of those characteristics with the distinctions between traditional and Roth IRAs affects the selection of a default IRA.

#### 1. Characteristics of Individuals Most Likely to Be Covered by an Automatic Enrollment IRA Program

The state automatic enrollment IRA programs are intended to provide a retirement savings vehicle for individuals who do not have access to an employer-sponsored pension plan. Thus, the individuals most likely to be covered by state automatic enrollment IRA programs are those who currently do not have access to an employer-sponsored pension plan.

---

[149] *Cf.* STAFF OF J. COMM. ON TAXATION, Present Law and Background Relating to the Tax Treatment of Retirement Savings, *supra* note 142 (stating that restriction designed to ensure that qualified plan distributions are not "taken too late so that they are primarily a means of estate planning"); STAFF OF J. COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, VOL. II 197 (Comm. Print 2001) (stating that "the minimum distribution rules reflect the perspective that the primary purpose of the special tax benefits for qualified retirement plans is retirement savings and that tax-favored retirement plans should not primarily be used as a means of estate planning.").

[150] *See* Treas. Reg. § 1.408-2(b)(6) (2007).

### a. *Workers Covered by the State Automatic Enrollment IRA Programs Tend to Have Lower Incomes and Be Younger*

Surveys and studies done at the national level consistently[151] show that individuals who do not have access to an employer-sponsored pension plan tend to be lower-paid[152] and younger[153] than workers with access to an employer-sponsored pension plan. Surveys and studies focusing on the five states that have enacted automatic enrollment IRA programs confirm that the individuals targeted by these programs share these characteristics.

For example, Drs. Constanijin Panis and Michael Brien prepared a study identifying the target populations of the California and Illinois programs.[154] They found that the California program should cover about 7.8 million workers who are not currently covered by an employer-sponsored

[151] Although the surveys and studies do not report identical numbers, they report consistent trends. For a discussion of the reasons why precise numbers differ, *see*, Irena Dushi, et al., *Retirement Plan Coverage by Firm Size: An Update*, 75 SOC. SEC. BULL., no. 2 (2015); Craig Copeland, *Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2013*, EBRI Issue Brief No. 405, at 8 (Oct. 2014), https://www.ebri.org/pdf/briefspdf/EBRI_IB_405_Oct14.RetPart.pdf.

[152] *See*, e.g., THE PEW CHARITABLE TR., WHO'S IN, WHO'S OUT: A LOOK AT ACCESS TO EMPLOYER-BASED RETIREMENT PLANS AND PARTICIPATION IN THE STATES 14 (2016), http://www.pewtrusts.org/~/media/assets/2016/01/retirement_savings_report_jan16.pdf (stating that about 32% of individuals earning less than $25,000 reported having access to an employer-sponsored retirement plan compared to 75% of those earning $100,000 or more); BUREAU OF LABOR STATISTICS, News Release: Employee Benefits in the United States – March 2015 6, Table 1 (showing that only 38% of workers with average wages in the lowest 25% and 28% of workers with average wages in the lowest 10% had access to an employer-sponsored pension in March 2013 compared to 85% of workers with average wages in the highest 25% of wages); GAO, *supra* note 4, at 10 (estimating that median adjusted gross income of households without defined contribution plan or IRA in 2010 was $32,000 compared to $75,000 for those with defined contribution plan or IRA).

[153] *See, e.g.,* THE PEW CHARITABLE TR., *supra* note 152 (stating that about 47% of individuals between the ages of 18 and 29 reported having access to an employer-sponsored pension compared to 63% of workers ages 45 to 64).

[154] Constantijin W.A. Panis & Michael J. Brien, *Target Populations of State-Level Automatic IRA Initiatives* (Aug. 28, 2015), https://www.dol.gov/sites/default/files/ebsa/researchers/analysis/retirement/Targetpopulationsofstatelevelautomaticirainitiatives.pdf.

pension plan[155] while the Illinois program should cover about 1.7 million workers who are not covered by an employer-sponsored pension.[156] They found that the targeted employees in California had median annual earnings of $21,000 in 2013 compared to $45,000 for private-sector workers with access to an employer-sponsored pension plan[157] while the targeted employees in Illinois had median annual earnings in 2013 of $21,000 compared to $44,000 for private-sector workers with access to an employer-sponsored pension plan.[158] With respect to the age distribution of workers, Drs. Panis and Brien found that 31% of the targeted workers in California are under the age of 30 compared to 21% of comparison workers[159] and 37% of the targeted workers in Illinois are under the age of 30 compared to 24% of comparison workers.[160]

