Inclusion in Asset Building: Research and Policy Symposium

The Universal Piggy Bank: Designing and Implementing A System of Savings Accounts for Children

Fred T. Goldberg, Jr.
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Policy Report

Center for Social Development

Washington University in St. Louis
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Center for Social Development
Washington University
George Warren Brown School of Social Work
Campus Box 1196
One Brookings Drive
St. Louis, Missouri 63130
Telephone: (314) 935-7433
Fax: (314) 935-8661
http://gwbweb.wustl.edu/csd
E-mail: csd@gwbmail.wustl.edu

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Mr. Goldberg and Ms. Cohen are colleagues in the Washington, DC, office of Skadden, Arps Slate, Meagher & Flom, LLP. Mr. Goldberg served as IRS Chief Counsel (1984-1986), IRS Commissioner (1989-1992) and Assistant Secretary of the Treasury for Tax Policy (1992). He was Executive Director of the Kerrey-Danforth Bipartisan Commission on Entitlement and Tax Reform (1994-1995), a Member of the National Commission on Restructuring the IRS (1996-1997), and a Member of the CSIS National Commission on Retirement Policy (1997-1998). He is co-author, with Professor Michael Graetz of Yale Law School, of "Reforming Social Security: How To Implement a Practical and Workable System of Personal Retirement Accounts," National Bureau of Economic Research Working Paper 6970 (December 1998), reprinted in Shoven, John B., (ed.), Administrative Aspects of Investment-Based Social Security Reform (NBER), at 9-39. Ms. Cohen has been with Skadden, Arps, Slate, Meagher & Flom since graduating from the University of Virginia School of Law in 1995. She received her undergraduate degree from Stanford University in 1992. Since joining Skadden, Arps, she has worked closely with Mr. Goldberg on numerous matters as a member of the firm's Tax Department.

Abstract and Summary

This paper identifies the primary design issues that must be addressed before enacting a system of savings accounts for children (CSAs) and describes a method for implementing whatever system is adopted. From both design and implementation perspectives, three questions must be answered: (1) how are the accounts funded, (2) how are they administered, and (3) what rules govern distributions?

The most difficult design issues relate to funding and rules governing distributions. With respect to funding, the primary issue is: how should federal tax incentives should be structured? The basic choices are: (i) a Universal System (i.e., funded through a 100% tax credit automatically provided to all eligible children), (ii) a Voluntary System (i.e., funded through voluntary contributions encouraged by tax incentives), or (iii) Hybrid System with both universal and voluntary features.

Within the context of each of those Systems, the primary choices are: (i) a Refundable System (i.e., tax incentives refundable, and therefore available to low income taxpayers available even in the absence of sufficient tax liability to use those incentives); and (ii) a Means Tested System (i.e., phased-out for upper income taxpayers).

With respect to distributions, the primary issue is: under what circumstances should distributions be permitted? The basic choices are: (i) CSA funds can be used only to meet retirement needs, with unused funds distributed on the death of the beneficiary; (ii) CSA funds can also be withdrawn for specified investment purposes (e.g., education, a home or a business) and/or for specified needs (e.g., disability or health care); (iii) CSA funds can be withdrawn for any purpose; or (iv) a hybrid system with different portions of the funds subject to different distribution rules.

By building on existing administrative structures (principally, the Internal Revenue Service and mutual funds maintained by the private sector), and by applying lessons learned from various retirement programs (principally, the federal government's Thrift Savings Plan and private sector experience with various tax-based savings incentives), CSAs can be implemented in a way that: (i) is easy to understand and administer; (ii) minimizes administrative costs and distributes those costs in a fair and reasonable way; (iii) meets reasonable expectations for simplicity, security, control and independence; and (iv) accommodates a wide range of policy choices regarding design of the system, including those listed above.

The primary implementation question is whether CSA Investment Funds should be sponsored only by the private sector, or whether the government should also sponsor a limited number of "no frills" CSA Investment Funds. Either of these approaches could be readily implemented, and the choice would likely depend on how the design issues listed above are resolved.

The article concludes that CSAs reflecting a wide range of policy choices would be relatively easy to implement. The article also concludes that the design of CSAs raises a number of contentious policy issues that have been extremely difficult to resolve in other contexts. Finally, the article concludes that before CSAs can be enacted, general agreement would have to be

reached on two fundamental policy issues: (1) a Universal or Voluntary System, and (2) a Refundable or Non-Refundable/Means Tested System. These are difficult and contentious issues leading to very different models. The more politically viable model would be a voluntary system, encouraged by tax incentives and administered solely by the private sector, with few or no restrictions on withdrawals, where tax benefits were not refundable to low income taxpayers and were phased out for upper income taxpayers. The more politically difficult model, but the one with greatest potential for significant impact, would be a universal system with refundable credits that were not phased-out, combined with a voluntary add-on system, administered primarily but not exclusively by the private sector, with substantial restrictions on withdrawal of some (but not all) CSA funds.

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Background

The purpose of this paper is to identify the primary design issues that must be resolved before a system of savings accounts for children (CSAs) can be enacted, and to describe a practical and workable way of implementing whatever system is adopted.[1] It now seems increasingly likely that the CSA concept may receive more than passing consideration in the years ahead. Evidence for this potential can be found in legislation and legislative proposals over the past decade, and the current Presidential campaign.

Two noteworthy trends in public policy during the 1990s have been widespread concern over income-based policies to assist the poor and growing interest in policies to encourage wealth creation and savings.[2] The former culminated in bi-partisan support for welfare reform legislation that was enacted in 1996 and is reflected in the continuing, near-universal view that those reforms have been successful.[3] The latter is manifested by the enactment of "new or improved" savings incentives and the wide range of not-yet-enacted proposals that are now receiving serious consideration. For example:

- Roth IRA's – In 1997, Congress established a new type of voluntary IRA called the "Roth IRA."[4] Unlike a traditional IRA, contributions to a Roth IRA are not deductible and qualified distributions from Roth IRAs are not subject to tax. Because they do not involve a current tax deduction, contributions to Roth IRAs are available to low income taxpayers without regard to their tax liability. Roth IRAs are phased out between $150,000 and $160,000 for married individuals filing jointly and are phased out between $95,000 and $110,000 for single individuals. Funds can be withdrawn from Roth IRAs without tax or penalty after the taxpayer reaches age 59½, upon death or disability, and for first-time home buyer expenses up to $10,000. Roth IRAs are not subject to minimum distribution requirements.

- Individual Development Accounts (IDAs) – IDAs are voluntary matched savings accounts designed to help low-income families accumulate wealth for productive assets such as a first home, a college education or a small business. Financial institutions, foundations, churches and state and local governments generally fund the matches to the personal savings accounts of participating individuals. In 1998, Congress passed the Assets for Independence Act which committed $125 million over five years to provide federal matching and to support hundreds of community and state IDA initiatives.

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1 Aspects of the administrative structure and certain data described here are based on, and in some cases reprinted from, Goldberg and Graetz, "Reforming Social Security: A Practical and Workable System of Personal Retirement Accounts," National Bureau of Economic Research Working Paper 6970 (December 1998) (hereinafter, "Goldberg and Graetz").

2 Tax incentives for retirement savings by individuals have been in the law for more than 25 years (the first Individual Retirement Account legislation was enacted in 1974), and employer-sponsored retirement plans have been favored by the tax law for many decades.

3 See Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 110 Stat. 2105 (1996). The House of Representatives approved the measure by a vote of 328 to 101; the Senate approved the measure by a vote of 78 to 21.

4 See Section 408A of the Internal Revenue Code of 1986, as amended (the "Code").

X Education Individual Retirement Accounts – The Taxpayer Relief Act of 1997 permits individuals to establish education IRAs.[5] Contributions to an education IRA must be made before the designated beneficiary reaches the age of 18 and are not deductible. Aggregate annual contributions to an education IRA are limited to $500 per beneficiary and phased out based on the contributor's modified adjusted gross income. A taxpayer contributing to an education IRA may, but need not, be related to the beneficiary. There is no limit on the number of education IRAs that can be established for any beneficiary (subject only to the income phase-out and $500 per year per beneficiary rules). Amounts can be withdrawn from an education IRA tax-free if they are used for qualified higher education expenses (e.g., tuition, fees, books, supplies and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution). Any balance remaining in an education IRA when the beneficiary becomes 30 years old must be distributed, is included in the beneficiary's income, and is subject to an additional 10% penalty. There are no tax consequences if amounts in an education IRA are rolled into an education IRA for another beneficiary of the same family or if the beneficiary of an education IRA is changed to a family member of the old beneficiary.

X Medical Savings Accounts. The Health Insurance Portability and Accountability Act of 1997 allows individuals covered by high deductible health care plans to make tax deductible contributions to medical savings accounts ("MSAs").[6] Taxpayers may deduct contributions up to the lesser of 65% of the annual deductible for self-only coverage (75% for family coverage) or the individual's compensation. Excess contributions are subject to a 6% tax. Distributions for qualified medical expenses are not included in gross income. However, distributions that are not used for qualified medical expenses are included in gross income and subject to an additional tax of 15%, unless (i) distributed upon death or disability of the beneficiary, or (ii) distributed after the beneficiary reaches the age for medicare eligibility. The provision was intended to test the MSA concept, and therefore limits the number of participants to approximately 750,000 families and sun-sets this year.

X Qualified State Tuition Programs ("Section 529 Plans"). The Small Business Job Protection Act of 1996 provided tax-exempt status to "qualified state tuition programs" established by a state under which persons may (i) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses, or (ii) make contributions to an account that is established for the sole purpose of meeting qualified higher education expenses of the designated beneficiary of the account. Contributions to a qualified state tuition program are nondeductible. A qualified state tuition program must provide adequate safeguards to prevent contributions in excess of those necessary to provide for qualified higher education expenses and must impose more than a de minimis penalty on any refund of earnings from the account which are not used for qualified higher education expenses of the beneficiary, made on account of death or disability of the beneficiary, or made on account of a scholarship, allowance or certain similar payments. Distributions from a qualified state tuition program are generally included in the distributee's income. A

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5 See Section 530 of the Internal Revenue Code of 1986, as amended (the "Code").

6 See Code Section 220.

change in beneficiaries is permitted tax-free so long as the new beneficiary is a member of the family of the previously designated beneficiary.

∃ Portman-Cardin Bill – In July of 2000, the House of Representatives passed the Portman-Cardin Bill on a 401-25 vote.[7] The bill would raise limits on contributions to IRAs, Roth IRAs and 401(k) plans, in particular for individuals age 50 and older. The Bill also would raise the maximum amount of tax-deductible dollars that employers can contribute to pensions, increase the size of pensions that they can fund, and reduce vesting requirements for employer pension matching contributions. In early September of 2000, a version of the Portman-Cardin Bill was introduced by Senate Finance Committee Chair William Roth (R-DE) and referred to the Senate Finance Committee. Senate approval is likely before the end of September.