#### b. *Workers Covered by the State Automatic Enrollment IRA Programs Tend to be Subject to Lower Income Tax Rates*

In the United States, individual income tax rates are progressive; that is, as an individual's income increases so does the rate at which the individual income tax is imposed.[161] In 2016, no tax is imposed on single

---

[155] *Id.* at 6. In a June 2012 study, Nari Rhee of the UC Berkeley Center for Labor and Education found that 6.3 million California workers did not have access to an employer-sponsored pension plan. *See* Nari Rhee, *6.3 Million Private Sector Workers in California Lack Access to a Retirement Plan on the Job*, UC BERKELEY CTR. FOR LAB. AND EDUC. RES. BRIEF (June 2012), http://laborcenter.berkeley.edu/pdf/2012/ca_private_pension_gap12.pdf.

[156] Panis & Brien, *supra* note 154, at 12.

[157] *Id.* at 6. If the sample is restricted to workers who reported working full time for at least 50 weeks during 2013, overall earnings were $32,000 for targeted workers compared to $55,000 for workers with access to an employer-sponsored plan. *Id.* According to the Rhee study, the median annual earnings of California workers who did not have access to an employer-sponsored pension in 2008-2010 was just under $26,000, half that of workers that did have access to an employer-sponsored pension. Rhee, *supra* note 155, at 7-8.

[158] Panis & Brien, *supra* note 156, at 12. If the sample is restricted to workers who reported working full time for at least 50 weeks during 2013, overall annual earnings were $35,000 among targeted workers and $50,000 among the comparison group. *Id.*

[159] *Id.* at 8.

[160] *Id.* at 14.

[161] Marvin A. Chirlestien and Lawrence Zelenak, *Federal Income Taxation* 3 (Robert C. Clark, 13th ed. 2015). For a discussion of the justification for the

individuals with income at or below $10,350[162] or on married couples with income at or below $20,700.[163] In essence, income up to those levels is subject to a zero percent tax rate. Once those levels are exceeded, positive tax rates apply.

In 2016, there are seven different positive tax rates or brackets: (1) 10%; (2) 15%, (3) 25%, (4) 28%, (5) 33%, (6) 35%, and (7) 39.6%.[164] Thus, for example, single individuals are subject to tax at the rate of 10% on their first $9,275 of taxable income (that is, income that exceeds the first $10,350 of income that is not subject to tax) and 15% on their taxable income over $9,275 but not over $37,650.[165] The highest tax bracket, 39.6%, only applies to taxable income over $415,050.[166] Married couples filing jointly are subject to tax at the rate of 10% on their first $18,550 of taxable income (that is, income that exceeds the first $20,700 of income that is not subject to tax) and 15% on their taxable income over $18,550 but not over $75,300.[167] The highest tax bracket, 39.6%, applies to taxable income over $466,950 for married couples.[168]

Because the individuals covered by the state automatic enrollment IRA programs tend to have lower incomes and individual income tax rates are progressive, individuals covered by the state programs tend to be subject

---

progressive income tax, *see* Meredith R. Conway, *Money, It's a Crime, Share it Fairly But Don't Take a Piece of My Pie: The Legislative Case for the Progressive Income Tax*, 39 J. Legis. 119 (2012-2013), http://scholarship.law.nd.edu/cgi/viewcontent.cgi?article=1030&context=jleg.

[162] In 2016, the basic standard deduction for single taxpayers is $6,300. I.R.C. § 63(c)(2) (2015); I.R.S., IN 2016, SOME TAX BENEFITS INCREASE SLIGHTLY DUE TO INFLATION ADJUSTMENTS, OTHERS ARE UNCHANGED, (2015). No tax is imposed on income up to the standard deduction. In addition, a personal exemption of $4,050 is allowed for each taxpayer and each family dependent. I.R.C. § 151(d) (2015); I.R.S., *supra* note 162. Thus, a single individual with no dependents is entitled to receive up to $10,350 free of taxation in 2016.

[163] In 2016, the standard deduction for married couples filing jointly is $12,600. I.R.C. § 63(c)(2) (2015); I.R.S., *supra* note 162. No tax is imposed on income up to this level. In addition, a personal exemption of $4,050 is allowed for each taxpayer and each family dependent. I.R.C. § 151(d) (2015); I.R.S., *supra* note 162. Thus, a married couple with no dependents is entitled to receive up to $20,700 free of taxation: $12,600 + (2 x $4,050) = $20,700. The tax-free amount increases by $4,050 for each dependent the married couple has.