∃ Frist Bill – In May 1999, Senator Bill Frist (R-TN) introduced a bill that would have repealed education IRAs, allowed funds in a Roth IRA to be withdrawn to pay for qualified elementary, secondary and higher education expenses (including home schooling), and repealed phase-outs for Roth IRAs.[8]

∃ Coverdell Bill – In July 1997, Senator Paul Coverdell (R-GA) introduced a bill that would have expanded application of the education IRA to include qualified elementary and secondary education expenses (including home schooling expenses) in addition to higher education expenses.[9] The bill also would have increased the annual contribution limit from $500 to $2000, permitted corporations to contribute to Educational IRAs, and waived the age limitation for special need beneficiaries. In October 1997, Representative Bill Archer (R-TX) introduced a bill that included the same provisions advocated by Senator Coverdell.[10] During the summer of 1998, the House of Representatives approved the measure by a vote of 225 to 197, and the Senate approved the measure by a vote of 59-36. The measure was vetoed by the President on July 21, 1998. Despite the veto, other proposals have been made to expand the use of Education IRAs. For example, in May 1999, Senator Susan Collins (R-ME) introduced another bill that, similar to the Coverdell bill, would have increased the annual contribution limit for Education IRAs from $500 to $2000.[11] In July 1999, Representative Archer introduced a new bill containing the same provisions as the Coverdell Bill.[12] The House of Representatives approved the measure by a vote of 221-206 and the Senate approved the measure by a vote of 50-49. Again, the bill was vetoed by the President on September 23, 1999.[13]

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[7] H.R. 1102, 106th Cong. (2000). The bill was sponsored by Representatives Rob Portman (R-OH) and Ben Cardin (D-MD), among others.

[8] S. 1013, 106th Cong. (1999).

[9] S. 1133, 105th Cong. (1997).

[10] H.R. 2646, 105th Cong. (1997). A companion bill was introduced in the Senate by Senators Coverdell (R-GA) and Torricelli (D-NJ).

[11] S. 1054, 106th Cong. (1999).

[12] H.R. 2488, 106th Cong. (1999). The Senate version of the bill was sponsored by Senator Bill Roth. S. 1429, 106th Cong. (1999).

[13] The President's veto of the Coverdell Bill highlights one of the most contentious issues in the context of tax-favored savings accounts for children – the fear on the part of many Democrats, and the hope on the part of many Republicans, that such accounts are a first step down the road to school vouchers.

∃ Social Security Private Account Proposals – In recent years there have been a number of mainstream proposals to create private Social Security accounts. For example, in 1995, Senators Robert Kerrey (D-NE) and Alan Simpson (R-WY) introduced a Social Security reform proposal that would have allowed workers to divert a portion of their payroll taxes into a personal investment plan which they would own and control.[14] In March 1998, Senator Moynihan proposed reforming Social Security by cutting the payroll tax and letting Americans use the money for private retirement accounts.[15] On April 28, 1999, Ways and Means Chairman Bill Archer (R-TX) and Representative E. Clay Shaw Jr. (R-FL), chairman of the Social Security subcommittee, proposed a plan to give workers money through payroll tax rebates that would be invested in private retirement accounts. Today, proposals for Social Security private accounts have become part of the Republican orthodoxy and are supported by a number of moderate Democrats (e.g., Senators Moynihan, Kerrey and Breaux, Representative Stenholm and the Democratic Leadership Council Chaired by Senator Lieberman).

Against this backdrop, there has been an effort to promote savings accounts for children that go beyond education-based initiatives such as education IRAs and Section 529 Plans. The initial effort along these lines was initiated by Senators Kerrey and Lieberman in 1995. Their "KidSave" proposal would have given parents the opportunity to deposit $500 a year into a retirement account in their child’s name from birth to age 18 and receive a nonrefundable credit.[16] The tax deferred account would have been governed by the IRA rules, with the exception that children would be allowed to take a 10-year loan against the money for higher education.[17] Senators Kerrey and Lieberman hoped to offer KidSave to all children, but concluded that revenue considerations might require a phase-out.[18] The KidSave effort culminated in 1997, when the Senate, by a vote of 80 to 18, approved legislation that would have established a broad based system of savings accounts for children.[19] The Senate approach was rejected by the House Republican Leadership in favor of the $500 child credit that was ultimately enacted into law later that year.[20]

Since 1997, there has been continued interest in versions of the KidSave proposal. For example:

∃ In January 1997, Representative Amo Houghton (R-NY) introduced legislation that would have established Child Retirement Accounts (CRAs) for children under age 6,

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14 S. 824, 104th Cong. (1995).

15 S. 1792, 105th Cong. (1998).

16 See e.g., 141 Cong. Rec. S16056-8 (Oct. 27, 1995) (statement of Senator Lieberman).

17 In all likelihood, the limitation to post-secondary education reflected a concern that the measure would be attacked as promoting school vouchers.

18 See e.g., 141 Cong. Rec. S16056-8 (Oct. 27, 1995) (statement of Senator Lieberman).

19 The Senate bill allowed a maximum non-refundable tax credit of $500 for each qualifying child under the age of 17 (under 18, starting in 2003). In the case of each child age 13-17 (13-18, starting in 2003), the credit would have been available only for amounts contributed to a qualified tuition program (a so-called Section 529 Plan) or an educational IRA. A subsequent withdrawal of the credit amount for a non-qualified use would have resulted in 100% recapture of the credit. Exceptions from the 100% recapture were provided in certain circumstances including withdrawals made due to death, disability, and receipt of certain scholarships by the beneficiary. The credit was phased out for taxpayers with AGI in excess of certain thresholds. See S. 949, 105th Cong. § 101 (1997).

20 P.L. 105-34, § 101(a) (enacting Code Section 24).

funded directly by federal government contributions of $1,000 each year for five years.[21] Under that proposal, CRA funds could be borrowed for post-secondary education and first-time home purchases.

∃ In June 1998, Senators Kerrey, Moynihan, Breaux and Leiberman introduced a bill that would have established a KidSave account for each individual born on or after January 1, 1997.[22] Under the proposal, after a transition period, each KidSave account would have been credited with $1,000 at birth and an additional $500 each year through the child's fifth birthday. The proposal also would have established in the Treasury a KidSave Investment Fund that would be administered in the same manner as the Thrift Savings Plan under the Federal Employees Retirement System.

∃ Senators Kerrey and Moynihan again introduced a bill containing a KidSave proposal in January 1999.[23]

∃ In May 1999, Senator Frist introduced a bill that would have allowed people to establish child savings accounts within Roth IRAs and provided an additional refundable credit for contributions to child savings accounts.[24]

∃ In July 1999, Senators Judd Gregg (R-NH), John Breaux (D-LA), Robert Kerrey (D-NE), Craig Thomas (R-WY), Charles Grassley (R-IA), Charles Robb (D-VA) and Fred Thompson (R-TN) introduced a bill containing a KidSave proposal similar to the Kerrey-Moynihan proposal.[25] The same Senators reintroduced the KidSave proposal again in June 2000.[26]

While policies to encourage wealth creation have been a focus of attention throughout the 1990s, the 2000 Presidential campaign has given them far greater prominence. The Republican candidate, Governor George W. Bush, supports voluntary private accounts for younger workers as part of Social Security reform (as well as a host of other savings incentives, including IDAs and enhanced educational savings accounts). While the Democratic candidate, Vice President Gore, claims to be unalterably opposed to private accounts as part of Social Security reform, he is proposing Retirement Savings Plus – a voluntary, tax-free, personal saving account with government matching as a supplement to Social Security. The Democratic candidate for Vice President, Senator Joe Lieberman, has said that "individual control of part of the retirement/Social Security funds has to happen,"[27] was the initial co-sponsor of KidSave legislation, and has been a strong supporter of IDA's. Under these circumstances, major policy initiatives focused on wealth creation are likely next year, regardless of who wins in November.

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21 H.R. 194, 105th Cong. (1997).
22 S. 2184, 105th Cong. (1998).
23 S. 21, 106th Cong. § 11 (1999).
24 S. 1013, 106th Cong. (1999). See also discussion at footnote **[X]**, infra.
25 S. 1383, 106th Cong. § 102 (1999).
26 S. 2774, 106th Cong. (2000).
27 Senator Joe Lieberman, interview with the Copley News Service, May 4, 1998. Senator Lieberman is chairman of the Democratic Leadership Council ("DLC"). While the DLC has been silent on the issue of late, we believe it is fair to characterize their position as favoring private accounts as part of Social Security Reform.

Introduction and Overview

CSAs pose the same three design and implementation questions: (1) how are the accounts funded, (2) how are they administered, and (3) what rules govern distributions? Funding is addressed below in Part I, administration is addressed below in Part II, and distributions are addressed below in Part III.

The most difficult design issues relate to funding and rules governing distributions.

- With respect to funding, the primary issue is: how should federal tax incentives be structured?[28]

- The fundamental choice is whether to establish: (1) a Universal System (i.e., funded through a 100% tax credit that is automatically credited to each eligible child), (2) a Voluntary System (i.e., funded through voluntary contributions encouraged by tax incentives), or (3) a Hybrid Funding System with both universal and voluntary features.

- Within the context of each of these structures, the fundamental choices are whether to provide for a Refundable System (i.e., tax benefits that are refundable and therefore available to low income taxpayers even in the absence of sufficient tax liability to use those benefits), and whether to provide for a Means-Tested System (i.e., tax benefits that are phased-out for upper income taxpayers).

- With respect to distributions, the primary issue is: under what circumstances should distributions be permitted? The basic choices are: (1) CSA funds can be used only to meet retirement needs, with unused funds distributed on the death of the beneficiary; (2) CSA funds can also be withdrawn for specified investment purposes (e.g., education, a home or a business) and/or for specified needs (e.g., disability or health care); (3) CSA funds can be withdrawn for any purpose; or (4) segmented (or parallel) CSA funds, with different distribution rules applicable to each segment.

What is important to emphasize is that these are fundamental policy questions of great importance. The views on all sides are strongly held and reflect core principles that are not easily compromised.

Unlike the design issues, implementation is relatively easy. By building on existing administrative structures (principally, the Internal Revenue Service and mutual funds maintained

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[28] As discussed below, we propose that the program be structured and administered through the tax system. Some have suggested that the federal government should simply distribute funds to designated accounts each year on behalf of eligible beneficiaries. While this approach would have the virtue of simplicity if all children were eligible without regard to their parents' income, it would raise a number of issues. If the IRS were not involved, the federal government would have to create a new administrative structure to determine eligible beneficiaries and the accounts that should be funded. Also, as an expenditure program, it would be subject to the annual appropriations process or have to be structured as an entitlement program. Finally, we believe that a direct expenditure program would likely encounter substantial political opposition from all quarters – including those who would attack it as a welfare state entitlement program and those who would attack it as taking scarce resources away from other, more worthy expenditure programs.

by the private sector), and by applying lessons learned from various retirement programs (principally, the federal government's Thrift Savings Plan and private sector experience with various tax-based savings incentives), CSAs can be implemented in a way that is (a) easy to understand and administer; (b) minimizes administrative costs and distributes those costs in a fair and reasonable way; (c) meets reasonable expectations for simplicity, security, control and independence; and (d) can accommodate a wide range of policy choices (including those listed above), as well as changes in those choices over time. The primary implementation question is whether CSA Investment Funds should be sponsored only by the private sector, or whether the government should also sponsor a limited number of "no frills" CSA Investment Funds. Either of these approaches could be readily implemented, and the choice would likely depend on how the design issues listed above are resolved.

The article concludes (Part IV) that CSAs reflecting a wide range of policy choices would be relatively easy to implement. The article also concludes that the design of CSAs raises a number of contentious policy issues that have been extremely difficult to resolve in other contexts. Finally, the article concludes that before CSAs can be enacted, general agreement would have to be reached on two fundamental policy issues: (1) a Universal or Voluntary System, and (2) a Refundable or Non-Refundable/Means Tested System. These are difficult and contentious issues leading to very different CSA models. The more politically viable CSA program would be a voluntary system, encouraged by tax incentives and administered solely by the private sector, with few or no restrictions on withdrawals, where tax benefits were not refundable to low income taxpayers and were phased out for upper income taxpayers. The more politically difficult model, but the one with greatest potential for significant impact, would be a universal system with refundable credits that were not phased-out, combined with a voluntary add-on system, administered primarily but not exclusively by the private sector, with substantial restrictions on withdrawal of some (but not all) CSA funds.

I. Funding CSAs

A. Policy Issues. The CSA concept is that some or all children would have access to savings accounts established for their benefit, funded in whole or in part through tax credits and/or other tax incentives. While there are infinite variations on this theme, there are only five basic policy choices, each of which is summarized below.

1. Universal or Voluntary Participation**Error! Bookmark not defined.**. Should participation in CSAs be universal or voluntary with respect to eligible participants? A Universal System would entail a 100% tax credit in the amount of the intended benefit that would be provided all eligible children.[29] For example, if the program were structured as a $1,000 per child tax credit, all eligible children would have their CSAs funded through a $1,000 tax credit. Under a Voluntary System, taxpayers could chose to establish CSAs on behalf of their children. For example, if the program were structured as a $1,000 per child tax credit,

[29] As noted below, the amount the credit could vary (depending, for example, on the parents' income), and all children might not be eligible in a Universal System. This distinction is important in other contexts. For example, Social Security is generally (and properly) viewed as a universal system. However, it is universal only with respect to covered workers. Likewise, certain employer-sponsored retirement programs are also universal, but only with respect to covered workers.

eligible taxpayers could elect to fund CSAs for their eligible children, or choose instead to take the credit themselves. Unlike Universal CSAs, which would have to be funded with 100% credits for eligible participants, various tax incentives could be used to encourage the funding of Voluntary CSAs. These incentives could replicate current law – for example, contributions could be tax deductible and earnings could be tax deferred (traditional IRAs); or, contributions could be non-deductible, but earnings and distributions could be tax exempt (Roth IRAs and education IRAs); or, contributions could be non-deductible and earnings could be tax deferred (after-tax IRAs and Section 529 Plans). Alternatively, new incentives could be provided – for example, contributions could receive a partial tax credit (e.g., a 20% credit on contributions up to some limit); or, contributions could be tax deductible and distributions could be tax exempt.

Along with refundability and rules governing distributions (discussed below), the question of whether CSAs should be universal or voluntary is the basic and most important design question. A Universal System reflects the judgement that all eligible children should participate – a Voluntary System reflects the judgement that parents are ultimately responsible for making such decisions.[30] Before summarizing the primary arguments on both sides of this issue, it is worth noting that there are two ways to think about universality in the context of policies to create wealth. One framework focuses on the fact of wealth – the amount of money to which each child is entitled. This approach, most recently advocated by Professors Bruce Ackerman and Anne Alstott of Yale Law School, is premised on the view that all Americans, by reason of living or being born here, are "entitled" to significant wealth (an "$80,000 stake," as Ackerman and Alstott put it) to assure access to opportunities when they become adults.[31] The other framework focuses instead on the need for an infrastructure that permits all Americans to save and create wealth. Under this view, the goal is not to provide a universal entitlement to wealth; rather, the goal is to provide a universal platform that all individuals can use to save and create wealth as they chose (with or without "encouragement" in the form of tax incentives provided by the federal government). While the purpose of this paper is not to debate these competing constructs, we should acknowledge our own view that the $80,000 "entitlement" concept is deeply flawed on policy grounds and has no viability whatsoever as a political matter. In contrast, a universal savings infrastructure is a modest and appropriate public investment that may have some prospect for political acceptance.

Following are among the primary arguments advanced by proponents of a Universal System:

∃ CSAs are in the nature of a public good that should be provided to all eligible children. Society as a whole would benefit from the behavioral, economic and fiscal impact of a CSA program that creates a universal savings infrastructure.

∃ Universal CSAs would create a savings platform that would remove barriers to additional, voluntary savings by children and families. In contrast, a purely Voluntary

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[30] At various times, we refer for convenience to "parents" in describing persons who establish or fund CSAs for the benefit of children. We recognize that the situation is more complex, since 4% of all children live with someone other than a "parent" (*e.g.*, a grandparent, other relative or foster parents) or have their own household. See Forum on Child and Family Statistics, "America's Children 2000" (www.childstats.gov). Throughout this paper, we try to note when special rules may be necessary or desirable for these children.

[31] BRUCE A. ACKERMAN AND ANNE ALSTOTT, THE STAKEHOLDER SOCIETY (1999).

System of CSAs would do nothing to remove the structural barriers to saving and result in limited participation by those children and families who would benefit most from CSAs.

∃ In large measure, Social Security is the most popular and successful of all government programs because it is universal. The same policies that support universality in the context of Social Security support Universal CSAs.

∃ Universal CSAs could be structured to guarantee universal access to post-secondary education for all children.

∃ Universal CSAs that could not be distributed prior to retirement or the death of the beneficiary (see, Part III, below) would provide a life-long platform for additional, voluntary savings.

∃ Universal CSAs that could be used only to meet retirement needs would amount to pre-funding the government's existing obligations to provide retirement income and health care benefits to the elderly. They are a prudent and practical way of addressing the actuarial short-falls in the Social Security and Medicare Trust Funds, and the future demands on general revenue that will be imposed by both Medicare and Medicaid.

∃ Universal CSAs are a prudent tax cut because they increase long-term savings and promote economic growth.

∃ A Universal System is easier to administer and understand.

Following are among the arguments advanced by those who support a Voluntary System, but oppose a Universal System:[32]

∃ While tax incentives to encourage savings for children may be appropriate, parents should decide what is in the best interests of their children.

∃ Universal CSAs would become another unfunded entitlement program.

∃ Universal CSAs would require government-sponsored Investment Funds (see Part II, below), leading to government interference in the capital markets.

∃ Whatever the initial design, political pressures would ultimately cause Congress to permit CSAs to be used for almost any purpose.[33] At that point, many of the benefits described above would be lost and a Universal System would be nothing more than a deferred "give away" by the federal government.

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[32] It is, of course, worth noting that CSAs in any form would continue to be opposed by those who would prefer to use federal revenues to pay down the deficit, to cut taxes in some other way, or to spend money elsewhere.

[33] For example, under current law, IRA and 401(k) plans can be withdrawn or borrowed without penalty for various purposes, and can be withdrawn for any purpose on payment of 10% penalty.

∃ Even if a Universal System were better in theory, it would have no chance of enactment. A Voluntary System supported by strong tax incentives would be far better than nothing. Those who argue for a Universal System are sacrificing "good" policy in the futile pursuit of a "better" policy.

∃ Universal CSAs would be complicated and pose significant, ongoing administrative difficulties.[34]

Beyond these questions of ideology, politics and political philosophy, there is the practical question of which taxpayers would chose to participate in a Voluntary System. As described below, CSAs would likely have certain features encouraging participation – (a) tax-free (or tax deferred) accumulation of earnings; (b) rules protecting CSA funds from creditor claims; and (c) rules providing that CSA funds could not be considered in determining eligibility for means-tested government programs and for scholarships offered by tax-exempt academic institutions. Voluntary participation could also be encouraged through some or all of the following: (a) additional tax incentives, like those described above, for those taxpayers who establish CSAs for their dependents (e.g., a credit or deduction for those parents who chose to fund CSAs for their children); (b) procedures that would automatically fund a CSA with some or all of the $500 child tax credit unless the taxpayer affirmatively elected not to fund the CSA and elected instead to receive those funds directly;[35] and/or (c) by providing flexible distribution rules, on the theory that taxpayers would be less hesitant to fund a CSA if they knew they could gain easy access to the funds.

Participation levels would depend on a variety of factors, including how the program was structured and marketed. It is worth noting, however, that patterns of asset ownership and participation in other voluntary savings programs (e.g., IRAs, IDAs, 401(k) plans, education IRAs, and medical savings accounts) suggest that participation in Voluntary CSAs would be limited, especially among low and middle income families. For example:

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[34] As noted below, we believe this particular objection is demonstrably wrong in the context of a properly designed system.

[35] On February 14, 2000, the Internal Revenue published a revenue ruling clarifying that employers may automatically reduce an employee's compensation by a certain amount and have that amount contributed as an elective deferral to an employer's 401(k) plan. Rev. Rul. 2000-8, 2000-7 I.R.B. 617; see also Rev. Rul. 98-30, 1998-25 I.R.B. 1. In a joint statement, Labor Secretary Alexis M. Herman and Treasury Secretary Lawrence H. Summers described automatic enrollment in 401(k) plans as a "promising method of encouraging participation by those who disproportionately have been missing the benefits of a regular, disciplined approach to retirement saving." See Eve Tahmincioglu, *Ready or Not, Welcome to the 401(k) Plan*, N.Y. Times, Aug. 20, 2000, at sec. 3, p. 10.