[164] I.R.C. § 1 (2014).

[165] I.R.S. Rev. Proc. 2015-53 § 3, Table 3.

[166] *Id.*

[167] I.R.S. Rev. Pro. 2015-53 § 3, Table 1

[168] *Id.*

to lower income tax rates. For example, according to Drs. Panis and Brien's study of the California and Illinois programs, most targeted workers (61% in California and 59% in Illinois) were in tax brackets of 0% or 10% compared to 42% of the comparison group in California and 40% of the comparison group in Illinois.[169] Moreover, less than 13% of targeted workers in California and less than 14% of targeted workers in Illinois were in 25% or higher tax brackets compared to 30.4% of the comparison group in California and 28% of the comparison group in Illinois.[170] According to a Connecticut study, about half of Connecticut workers not covered by an employer-sponsored pension are not required to pay income taxes because their earnings are too low.[171]

#### c. *Tax Rates for Younger Workers Covered by the State Automatic Enrollment IRA Programs are Likely to Increase Over Time*

In the United States, as in many countries, wages tend to increase with age.[172] Thus, the wages of the younger workers covered by the state automatic enrollment IRA programs are likely to increase over time. Because tax rates increase as wages increase, the younger workers covered by the programs are likely to face higher tax rates over time.

Whether the younger workers covered by the state automatic enrollment IRA programs will face higher tax rates in retirement depends, of course, on their income at retirement as well as the prevailing tax rates at the time of their retirement. At least some younger workers covered by the state automatic enrollment IRA programs are likely to have higher incomes at retirement than in their early years of coverage by the state automatic enrollment IRA programs and thus are likely to face higher tax rates in retirement.

---

[169] Panis & Brien, *supra* note 154, at 7, 13.

[170] *Id.*

[171] *Connecticut Report to Legislature*, *supra* note 118, at 12-13 (extrapolating from 2010 census data).

[172] Pnina Alon-Shenker, *Nonhiring and Dismissal of Senior Workers: Is It All about the Money?*, 35 COMP. LAB. L. & POL'Y J. 159, 172-73 (2014) (noting that "[b]ecause the linkage between work experience and age is strong, wages often increase at least indirectly with age"); Christine Jolls, *Hands-Tying and the Age in Discrimination Employment Act*, 74 TEX. L. REV. 1813, 1815 (1996) (noting that "higher pay based on age – wholly apart from productivity or seniority at a particular firm – seems to be a fairly robust empirical fact about our economy.").

### 2. Interaction between Characteristics of Workers Covered by Programs and Difference in Timing of Taxation

As discussed above,[173] if tax rates remain constant, from an economic standpoint, individuals should be indifferent as between a traditional and Roth IRA. On the other hand, if they face lower tax rates in retirement, they would be better off with a traditional IRA, and if they are subject to higher tax rates in retirement, they would be better off with a Roth IRA.

Given the relatively low income tax rates to which most workers covered by state automatic enrollment IRA programs are subject and the fact that the workers tend to be younger and thus likely to earn higher wages over the course of their careers, most workers covered by the state automatic enrollment IRA programs are likely to face either the same or higher income tax rates in retirement. This suggests that most workers should be either indifferent as to the type of default IRA or prefer a Roth IRA.

If the economic impact of the timing of taxation were the sole factor to be taken into account in selecting a default IRA, it seems that a Roth IRA should be the default IRA because more workers enrolled in a state automatic enrollment IRA program are likely to benefit from a Roth IRA than from a traditional IRA. As discussed above, however, the timing of taxation is not the sole difference between traditional and Roth IRAs. There are other distinctions between traditional and Roth IRAs.

### 3. Interaction between Characteristics of Workers Covered by Programs and Difference in Income Limits

As discussed above,[174] income limits apply in a different fashion to traditional and Roth IRAs. Specifically, the income limits prohibit individuals from contributing to a Roth IRA once they reach the limits while they prohibit an individual from deducting contributions to a traditional IRA once they reach the limits. Moreover, the income limits on the deductibility of contributions to traditional IRAs only apply if the individual and/or his or her spouse is covered by an employer-sponsored pension.