Table 1: Participation Rates in Retirement Plans and Mutual Funds by Income[36]

Family/Household Income	Retirement Accounts: Percent of Families with Retirement Accounts	Retirement Accounts: Percent of Families Contributing to 401(k) Plans	Mutual Funds: Percent of Households holding Mutual Funds
	(Fed, 1995)	(Treasury, 1995)	(ICI, 2000)
Less than $5,000		3%	
$5-10,000	6%	8%	
$10-15,000		13%	17%[3]
$15-20,000	24%[1]	23%	
$20-30,000		37%	37%[4]
$30-50,000	53%[2]	52%	49%[5]
$50-75,000		63%	66%
$75-100,000	70%	64%	77%
$100-200,000		59%	
$200,000 and over	85%	44%	79%
All Families/HHs	43%	28%	49%

Sources:

Fed data from Arthur Kennickell et al. "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances" Federal Reserve Bulletin, January 1997.

Treasury data from David Joulfaian and David Richardson, "Contributions to Defined Contribution Pension Plans: Evidence from Individual Tax Returns", Department of the Treasury, Mimeo.

ICI data from Investment Company Institute, "Fundamentals: Investment Company Institute Research in Brief," August 2000.

[1] Family income of $10-25,000
[2] Family income of $25-50,000
[3] Household income of less than $25,000
[4] Household income of $25-35,000
[5] Household income of $35-50,000

2. Refundable or Non-Refundable Credit. If a credit mechanism is used, should it be refundable or available only to off-set income or payroll tax liability?[37] Refundable CSAs would entail a system where eligible participants would receive a credit without regard to their tax liability. For example, if the program were structured as a $1,000 per child tax credit, all eligible children would have their CSAs automatically funded without regard to the tax liability of the taxpayers claiming them as dependents. Non-Refundable CSAs would entail a system where the amount of any credit would be limited to the tax liability of the taxpayers claiming eligible children as dependants. For example, if the program were structured as a $1,000 per child tax

[36] The information presented here and at Tables 2-5 was provided by Ernst & Young, LLP. We would like to thank them for their assistance and timely response to last-minute requests. We would also like to absolve them from any responsibility for our analysis and the views we express.

[37] Under current law, the earned income tax credit is the only refundable credit that may result in a negative income tax liability. While that feature is justified by some on grounds that it represents a refund of payroll taxes, it is treated for federal budget purposes as an expenditure rather than a reduction in tax revenue. For tax years after 1997, certain low income taxpayers are eligible to treat the child tax credit as a component of the earned income tax credit and receive an additional refundable credit. See Code Section 32(n).

credit, the taxpayers' credit would be limited to the lesser of $1,000 per eligible child or the taxpayers' tax liability. If the credit were not refundable, a number of issues would have to be resolved – for example, would tax liability include both income and payroll taxes; would tax liability be determined before or after application of other provisions (e.g., the earned income and child care tax credits); how would a tax credit be apportioned if the limitation applied in a situation where the taxpayers had more than one eligible child?

In this regard, it is important to note that both Universal and Voluntary Systems can be either Refundable or Non-Refundable. For example, if the system were structured as a 20% credit for amounts up to $1,000 voluntarily contributed on behalf of a beneficiary, that credit could be available only to the extent of the parents' tax liability, or could be refundable. Under that system, if a family with $100 dollars of tax liability decided to contribute $500 to a CSA, then their credit would be $100. If they decided to contribute $1,000 to a CSA, their credit would $200 in a Refundable System, but only $100 in a Non-Refundable System.

Proponents of a Refundable CSA System argue that children should not be disadvantaged by their parents' tax liability. They argue that the purpose behind CSAs (i.e. to create wealth and wealth creation opportunities for all children) has no connection to the tax liability of the child's parents. Indeed, if there is a connection, it supports a Refundable System – where the parents' tax liability is so low that refundability becomes an issue (in our example, a tax liability under $1,000 per eligible child), it indicates the child is living in poverty and has even a greater need for a fully-funded CSA. Proponents of a Refundable System also argue that it would be easier to administer and understand than a Non-Refundable System or a System providing for carryover of tax benefits. On the other hand, some oppose a Refundable System on grounds that it would be yet another discredited welfare program and would create tax compliance problems like those affecting the earned income tax. Others, who support government's role in providing for low income families, would oppose Refundable CSAs on grounds that the money should be used to meet other, more pressing needs.

Along with the choice between a Universal or Voluntary System, and the account distribution issues addressed below, this is the most significant and contentious CSA design question. Moreover, this issue has enormous practical implications. For example, as noted below (Part I.A.5) a Non-Refundable System providing for a one-time, $1,000 credit would exclude almost 50% of all children. One way to illustrate the impact of a Non-Refundable System is by reference to the taxable income and estimated adjusted gross income thresholds for income various levels of income tax liability. As shown in Tables 2 and 3, the these thresholds are quite high.

Table 2: Taxable Income and Estimated Adjusted Gross Income Threshold for Income Tax Liability of $100, $500, and $1,000, by Family Size, Married Filing Jointly, 1999

Tax Liability	One Child		Two Children	
	Taxable Income	Est. AGI	Taxable Income	Est. AGI
$100	$7,878	$23,328	$10,304	$28,504
$500	$9,169	$24,619	$11,413	$29,613
$1,000	$10,783	$26,233	$13,333	$31,535

Table 3: Taxable Income and Estimated Adjusted Gross Income Threshold for Income Tax Liability of $100, $500, and $1,000, by Family Size, Single Head of Household, 1999

Tax Liability	One Child		Two Children	
	Taxable Income	Est. AGI	Taxable Income	Est. AGI
$100	$9,735	$21,585	$12,460	$27,006
$500	$11,026	$22,876	$13,516	$28,116
$1,000	$12,640	$24,490	$14,902	$29,502

Unfortunately, the debate over refundability has been couched in normative terms that are not particularly helpful, nor have the administrative issues been fully explored. We believe that the case for refundable credits is compelling on grounds of tax policy and tax administration, particularly in the context of a one-time or short-duration credit (e.g., $1,000 at birth in a Universal System or 20% of amounts contributed in a Voluntary System). While a detailed discussion of the refundability issue is beyond the scope of this paper, following is a brief summary of the key arguments.

(a) Annual Tax Filing and Carryover Rules. Administrative considerations require that taxpayers file their returns and pay their taxes each year. While there is no practical alternative, the annual accounting period results in numerous distortions.[38] The tax law tries to rectify a number of these distortions, primarily through carry-forwards and carrybacks. For example: businesses can use their losses to off-set prior or future year income, can use their alternative minimum tax liability as a credit against future year regular tax liability, and can carry-back (or forward) their unused R&D and foreign tax credits. Individuals can carry their capital losses forward for an unlimited time; corporations can carry their capital losses back 3 years or forward 5 years; both individuals and corporations can carry their excess charitable contributions forward 5 years. Individuals can carry-over their unused passive losses to off-set passive income in other

[38] See e.g., Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 294 (May 4, 1987) (the net operating loss carryover provisions "perform a needed averaging function by reducing the distortions caused by an annual accounting system."); John W. Lee and Mark S. Bader, "Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income," 12 J. Corp. L. 137, 171-186 (1987) (discussing the open transaction doctrine as an exception to the annual accounting rule aimed at reducing distortions); Wm. D. Elliott "The Tax Benefit Rule: A Common Law of Recapture," 39 SW. L.J. 845 (1985) (discussion of the tax benefit doctrine as an exception to the annual accounting rule aimed at minimizing distortions).

years. All of these provisions are entirely appropriate on tax policy grounds, as they simply mitigate the arbitrary impact of our annual tax filing system.[39]

(b) Annual Tax Filing and CSAs. The same sort of arbitrary impact is prevalent in the context of CSAs. One way to illustrate this point is by example, assuming a $1,000 CSA tax credit for each new-born child.[40] Following are two of the more obvious situations where families can "lose" the CSA credit as the result of our annual tax filing system:

∃ Example 1. A husband and wife (Jodi and Jonathan) both work; their tax liability in 2002 is $1,500. They have their first child, Rachel, in February 2003. Because one or both parents take time off to care for Rachel, and because they are eligible for the earned income tax credit and the child credit, their tax liability in 2003 falls to $0. Because the CSA tax credit is non-refundable, there is no CSA for Rachel.[41] They both go back to work in 2004. Their incomes go up and they work additional overtime to cover the costs of caring and providing for Rachel; as a result, their tax liability in 2004 is $1,500. In 2005, they have their second child, Ben. Having learned from prior experience, they don't take time off to care for him – instead, because their incomes have increased and they continue to work overtime, their tax liability remains at $1,500. Because they have sufficient tax liability, Ben ends up with a $1,000 CSA. It seems clear that the family (especially Rachel) has been subject to the arbitrary impact of the annual tax filing system. If the family were permitted to carry forward its 2002 tax liability, or carry back its 2004 tax liability, they could have also funded a $1,000 CSA for Rachel.

∃ Example 2. A husband and wife (Mike and Jody) have a tax liability of $1,000 each year, from 2002 through 2004. Their neighbors (Cliff and Mary) also have a tax liability of $1,000 each year, from 2002 through 2004. Mike and Jody have their first child, Abby, in 2002; they have their second child, Ashleigh, in 2004. Despite the fact that the CSA tax credit is not refundable, Abby and Ashleigh both end up with $1,000 CSAs. Cliff and Mary are equally blessed with children, but their timing differs. They have twin boys, Jake and Sam, during 2003. Because the CSA tax credit is not refundable, and assuming the credit they do get is divided equally, Jake and Sam end up with $500 CSAs. If Cliff and Mary were permitted to carry forward their 2002 tax liability, or carry back their 2004 tax liability, Sam and Jake would have ended up (like Abby and Ashleigh) with $1,000 CSAs

39 Prior to its repeal in 1986, income averaging permitted taxpayers to reduce the impact of year-to-year fluctuations in their income. Repeal was simply a way to raise revenue in the context of substantial rate reductions, and in our view cannot be justified on policy or administrative grounds.

40 The $1,000 credit example is easy to describe and consistent with legislation proposed to date. However, the same analysis would apply in the context of a Voluntary System with, for example, a 20% credit. It should also be noted that deductions can be treated as credit-equivalents. For example, a $1,000 deduction for a taxpayer in the 15% bracket is equivalent to a $150 credit.

41 In a system also permitting voluntary contributions, Jodi and Jonathan could, of course, chose to contribute their own funds to a CSA for Rachel.

These examples illustrate how the administrative convenience of an annual filing period can violate the important tax policy concept of neutrality.[42] Example 1 illustrates a situation where the tax law is not neutral with respect to behavior – if Jodi and Jonathan had continued to work during 2003, or had staggered their time off during 2002, 2003 and 2004, Rachel would have qualified for the $1,000 CSA tax credit. As a matter of tax policy, the law should be neutral with respect to parents' behavior regarding their new-born children; at a minimum, it should not penalize the decision to take time off from work. Example 2 illustrates a situation where the tax law is not neutral with respect to similarly situated taxpayers. There is no principled reason why Abby and Ashleigh should end up with $1,000 CSAs while Sam and Jake end up with $500 CSAs.

Particularly in the context of a credit that is intended to create a long-term asset, rather than cover costs incurred during a particular year, the tax policy concept of neutrality argues for permitting taxpayers to carryover the CSA credit.[43] The problem with a carryover regime, however, especially in the context of CSAs, is that it would be quite complex. Among the many questions that would have to be addressed: (i) the appropriate carryover period(s), (ii) provisions to address lost earnings on CSAs that are not funded currently, (iii) the impact of changes in dependent status and changes in marital status, and (iv) rules governing allocations of the credit and earnings among children born to the same parents at different times. At the same time, it seems reasonable to assume (as a matter of shared confidence, if not objective evidence) that most parents will pay sufficient income tax to "cover" the cost of the CSA credit over their working lives. Accordingly, a refundable credit seems the best way to achieve the right policy result in an administrable and workable way.

(c) Compliance Issues. A frequent criticism of refundable credits to individuals, especially the EITC, is that they result in high levels of non-compliance and that the IRS has no practical way to police the rules or recover lost revenue. Setting aside the question of whether these criticisms are justified, what is important to note is that the CSA program is entirely unlike other refundable credits. First, depending upon how the program is structured, verification of eligibility is likely to be far easier. Second, most CSA funds will be retained by third party financial institutions for many years before they are distributed to beneficiaries. Combined with information reporting and matching programs, the IRS would be uniquely well positioned to detect non-compliance and recoup lost revenues.

(d) Other Options. While we believe that a refundable credit is the preferred policy for CSAs, there are other approaches that would mitigate the impact of annual tax filings. As noted above, one possible option would be some form of tax benefit carryovers. While complex, it would be far preferable to not addressing the issue at all. A second alternative would be to spread the funding of CSAs over a number of years. For example, if the credit were structured as

[42] One can, of course, think of many other – equally arbitrary – results in the context of a one-time or short-duration tax credit that is not refundable (for example, the single parent who is laid off during the year his or her child is born; a child born in December, where the parents take time off in the following year versus the child born in January, where the parents take time off during that same year; parents that have children when they are young and their earnings are limited versus parents that have children when they are older and their incomes are higher).

[43] It could be argued that in the context of credits intended to address current year "needs" (such as the EITC, the child credit, and the child care credit), distortions caused by the annual accounting period are not quite as extreme, and that the case for carryovers is not as compelling.

a $100 - $125 each year for 10 - 15 years instead of a one-time $1,000 credit for new-born children, [44] many more children would be covered by CSAs.

3. Fixed or Phased-Out Tax Incentives. Should CSAs be available to all children on the same basis, or should CSAs be phased out for children of upper income taxpayers (however defined)?[45] Under a system with No Phase-Outs, taxpayers would not lose their eligibility based on their income. For example, under a Universal System, with Refundable Credits and No Phase-Out, if the program were structured as a $1,000 per child tax credit, all children would have their CSAs automatically funded without regard to the tax liability of the taxpayers claiming them as dependents (i.e., CSAs would be funded for all children, including those living in poverty and those living in penthouses). Under a system that includes Phase-Outs, taxpayers with incomes above some level would lose eligibility for some or all CSA tax benefits. For example, if the $1,000 credit was phased out entirely for taxpayers filing joint returns with incomes above $200,000, then a family with taxable income above that amount would receive no credit. If the credit were phased out, a number of issues would have to be resolved – for example, would taxpayers subject to the phase-out be permitted to fund CSAs on an after-tax basis;[46] how would the credit be apportioned if the limitation applied in a situation where the taxpayers had more than one eligible child?

Proponents of a Phase-Out System argue that parents with sufficient income have the ability to fund savings accounts for their children and should not be subsidized by the federal government. They also argue a phase-out would make a CSA program more feasible by limiting revenue costs and that any tax revenues that would otherwise go to subsidize the CSAs of upper income taxpayers should be used for other purposes. Some who oppose a phase-out argue that phase-outs are not an accurate measure of whether families have the means – and are willing – to establish CSAs for their children. They argue that the benefits of CSAs should not be lost to a child merely because of his or her parents' financial condition during the funding period – there are no assurances that the parents' financial condition will be sustained or that the parents will decide to provide for the child's future. A phase-out that would avoid this uncertainty would have to be so high as to be meaningless. Some opponents of a phase-out argue that as a matter of fairness, since upper income taxpayers would provide most of the tax revenue to fund CSAs, they should be able to participate on the same basis as other taxpayers. Some who favor a Refundable Program also oppose phase-outs on grounds that a program covering all children is the primary policy justification for CSAs, and its primary political appeal. Finally, some argue that a system with no phase-outs would be far easier to administer and understand.

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[44] In order to account for the time value of money, the credit would have to be greater than $100 and/or the credit period would have to be longer than 10 years, to equate this arrangement with a current $1,000 credit.

[45] Under current law, Social Security is a progressive system, taking both taxes and benefits into account (*i.e.*, relative to their contributions, higher income participants receive smaller benefits). Likewise, almost every tax-favored savings program is also progressive in the sense that (i) the ability to participate is phased out for upper income individuals (*e.g.*, IRAs, IDAs, education IRAs, and medical savings accounts), or (ii) the benefits are capped (*e.g.*, employer-sponsored qualified plans). In addition, exemptions for children and the child credit are also phased-out for upper income individuals. Attachment 1 is a list of current phase-outs and benefit limits for various tax-favored savings programs, exemptions for dependent children, and the child credit.

[46] Allowing taxpayers to contribute money to a CSA without receiving any current tax benefit (*i.e.*, a credit or deduction) would reduce the costs of a CSA program while providing some incentive for parents to save for their children's futures.

4. Additional Contributions. Should additional contributions be permitted beyond those provided for in a Universal System, or beyond those encouraged by tax incentives in a Voluntary System? If so, how should they be structured (e.g., who would be permitted to make contributions and subject to what dollar limits)? In the context of a Universal System, should there be tax incentives to encourage additional contributions? If tax incentives are provided, how should they be structured (e.g., as credits or deductions; should they be phased-out)?

The question of additional contributions relates in important ways to other CSA design issues. For example, permitting additional contributions could help mitigate the impact of a system that was Non-Refundable and/or Phased-Out. In addition, as noted at Part III, below, the rules governing distributions of Additional Contributions could differ from the rules governing other contributions to a CSA.

It should also be noted that other provisions to encourage savings could be integrated with CSAs. For example, Education IRAs, IRAs and IDAs could be combined with CSAs. With CSAs as a platform, it seems likely that these other programs would be more readily available to beneficiaries and could also lead to meaningful simplification of existing rules.

5. How Much, How Often, Who, How Taxed. Regardless of how the foregoing issues are resolved, a number of other key questions must be answered relating to the size of CSAs and how they are funded – for example, the size and frequency of any tax credit (e.g., a one-time $1,000 credit, a $100 per-year credit, or a 20% credit on contributions up to $1,000); amounts permitted as voluntary contributions (e.g., a $250 per year, per person, per child limit; or, aggregate permitted additional contributions of $2,000 per year, per child); and the tax treatment of voluntary contributions (are they tax deductible or made with after tax dollars). As noted below, there is the all important question of effective dates – what about children not covered by the basic rules? For example, if CSAs are structured as a one-time tax credit of $1,000 for new-born children, what about the 71 million children under 18 and the 19 million children under 5?[47] Questions must also be answered regarding the tax treatment of earnings on CSAs and distributions from CSAs (for example, the law might provide that earnings and distributions are tax exempt; or, earnings are tax deferred and distributions are taxable).[48] Finally, regardless of how the CSA program is structured, there are a number of special circumstances that Congress might chose to address. For example, if the system is not otherwise Universal and Refundable, it may nonetheless be desirable to establish CSAs for foster children through 100% tax credits or funds paid directly by the federal government. Likewise, Congress might also chose to provide special rules for adopted children and/or children with various long-term disabilities.

The answers to the questions of how much, how often, who and how taxed will significantly impact the overall cost of a CSA program and its likelihood of being enacted into law. For

[47] See U.S. CENSUS BUREAU, U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES, p. 17 (119th ed. 1999) (middle series).

[48] In theory, the tax economics of IRAs (a current tax deduction and deferral) are identical to the tax economics of Roth IRAs (no current deduction, no tax on distributions). Providing a current deduction and not taxing future distributions would result in a negative effective tax rate.

example, approximately 3.9 million children are born in the United States each year.[49] In addition, the Census Bureau estimates that there are approximately 19 million resident children in the United States who are under 5 years old and 71 million resident children under the age of 18.[50] The following chart illustrates the potential revenue cost of a CSA program for all children born after 2001, comprised of an initial $1,000 credit and additional $500 credit each year for five years.[51] The revenue estimates show the 10-year cost of (i) a Universal, Refundable System with No Phase-Outs; (ii) a Universal, Refundable System with Phase-Outs; and (iii) a Universal, Non-Refundable System with Phase-Outs.

[49] National Vital Statistics Reports, Centers for Disease Control and Prevention, "Births, Marriages, Divorces and Deaths: Provisional Data for September 1999," p. 1 (July 28, 2000) (there were approximately 3,947,000 live births during the 12 month period ending September 1999 and 3,913,000 live births during the 12 month period ending September 1998).

[50] See U.S. CENSUS BUREAU, U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE U.S. 17 (119th ed. 1999) (middle series).

[51] This is the funding proposed by Senators Breaux, Grassley, Gregg, Kerrey, Lieberman, Robb, Thomas and Thompson in 1999 and 2000, and by Senators Kerrey and Moynihan in 1998.