Focusing on the applicability of income limits to Roth IRAs, the Connecticut Retirement Security Board recommended to the Connecticut legislature that traditional IRAs serve as the default IRA because the income

---

[173] *See supra* Section IV(A).
[174] *See supra* Section IV(B)(1).

limits applicable to Roth IRAs make them more administratively complex.[175] Specifically, the Board "recommend[ed] a Traditional IRA as a default over a Roth IRA, because the Roth IRA adds administrative complexity. With a Roth IRA, the program would need to determine which participants were eligible for a Roth on a tax basis, and those employees that are auto-enrolled may be penalized if they were ineligible for a Roth."[176] The BCCRR, on the other hand, contends that the distinction in income limits points toward selecting a Roth IRA rather than a traditional IRA. According to the BCCRR, the income limits applicable to Roth IRAs are more straightforward and easier for individuals to understand than the income limits for traditional IRAs; the traditional limits may be confusing for workers going in and out of a state system because they only apply if the worker and/or his or her spouse is covered by an employer-sponsored pension plan.[177]

Undoubtedly, income limits apply to traditional IRAs in a different fashion than to Roth IRAs. That distinction, however, should not drive the choice of default IRAs. The income limits only apply to individual taxpayers with earnings equal to or greater than \$117,000 and to married taxpayers filing jointly with earnings equal to or greater than \$184,000. Because the workers covered by state automatic enrollment IRA programs tend to have lower incomes, few workers are likely to be subject to these limits.[178] Indeed, according to the Connecticut Retirement Security Board less than 10% of the population subject to the Connecticut program would exceed the individual limit.[179] Selecting the default IRA based on the income limits would be a bit like having the tail wag the dog.

---

[175] *BCCRR Connecticut Report*, *supra* note 118, at 10-11. The Connecticut Board, however, recognized that access to accumulated savings might be important to participants and recommended that the legislature give the implementing Board the final authority to select the default IRA. *Id.*

[176] *Id.* at 11.

[177] *Id.* at 10.

[178] It is, of course, possible for a low-income worker to be married to a high-income worker so that the family income of a low-income worker exceeds the limit. The needs of such individuals, however, should not drive the choice of default IRAs. Higher-income families are in a better position to get tax advice than lower-income families.

[179] *Connecticut Report to Legislature*, *supra* note 118, at 14.

4. Interaction between Characteristics of Workers Covered by Programs and Difference in Contribution Limits

As discussed above,[180] the contribution limits for traditional and Roth IRAs are nominally identical for workers under age 70 ½. Specifically, workers under the age of 50 may contribute up to $5,500 while workers between the ages of 50 and 70 ½ may contribute up to $6,500. Effectively, however, the Roth IRA limit is higher than the traditional limit because the Roth limit is an after-tax limit while the traditional limit is a before-tax limit.

The BCCRR has pointed to the effectively higher limit for Roth IRAs as a reason in favor of selecting the Roth IRA as the default IRA.[181] Specifically because the Roth IRA limit is an after-tax limit, workers may have more retirement income on an after-tax basis with a Roth IRA than with a traditional IRA.[182]

Undoubtedly, workers subject to a positive income tax rate in retirement will have higher after-tax income in retirement if their IRA distributions are from a Roth IRA that is not subject to income tax than if they are from a traditional IRA that is subject to income tax. For most workers, however, that difference is not due to the effective difference in the contribution limits but instead is due to the fact that Roth contributions are subject to tax when made while contributions to traditional IRAs are not subject to tax until distributed.

Few workers are likely to be constrained by the $5,500 contribution limit applicable to both traditional and Roth IRAs. Currently, the three states that have established a default contribution rate have set that rate at three percent.[183] Only workers with income equal to or in excess of $183,333 would have default contributions of $5,500 at a contribution rate of three percent. Even if the default contribution rate were increased to six percent, only workers with income equal to or in excess of $91,667 would have default contributions of $5,500.

Arguably, a Roth IRA is superior to a traditional IRA because a Roth IRA effectively requires workers subject to positive income tax rates to contribute more to their IRA. In essence, workers subject to positive tax

---

[180] *See supra* Section IV(B)(2).

[181] *BCCRR Connecticut Report*, *supra* note 118, at 10-11; *BCCRR Oregon Memo*, *supra* note 84, at 2.

[182] *Id.*

[183] *See* CAL. GOV'T CODE § 100032(h); 820 ILL. COMP. STAT. § 80/60(c); 2016 Conn. Acts No. 16-29 § 1(3).

rates are effectively contributing more to a Roth IRA than a traditional IRA because with a Roth IRA not only are they contributing the nominal contribution to the Roth IRA but they are also effectively contributing the taxes by paying the tax in the year of contribution rather than the year of distribution.