Table 4. Revenue Estimate of CSA Proposal Dollars in Millions

	Fiscal Year:											
	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2002-06**	**2002-11**
Fully Refundable Credit with No Phaseout:												
Total gross credit	$0	$4,000	$5,999	$7,997	$9,995	$11,992	$13,988	$13,988	$13,988	$13,988	$27,991	$95,934
Tax-exempt investment income	$0	$9	$44	$96	$166	$257	$369	$499	$638	$787	$315	$2,865
Total revenue impact	$0	$4009	$6,043	$8,093	$10,161	$12,249	$14,357	$14,487	$14,626	$14,775	$28,305	$98,799
Number of children with new accounts (thousands)	0	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000	16,000	36,000
Fully Refundable Credit with Phaseout:												
Total gross credit	$0	$3,854	$5,780	$7,705	$9,630	$11,554	$13,478	$13,478	$13,478	$13,478	$26,969	$92,433
Tax-exempt investment income	$0	$9	$42	$92	$160	$248	$355	$481	$615	$758	$303	$2,760
Total revenue impact	$0	$3,863	$5,822	$7,798	$9,790	$11,802	$13,833	$13,958	$14,092	$14,236	$27,272	$95,193
Number of children with new accounts (thousands)	0	3,854	3,854	3,854	3,854	3,854	3,854	3,854	3,854	3,854	15,416	34,686
Non-Refundable Credit with Phaseout:												
Total gross credit	$0	$2,123	$3,308	$4,493	$5,677	$6,861	$8,045	$8,045	$8,045	$8,045	$15,601	$54,644
Tax-exempt investment income	$0	$5	$23	$52	$92	$143	$207	$282	$361	$447	$173	$1,613
Total revenue impact	$0	$2,127	$3,332	$4,545	$5,769	$7,005	$8,253	$8,327	$8,407	$8,492	$15,774	$56,257
Number of children with new accounts (thousands)	0	2,123	2,123	2,123	2,123	2,123	2,123	2,123	2,123	2,123	8,492	19,107

Estimates calculated by Ernst & Young LLP based on publicly available data. The assumptions underlying these revenue estimates are:

1. Available for children born on or after January 1, 2002.
2. 100% participation rate (or government establishes account for children when assigned Social Security Number).
3. $1,000 credit/investment in account takes place on January 1 of the year following birth.
4. Additional $500 credits in second through sixth years occur on January 1.
5. Average live births of 4 million per year.
6. Average investment return of 7.08% equivalent to a balanced mutual fund return using the historical real return of 60% long-term government bonds and 40% large-cap stocks plus projected inflation by the Congressional Budget Office.
7. Incorporates Census Bureau mortality rates.
8. Investment accounts not subject to withdrawal or borrowing before age 18, so no distributions except for mortality. Distributions for mortality not subject to tax.
9. When not fully refundable, only refundable against federal income tax.
10. Phase-out occurs ratably between $100,000-$200,000 of family AFI.

Following are among the significant implications of Table 4:

∃ A Phase-Out of the credit for adjusted gross incomes between $100,000 and $200,000 would reduce the number of eligible children by 146,000, or roughly 4% of children born each year, and would result in a corresponding reduction in the cost of the program (i.e., about $146 million in 2003 and about $3.6 billion over ten years).

∃ In contrast, a Non-Refundable System would reduce the number of covered children by almost 1.7 million, or roughly 43% of all children born each year. As a result, the revenue impact of a Non-Refundable System would be far more dramatic: a reduction in program cost of $1.7 billion in 2003 and $39 billion over ten years.

∃ The fully phased in cost of a Universal, Refundable System with No Phase-Outs (Year 2008 and beyond) would be about $14 billion each year. To put that number in context, the Fiscal Year 2000 cost of the non-refundable, phased-out $500 child credit is about $19 billion; the Fiscal Year 2000 revenue loss from the net exclusion of contributions and earnings from IRAs and Keoghs is about $16 billion; and the Earned Income Tax Credit is about $30 billion.

Above all, and as discussed above, Table 4 highlights the importance of the question whether the CSA system is Refundable or Non-Refundable.

6. Future Account Values. The future value of CSA accounts will, of course, depend on how the program is structured, voluntary contributions, and investment returns. However, assuming that the program is structured as reflected above (an initial $1,000 contribution followed by $500 each year for five years, with no withdrawals and no additional contributions), a fully funded CSA account would have the following future values:[52]

Table 5: Future CSA Account Balances at Various Ages, Assuming 7.08% Rate of Return

Age	Account Balance
10	$ 6,000
18	$ 10,400
25	$ 16,800
35	$ 33,400
45	$ 66,200
55	$131,100
65	$259,900

7. Transition Issues. As with many new policy initiatives, the CSA program would pose a number of transition issues. These issues are extremely important in the context of a Universal

52 Assumes an average pre-tax rate of return of 7.08% (the same rate assumed in Table 4), which is consistent with historical average returns on an investment in a balanced mutual fund of 60% bonds and 40% equities and an inflation rate of 2.6%. Under different investment assumptions, of course, the return could vary significantly.

System. For example, assume a system that provides a $1,000 credit for each child in the year following the year of his or her birth, effective for children born in or after 2001. Jane Smith is born in 2000; her brother Steve Smith is born in 2001. At 65, Steve's CSA account is worth almost $260,000 assuming an annual growth rate of about 7%; at 65 Jane has nothing (unless she has saved on her own). While less graphic in the context of a Voluntary System (since parents may chose not to participate, or may make compensating arrangements for their other children), the same issues arise in that context as well.

If the judgement is made that this transition issue should be addressed, there are a number of options. For example:

- Those not eligible for CSAs (and others on their behalf) could be allowed to make voluntary "catch up" contributions. Under this approach, following are among the issues that would have to addressed: (i) would all individuals be eligible to make such contributions, or would there be some age limit;[53] (ii) would the amount of any permitted "catch up" contributions take into account earnings that would have accrued from earlier funding;[54] (iii) would tax incentives be provided to encourage contributions (if so, how would they be structured); and (iv) would there be any time limits on when contributions could be made?

- Especially in a system of Universal CSAs, gradual funding would reduce year-to-year disparities. For example, rather than a one-time funding of $1,000 for new-born children, funding accounts at the rate of $100 each year for 10 years would substantially minimize year-to-year differences.[55]

- Another alternative in the context of Universal CSAs would be to provide one-time funding for those above the eligibility age. For example, if the program were structured as a $1,000 credit for each child in the year following the year of birth for all children born in or after 2001, the legislation could provide that all children age 18 or under in 2001 would also be eligible for a $1,000 credit.

These options are not mutually exclusive, and the choice of transition rules would likely be influenced by the structure of the program and revenue considerations. For example, a fully Voluntary System would easily accommodate voluntary catch up contributions while a Universal System could accommodate any combination of the options described above. In the context of voluntary contributions, the revenue costs would depend on the tax incentives provided to make such contributions and estimated participation rates. If the transition issue were addressed in a Universal System through a one-time "catch up" contributions, the revenue costs would be quite substantial. For example, a one-time credit of $1,000 for all children below age 18 at the

[53] For example, would "catch up" contributions be permitted for everyone, or only children under age 18?

[54] For example, would "catch up" contributions be eligible for the same credits and/or deductions as those generally available to participants on an ongoing basis? Would those credits and/or deductions be modified (*e.g.*, the amount could be reduced, or they could be subject to phase-out rules). Or, would tax benefits be limited to the tax treatment of accumulated earnings (deferral or exemption)?

[55] Note that similar results would be achieved in the context of a Universal System with a one-time funding regime if the amount of the contribution were phased-in. In the example above, CSAs for children born in 2001 could be funded with $100; CSAs for children born in 2002 could be funded with $200; etc..

beginning of 2002 would have a first year cost of $74.9 billion and, taking into account the tax deferral on CSA earnings, a ten year cost of $81.9 billion.

B. *Administrative Issues*

1. A General Structure for Initial Funding. Regardless of the system that is adopted, there are two ways to accomplish the funding of CSAs: parents could fund CSAs and claim available tax benefits when they file their tax returns; or, the IRS could disburse funds to accounts designated by taxpayers on their tax returns. The former – direct payment or funding by taxpayers who claim tax benefits on their tax returns – is the way tax benefits are generally claimed (*e.g.*, home mortgage interest, child care credits, IRAs and education IRAs).[56] This approach is quite straight-forward and would function in the context of any system of CSAs. For example, even in the context of a Universal Refundable System with a $1,000 credit for all new-born children, parents could be required to contribute $1,000 in a CSA account for their new-born child, and then file a tax return claiming a refundable credit for that contribution. Likewise, in a Voluntary System (whether Refundable or Non-Refundable), parents could choose to fund CSAs and claim available tax benefits on their returns in the same way that taxpayers fund and claim tax deductions for their IRAs. For example, in the case of a 20% credit on contributions of up to $1,000, parents could be required to make a contribution as a pre-requisite for claiming the credit; that credit could be either Refundable or Non-Refundable.

The novel question is whether CSAs should provide for funding by the IRS, and whether such a system would be administrable. For example, in a Universal System with a $1,000 credit for each new-born child, the IRS could fund a CSA for each eligible child claimed as a dependent on a federal income tax return. In a Voluntary System with a $1,000 per child credit where parents could elect to fund a CSA for their child or take the money themselves, the IRS could fund a CSA for every eligible child for whom the election is made. Finally, in a Voluntary System where the parents had to provide part of the funding themselves, parents choosing to fund CSAs could show their share of the contribution as additional tax liability as a condition for IRS funding and claim any available tax credit or deduction.[57] Again, all of these arrangements would work equally with both Refundable and Non-Refundable Systems.

Under any CSA system with IRS funding, the IRS would gather all of the necessary information relevant to CSAs as part of its routine processing of tax returns. As now occurs with respect to tax refunds, the IRS would provide each child's CSA information to the Treasury Department's Financial Management Service ("FMS"). In much the same way that it handles other funding activities on behalf of the federal government, FMS would then wire transfer the appropriate amount to each child's designated investment fund.

[56] The primary exception is certain work-related benefits that are funded directly by the employer and are not taxed to the worker.

[57] This system is not as complicated as it may sound, and would be relatively easy to administer. For example, the CSA Information Form (described below) could walk the taxpayer through the computation, showing the gross amount of the contribution (including credit) to the CSA and the net amount to be contributed by the taxpayer as an additional payment due. Since more than 70% of all taxpayers receive refunds, most taxpayers would finance their contributions through reduced refunds rather than additional payments.

There are several arguments in favor of IRS funding:

∃ For taxpayers with no other experience dealing with financial institutions, IRS funding would likely simplify the process.

∃ IRS funding would be a practical necessity for taxpayers who did not otherwise have the resources to finance CSAs (this would be particularly true if CSAs were structured as a Universal, Refundable program). In this regard, it should be noted that IRS funding would be useful even in a Voluntary System because more than 70% of all taxpayers receive refunds – and for many of those taxpayers, those refunds would be the most likely source of money to finance CSA contributions.

∃ IRS funding would materially reduce overall administrative costs because deposits would take place only once each year and would be made electronically through wire transfer (*i.e.*, private sector financial institutions would not have to deal with individual deposits made by check and sent by mail).

∃ By having the IRS establish and fund CSAs, compliance and fraud issues would be significantly reduced because the government is assured that the funds have been appropriately deposited in CSAs.

What is important to emphasize is the feasibility of this system. While there may be differences of opinion regarding the question of *whether* the IRS should fund CSAs, it is clear that such a system *could be* implemented. In the context of CSAs, the information required from the taxpayer and the administrative burden on taxpayers, the IRS and FMS would be very similar to that which is currently required for refunds. During the 1999 individual income tax filing season, more than 70% of all taxpayers filed refund returns.[58] Under current law, taxpayers may instruct the IRS to issue refunds through direct deposit to a bank account owned by the taxpayer, by including such instructions on the Form 1040. During the 1999 individual income tax filing season, approximately 23.5 million individuals – more than 26% of all those receiving refunds – used this direct deposit system.[59] Similarly, the increasing reliance on electronic funds transfers in other contexts, *e.g.*, the payment of welfare benefits, also suggests that the system described above can be implemented with relative ease.[60]

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58 GENERAL GOVERNMENT DIVISION, UNITED STATES GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: IRS' 1999 TAX FILING SEASON, p. 21 (December 1999) ("GAO 1999 REPORT").

59 GAO 1999 REPORT, p. 70.

60 One of the issues raised in connection with IRS funding of CSAs relates to potential time delays in funding that would reduce investment earnings. While such delays would occur, certainly relative to funding by taxpayers during the year, IRS procedures would minimize those delays. For example, during the 1999 individual income tax filing season, more than 70% of all taxpayers filed refund returns, and the IRS and FMS were generally able to issue those refunds within 2 to 4 weeks after returns were filed – 84.7% of refunds from paper returns were made in 40 days or less and 99.6% of refunds from electronic returns were made in less than 21 days. GAO 1999 REPORT, p. 21. These numbers improved during the first part of the 2000 individual income tax filing season – 95.5% of refunds from paper returns were issued in 40 days or less and 99.9% of refunds from electronic returns were made in less than 21 days. GENERAL GOVERNMENT DIVISION, UNITED STATES GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: IRS' 2000 TAX FILING SEASON, p. 5 (June 2000).

As a practical matter, an IRS funding option would be necessary in a Universal System to deal with those situations where taxpayers did not otherwise fund CSAs, and would be required in a Refundable System to provide funds for low income taxpayers. We also believe it would be desirable in a Voluntary System for the reasons noted above. By the same token, direct funding by taxpayers should be permitted in any system.

Under either approach, simple modifications could be made to existing income tax returns to provide the IRS with the necessary information to provide a credit or deduction to parents who fund CSAs. In addition, it would provide for computation of any tax credit or deduction. Finally, if a direct IRS funding option were provided, then a participating parent or legal guardian claiming one or more eligible children as dependents[61] could be required to attach a Children's Savings Account Information Form (a "CSA Information Form") to their federal income tax return. The CSA Information Form would set forth each child's name, birth date, and social security number. In addition, the CSA Information Form would allow parents to elect how funds in a child's CSA are invested (see discussion below). Participating parents would file a CSA Information Return starting in the first taxable year in which a child obtains a social security number and in each subsequent year in which the child is eligible to receive contributions into his or her CSA. Based on information collected from the parents' CSA Information Form, a CSA would be created and funded as directed, or funded as required by statute if the parent or legal guardian does not specify an investment option (see discussion below).

Because substantially all parents and legal guardians already file income tax returns, structuring CSAs around the existing federal income tax system minimizes administrative costs and imposes no significant incremental burden on participating taxpayers. The tax incentives that are provided would have a significant impact on the complexity of the CSA Information Form. On the one hand, it could be very simple to complete and ask only for information that is readily available to the parent and is already collected by the IRS. On the other hand, a non-refundable system with phase-outs would be more complicated. In any case, however, most of this information, other than investment choices and children's birth dates, is already collected by the IRS under current law in the processing of tax returns. The only "new" aspect of a CSA Information Form would be the selection of a particular investment option; however, parents who do not want to actively manage the investment portfolio of their children's CSAs could allow the statutory rules to determine how funds are invested.

Similarly, structuring CSAs around the existing federal income tax system minimizes administrative costs for the government (as compared, for example, to a requirement that parents make a separate filing with the Department of Labor, the Department of Health and Human Services, the Social Security Administration or other governmental body). Because the IRS already gathers most of the information relevant to CSAs through the routine processing of tax returns, the additional costs to the government of processing the CSA Information Form would

[61] See Code Section 152 (taxpayers may claim as a dependent (i) their own children, (ii) legally adopted children, (ii) children who are members of the taxpayer's household, if placed by an authorized placement agency for legal adoption, and (iv) foster children who have as their principal abode the home of the taxpayer and who are members of the taxpayer's household. As discussed below, special provisions would have to be made for children in the care of the state or in private adoption agencies.

not be significant. Even if the government assumed the responsibility of establishing and funding CSAs, the IRS and Treasury's FMS experience with refunds generally, and with the electronic deposit of tax refunds in particular, demonstrate that the funding technology is already in place and could be implemented easily. Thus, funding accounts in connection with the processing of tax returns would minimize the start-up costs that would be associated with other systems of crediting accounts.

Administering CSAs based on information collected during the processing of tax returns has several distinct advantages. The most significant advantage is flexibility in the face of a number of difficult policy decisions. For example, tax returns can be used to obtain the necessary information from participants regardless of whether the program is Universal or Voluntary. It also can accommodate a number of different incentives for voluntary contributions, including the use of credits and deductions. Certain policy decisions can only be effectuated if the CSA program is administered through the tax system, including any structure that provides tax incentives (other than a system that provides the same, fully refundable credit to all children). In addition, administering a CSA program through income tax returns would be required in any structure where benefits are dependent on the income of the parent or legal guardian.

2. Parents Not Required to File; Children Who Are Not Claimed as Dependants. If the CSA program provides refundable credits (or credits based on payroll tax liability), it is also necessary to provide for parents who choose not to file tax returns because their incomes are below the applicable filing thresholds.[62] The easiest way to address this issue would be to permit these parents to file their CSA Information Forms with an IRS Service Center during the tax return filing season. If the CSA program permits or requires direct financing by the child's parents, they can be required to provide evidence of a contribution when they file the CSA Information Form with the Service Center. If the CSA program provides for IRS funding, parents would need to file the CSA Information Form with the Service Center and contributions into their children's CSAs could be funded in the same way as CSAs for taxpayers generally.

As noted above, it is also necessary to provide for children who cannot be claimed as dependants on an income tax return (*e.g.*, children living in orphanages and state foster care facilities). If general revenues are used to fund CSAs for such children, orphanages and state foster care facilities could be permitted to file a CSA Information Form with an IRS Service Center for each child under their care.

A more difficult issue arises in a Universal, Refundable CSA Program where no CSA Information Forms are filed with respect to a child and the parent, legal guardian or foster care provider fails to file income tax returns. Under these circumstances, crediting any amount to a child's CSA would be virtually impossible without direct contact with the person responsible for that filing.

3. Error Corrections. Errors in CSA accounting and funding will inevitably occur. Of course, similar errors occur – and have to be corrected – in the context of income tax refunds,

[62] While several million individuals file returns each year showing income below the applicable filing thresholds, and almost one million individuals file returns each year showing no adjusted gross income, several million individuals do not file returns at all because their income falls below the applicable filing thresholds.

funding Social Security benefits, and private sector financial transactions. What is important to note is that CSAs, by their nature, are long-term accounts. As a result, any over- or under-funding can be remedied with relative ease.[63] Indeed, assuming the IRS implements an effective information matching program, there are almost no circumstances where the need for a downward adjustment will be identified after a CSA has been distributed. With respect to both over- and under-funding by the IRS, it would be necessary to provide rules regarding actual or imputed earnings (or loss) prior to the correction date. Thus, for example, where accounts are over-funded, the withdrawal could reflect actual gains or losses; where accounts are under-funded, earnings could be credited at a specified rate, *e.g.*, the Treasury rate applicable to the correction period. With respect to over-funding by taxpayers and third parties, the law could provide for sanctions similar to those applicable with respect to over-funding of other tax-favored accounts.

C. *Summary*. For many, the policy design issues described above are arcane, at best; for the high priests of tax policy, they are the source of endless debate (and occasional crusades); for others, they are the weapon of choice in partisan political combat. Regardless of perspective, however, CSAs can only become law if decisions are made regarding these issues. As indicated, the most difficult and contentious issues in the funding context are whether the system is Universal or Voluntary and whether it is Refundable or Non-Refundable.

With regard to administrative issues, two points should be emphasized. First, while they are the least glamorous (and most neglected) aspect of any public policy debate, they are critically important. The key to most policies is not the theory – it's the implementation. Second, regardless of how CSAs are designed, the funding phase can be implemented with relative ease, can accommodate a wide range of policy choices, and can accommodate changes in those policy choices over time. From an administrative standpoint, it makes most sense to rely on existing IRS systems to implement the funding phase. The only major administrative issue that would need to be resolved is whether the IRS and Treasury would play a direct role in funding CSAs. In a Universal or Refundable System, it seems likely that they would have to provide funding; in a Voluntary, Non-Refundable System, an IRS and Treasury role in funding CSAs may be desirable but would not be necessary.

II. Administering CSAs[64]

A. *Policy Issues*. Once CSAs have been funded, the question becomes how they are invested and administered. The primary issues that arise in this context relate to: (1) whether the federal government, the private sector, or both should sponsor CSA investment funds; and (2) how should CSA Funds sponsored by the private sector be regulated?

The primary arguments in favor of government-sponsored CSA investment funds ("GCSA Funds") are simplicity and reduced administrative costs. Simplicity is achieved through minimizing the choices faced by participants, many of whom would have no familiarity with private financial markets. Families who have no other investment experience may find it far

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63 As noted above, this would avoid many of the compliance problems encountered in other contexts (e.g., the Earned Income Tax Credit).
64 Portions of the discussion regarding administration of CSAs are taken from Goldberg and Graetz, 16-23.

easier to choose from a limited number of "no frills" funds sponsored by the federal government, rather than sort through more than 7,700 mutual funds offered by the private sector.[65] Administrative cost savings are achieved through GCSA Investment Funds because the government would not incur the marketing costs incurred by the private sector. It can also be argued that a government-sponsored system would enhance tax compliance (because the government could directly monitor funding, funding limits, and distributions) and provide investment security (by limiting investment choices, assuring proper disclosure, and preventing fraudulent misuse of funds). Finally, if a system of Universal CSAs were enacted (*i.e.*, a 100% credit, whether Refundable or Non-Refundable), then GCSA Investment Funds would likely be necessary to deal with those situations where taxpayers made no investment election or did not claim the credit.[66]

The primary argument in support of CSA investment funds sponsored by the private sector ("PCSA Funds") are that they would allow individuals to avail themselves of the wide range of investment alternatives and investment services offered by the private sector, subject to whatever restrictions and regulations Congress decided to impose. It is further argued that the government should not be in the business of running private investment funds, especially in competition with the private sector; that the goals of a government-sponsored system can be accomplished through regulation without direct government involvement; that the government would misuse CSA funds to interfere in the capital markets (by rewarding or punishing certain industries or companies, or by making investment decisions to address fiscal, social or foreign policy issues); and that the CSA goal of encouraging financial literacy is best achieved if participants learn to deal with private sector financial institutions.