Given the relatively low incomes of most workers targeted by state automatic enrollment IRAs, however, state automatic enrollment IRA programs do not need to be structured as Roth IRAs to increase contributions and thus retirement savings. Rather, default contribution rates can simply be set higher. Indeed, consultants and analysts typically recommend default contribution rates higher than the three percent rate in place in the current programs.[184]

For the few workers willing and able to contribute more than $5,500 in pre-tax dollars to a state automatic enrollment IRA, the Roth IRA may be the better default IRA due to the difference in contribution limits. For the majority of workers who are likely unable and unwilling to make the maximum contribution, however, the difference in contribution limits is simply irrelevant. Just as income limits should not drive the choice of a default IRA, contribution limits should not drive the choice of a default IRA.[185]

#### 5. Interaction between Characteristics of Workers Covered by Programs and Excise Tax on Pre-Age 59 ½ Distributions

As discussed above,[186] individuals may make income-tax-free and excise-tax-free withdrawals of contributions to Roth IRAs at any time. In contrast, not only are distributions from traditional IRAs subject to income tax, but distributions prior to age 59 ½ are generally subject to a ten percent excise tax. Only pre-age 59 ½ distributions of earnings on contributions to Roth IRAs are potentially subject to a ten percent excise tax.

---

[184] *See, e.g., Overture Financial LLC*, *supra* note 26, at 7 (recommending five percent default rate); *Connecticut Report to Legislature*, *supra* note 118, at 22 (recommending six percent default rate).

[185] In addition, the fact that workers may only contribute to a Roth IRA after age 70 ½ should not drive the choice of the default IRA. The state automatic enrollment IRA programs are intended to promote retirement savings for workers without access to an employer-sponsored pension. The vast majority, if not all, of the workers covered by the state automatic enrollment IRA programs are likely to have retired by age 70 ½.

[186] *See supra* Section IV(B)(3).

The BCCRR pointed to this difference in the imposition of excise taxes, which it referred to as a "penalty," as its first justification for recommending the Roth IRA as the default IRA. According to the BCCRR, a Roth IRA "provides a balance between retention and liquidity for a population that may need to access its funds for emergencies."[187] Even the Connecticut Board, which recommended the traditional IRA as the default IRA, recognized that the default IRA "must balance targeting asset accumulation and an income replacement ratio for retirement with creating a situation where an individual cannot access capital and potentially incurs high cost debt or experiences significant financial stress as a result."[188]

As the Connecticut Board and the BCCRR recognize, penalty-free access to retirement savings is likely to be very important to the population covered by the state automatic enrollment IRA programs. Penalty-free access to retirement savings, however, is a double-edged sword. On the one hand, the availability of penalty-free access to retirement savings may encourage workers to participate in a state automatic enrollment IRA program[189] and thus encourage workers to save more for retirement.[190] On the other hand, penalty-free access to Roth contributions makes it easier for workers to withdraw their retirement savings and thus can lead to retirement savings "leakage" with workers having less retirement savings when they reach retirement age.[191]

Undoubtedly, the ten percent excise tax on pre-age 59 ½ distributions would likely discourage early withdrawals from retirement savings vehicles and thus promote retirement savings. Nevertheless, it hardly seems fair or appropriate to impose this tax penalty, which serves as

---

[187] *BCCRR Connecticut Report*, *supra* note 118, at 10.

[188] *Connecticut Report to Legislature*, *supra* note 118, at 14.

[189] The state automatic enrollment IRA programs do not require workers to affirmatively elect to participate in the programs. They do, however, permit workers to opt out. The presence of penalties on withdrawals may result in more workers electing to opt out of participation.

[190] *Cf.* U.S. DEP'T OF TREAS., GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 119 (2003) (stating that ten percent excise tax on early distributions from IRAs "discourage[s] many taxpayers from making contributions because they are concerned about the inability to access the funds should they need them.").

[191] *Cf.* Norman P. Stein & Patricia E. Dilley, *Leverage, Linkage, and Leakage: Problems with the Private Pension System and How They Should Inform the Social Security Debate*, 58 WASH. & LEE L. REV. 1369, 1402-07 (2001) (discussing the problem of leakage from qualified employer-sponsored pension plans).

a quid pro quo for the favorable tax treatment accorded retirement savings,[192] to low-income workers who receive little or no tax benefit from the favorable tax treatment accorded IRAs.[193] As the BCCRR has noted, "[c]onsidering the population targeted, the possibility of a newspaper story – about a family paying a ten percent penalty to use money in their account to repair their roof – could be fatal to this initiative."[194]

In light of the fact that state automatic enrollment IRA programs tend to cover lower-income workers who receive little to no income tax benefit from the favorable tax treatment accorded IRAs, it appears that a Roth IRA, which minimizes the exposure to excise taxes on pre-age 59 ½ distributions, is a more appropriate default IRA than a traditional IRA.

6. Minimum Distribution Rules

As discussed above,[195] minimum distribution rules apply to traditional IRAs but generally do not apply to Roth IRAs. Specifically, the minimum distribution rules require that beginning at age 70 ½, the entire amount of a traditional IRA be distributed over the life expectancy of the individual (or over the lives of the individual and a designated beneficiary). Minimum distribution rules only apply to Roth IRAs after the death of the individual who established the Roth IRA.

The distinction between the application of the minimum distribution rules to traditional IRAs and Roth IRAs is only relevant to individuals who do not wish to begin receiving distributions from their IRAs once they reach age 70 ½. Because the state automatic enrollment IRA programs target lower-income workers, few workers covered by the state programs are likely to object to receiving minimum distributions once they reach age 70 ½. Thus, the distinction in the application of the minimum distribution should not play much of a role in the selection of a default IRA.[196]

---

[192] *See, e.g., supra* Section IV(B)(3).

[193] The favorable tax treatment accorded retirement savings has been described as an "upside down subsidy" because it offers higher-income individuals subject to higher income tax rates with greater tax benefits than lower-income workers subject to lower income rates. *See, e.g.,* Karen Burke & Grayson McCouch, *Lipstick, Light Beer and Back-Loaded Savings Accounts*, 25 VA. TAX REV. 1101, 1127-28 (2006) (using terminology).

[194] *Id.*

[195] *See supra* Section IV(B)(4).

[196] The BCCRR recognizes that the distinction in the application of minimum distribution rules is likely to be less important to low-income workers. *BCCRR*

### D. RECOMMENDATION

Overall, it appears that a Roth IRA is a more appropriate default IRA than a traditional IRA.

The most important factor pointing toward the selection of the Roth IRA as the default IRA is the fact that pre-age 70 ½ withdrawals of contributions to Roth IRAs are not subject to a ten percent excise tax, or penalty, while pre-age 70 ½ withdrawals of contributions to traditional IRAs may be subject to a ten percent excise tax. Although the excise tax is consistent with the goal of discouraging early distributions of retirement savings so as to ensure that retirement savings are used for retirement purposes, it does not seem fair or appropriate to impose a tax penalty on workers who receive little to no tax benefit from IRAs. Thus, the most appropriate default IRA is the Roth IRA which exposes workers to the least risk of an excise tax on early distributions.

The second factor pointing toward the selection of the Roth IRA as the default IRA is the difference in the timing of taxation of traditional and Roth IRAs. Because workers covered by state automatic enrollment IRAs tend to be younger and have lower wages, most workers should be either indifferent as to the type of default IRA or prefer the Roth IRA.

Arguably, the differences in contribution limits and application of minimum distribution rules also point in favor of a Roth IRA. Those differences, however, should not play much, if any, role in the selection of a default IRA; the differences only impact relatively high-income workers, a small subset of workers covered by the state programs. Similarly, the difference in income limits, which could support either type of IRA depending on one's point of view, is not relevant for most workers covered by a state automatic enrollment IRA program.

## V. CONCLUSION

Although state automatic enrollment IRA programs are created by state law, they are not independent of federal law. In order for workers covered by state automatic enrollment IRA programs to receive favorable federal income tax treatment, the IRAs under these programs must satisfy the requirements set forth in I.R.C. §§ 408(a) and 408(c). As currently structured, the state laws expressly satisfy some, but not all, of these requirements. Prior to final implementation, the programs will need to be

---

*Oregon Memo*, *supra* note 85, at 2; *BCCRR Connecticut Report*, *supra* note 118, at 11.

adjusted to ensure that all of the requirements are incorporated and expressly satisfied.

In enacting a state automatic enrollment IRA program, a state must select a default IRA. To date, the states have not been uniform in their choice. Some states have selected the traditional IRA while others have selected the Roth IRA. In light of the populations targeted by state automatic enrollment IRA programs and the difference in rules applicable to traditional and Roth IRAs, it appears that the Roth IRA is the more appropriate default IRA for a state automatic enrollment IRA program.