The primary argument in favor of restricting CSA investment options (whether private sector or government sponsored) is to regulate the risk incurred by CSA beneficiaries, especially those with no other investment experience. The restrictions could range from rules designed to limit down-side risk and/or volatility (*e.g.*, limit investments to funds meeting specified diversification requirements; limit equity investments to large cap index funds; limit fixed income investments to investment grade securities or Treasuries), to more expansive rules requiring age-appropriate investing (*e.g.*, mandated investments in so-called "life style funds," with asset allocations specified by statute or regulations, based on the age of the beneficiary). The primary arguments against substantial restrictions on CSA investments are that individuals are in the best position to make those kinds of decisions, and that leaving individuals in control of their investment

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65 There were 7,791 mutual funds in 1999 (excluding funds that invest in other mutual funds). INVESTMENT COMPANY INSTITUTE, MUTUAL FUND FACT BOOK 12 (2000).

66 The alternative would be to randomly assign those who failed to designate an investment choice to qualifying private sector sponsors of CSA funds.

It is also worth noting that this issue is more significant than might otherwise appear. The child tax credit was the fourth most common source of errors made on individual income tax returns filings in 1999. As of July 16, 1999, the IRS had mailed about 571,000 notices to taxpayers whose returns contained errors relating to that credit. About 88% of these errors were made by taxpayers who prepared their own returns. Service center processing officials estimate that about ½ of these taxpayers – or about 235,000 families – failed to take the credit, even though they checked the box indicating they had an eligible dependant and other information on the return (*e.g.*, amount of income) indicated that they were eligible. See GAO 1999 REPORT , p. 60.

decisions is an essential part of the CSA program because it empowers individuals to create wealth and encourages financial literacy.

We believe that the case for properly regulated private sector CSA investment funds is compelling, and an essential aspect of any program. The question of government-sponsored funds is far more difficult. On balance, we believe that government-sponsored CSA funds may also be appropriate as a "weigh station" on the road to investment in private sector CSA Funds – but only if limited as described below.

B. *Government-Sponsored CSA Funds*. Following are possible configurations for the government-sponsored CSA Funds model. We would require that the government contract out the management and administration of these Funds to the private sector.[67] From an investment and management standpoint, the government-sponsored funds would operate in much the same way as the highly successful federal employees' Thrift Savings Plan ("TSP").[68]

∃ Limited Choice Investment Profile: Individuals could be allowed to choose from among a limited number of equity index funds (*e.g.*, one based on the Dow Jones or the Standard and Poor 500; one based on the Russell 2000 or the Wilshire 5000; one foreign fund; and one emerging markets fund); and two fixed income funds (*e.g.*, an investment grade securities fund and a Treasuries fund).[69]

∃ Mandatory Investment Profile: As an alternative, the enabling statute and/or implementing regulations could specify a Mandatory Investment Profile. This Mandatory Investment Profile would be similar to so-called lifestyle funds – a mix of fixed income and equity index fund investments with the allocation among funds adjusted to provide a level of risk appropriate to the participant's age. As noted above, a Mandatory Investment Profile alternative would be required in a system of Universal CSAs to deal with those situations where the eligible taxpayer did not specify an investment choice.

∃ Participants would receive written account statements several times each year, and automated account information would be available at any time.

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[67] Requiring that GCSA Funds be contracted out to the private sector is intended to promote the efficient management and investment of CSAs and to reduce the very real risk that the government would use those funds to interfere in the capital markets.

[68] The TSP, which is a retirement savings and investment plan for federal employees that was established by Congress in the Federal Employees' Retirement System Act of 1986, is a defined contribution plan that provides federal employees with a choice of three investment options. First, employees can allocate all or a portion of their accounts to the "G Fund," which consists exclusively of investments in short-term non-marketable U.S. Treasury securities issued directly to the TSP by the U.S. Treasury. Second, employees can allocate all or a portion of their accounts to the "C Fund," which is invested in a Standard & Poor's 500 stock index fund. Third, employees can allocate all or a portion of their accounts to the "F Fund," which is invested in a Lehman Brothers Aggregate bond index fund. Presently, the Federal Retirement Thrift Investment Board, which is responsible for oversight and management of the TSP, contracts with Barclays Global Investors to manage and invest the amounts allocated to the C and F Funds by participants in the TSP. TSP is also adding two additional investment options (a Russell 2000 index and a foreign stock index).

[69] By law, the TSP may make equity investments only in a "commonly recognized index" which is a "reasonably complete representation of United States equity markets."

∃ Participants could reallocate funds a limited number of times each year at no charge (including, at the time they filed their tax returns). Additional changes would be permitted for a fee.

∃ If the system permitted voluntary additional contributions, those contributions could be made only to CSA Investment Funds sponsored by the private sector; *i.e.*, voluntary additional contributions to GCSA Funds would be altogether prohibited.[70]

∃ If the system permitted distributions from CSAs for purposes other than to meet retirement needs, then those distributions could only be made from CSA Funds sponsored by the private sector, and could not be made from government-sponsored CSA Funds.[71]

We anticipate that this configuration would minimize administrative costs while providing reasonable investment choices and investment services to individuals participating in GCSA Funds. It would, of course, be possible to increase or decrease the investment choices and/or services available to participants, with a corresponding increase or decrease in administrative costs. Assuming a configuration similar to the one described above, and after a phase-in period of three to five years, the likely annual administrative costs would be 30 to 50 basis points (0.3 to 0.5 percent). These costs compare favorably with the administrative costs of most private sector funds.[72]

We also anticipate that this configuration would effectively limit the government's role, and would encourage most participants in GCSA Funds to eventually shift their accounts to CSA Investment Funds sponsored by the private sector.

C. *Private Fund Options.* Regardless of whether the system provided for government-sponsored CSA Funds, the CSA program should permit individuals to invest their funds with one or more privately sponsored CSA Funds. As noted above, there are several reasons for making this option available:

∃ It allows individuals to avail themselves of the wide range of investment alternatives and investment services offered by the private sector.

∃ Because individuals can take advantage of private sector options, it will be easier to maintain the GCSA Funds as a low cost, easy-to-understand, limited-choice alternative.

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70 This limitation is appropriate to minimize the government's administrative costs and to restrict competition between the government and the private sector. It should be noted, however, that most of the administrative difficulties would be avoided if voluntary contributions to GCSA Funds were permitted only in connection with the filing of income tax returns.

71 Permitting distributions from GCSA Funds (other than for retirement income and health care needs) would impose substantial administrative burdens on the government, and lead to inappropriate government involvement in private decisions by individuals and families.

72 We have taken this estimate from Goldberg and Graetz at p. 17 (estimate of the costs of administering a Social Security private account system structured in much the same way as the GCSA Funds described above). See also, Goldberg & Graetz at Appendix B. While we have not updated that analysis, we believe that it properly reflects the costs that would be incurred to administer GCSA Funds.

∃ It will reduce the risk that the federal government will "compete" with the private sector.

∃ Finally, it will reduce the risk that politicians and interest groups will seek to use GCSA Funds to pursue unrelated political, social, economic or foreign policy objectives.

1. Funding CSAs Sponsored by the Private Sector. If participants are permitted to contribute to CSAs during the year and report those contributions to the IRS in filing their income tax returns, then the funding issue takes care of itself. If, as discussed above, CSAs are also funded by the IRS, then the question arises as to whether such funding of private sector accounts would be administratively feasible. As explained above, we think current systems could easily accommodate IRS funding.[73] More than 70% of all taxpayers filed refund returns[74] and the IRS and the Treasury Department's Financial Management Services ("FMS") are generally able to issue those refunds within 2-4 weeks after returns are filed.[75] Moreover, during the 1999 individual income tax filing season, approximately 23.45 million individuals elected to have their refunds directly deposited by FMS into their bank accounts.[76] Since funding CSAs is essentially the same activity, we believe it is clear that the IRS and FMS could readily accomplish that task.[77]

2. Regulating CSA Funds Sponsored by the Private Sector. It is apparent that private sector institutions sponsoring CSA Investment Funds, and the Funds themselves, will be regulated regarding permitted investments, financial solvency, and disclosure requirements. Existing regulatory mechanisms should be adequate for this purpose. For example:

∃ As with all tax-advantaged savings programs under current law (*e.g.*, qualified retirement plans, individual retirement accounts, Section 529 Plans, and medical and education IRAs), CSAs should be segregated from other investment funds (*i.e.*, there should be no commingling of assets).

∃ The diversification requirements applicable to mutual funds (regulated investment companies), and the fiduciary obligations under ERISA, provide a starting point for addressing various risk-related issues.

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73 In addition to IRS-specific experience with electronic funds transfers, the increasing reliance on electronic funds transfers in other contexts, e.g., the payment of welfare benefits, also suggests that IRS funding of CSAs sponsored by the private sector could be implemented with relative ease.

74 GAO 1999 REPORT, p. 21.

75 See footnote **[46]**, supra.

76 GAO 1999 REPORT, p 70.

77 Depending upon how the CSA program is structured, the scope of any IRS funding effort would likely be far smaller than the number of refunds that it already issues by way of direct deposit. For example, if the system involved a one-time contribution for young children, the maximum number of IRS funding transfers would be less than 4 million. If the system involved annual contributions over 5 years for each child, maximum number of IRS funding transfers would be less than 19 million. Also, while the number of beneficiaries who would rely on IRS funding is difficult to predict, it seems likely that many participants would choose to fund directly with the private sector, given the additional benefits of funding directly through the private sector (earlier funding, resulting in greater earnings; more investment flexibility; ability to make additional contributions).

∃ CSA Investment Fund sponsors could also be required to offer a minimum range of investment options (similar, for example, to the types of investment options described above that would be offered under the government-sponsored funds).[78]

X There would likely be many CSA Investment Fund sponsors, and each of those sponsors would likely offer a wide range of investment alternatives. However, a number of arguments support a rule requiring that individual beneficiaries maintain accounts with only one sponsoring institution. In particular, it would provide substantial flexibility with respect to investment choices, while: (i) minimizing administrative costs, (ii) facilitating compliance, and (iii) simplifying administration of the more complex distribution rules described below in Part III.[79]

∃ The system could build on current tax return and information reporting requirements to assure that the government receives the information necessary to monitor CSA contributions and the status of individual accounts.[80]

∃ There are several ways to determine which institutions would be permitted to offer CSA Funds, and the conditions under which those Funds could be offered.

∃ One approach would be to impose a uniform set of criteria regarding permitted investments, disclosure, and safety and soundness (*e.g.*, capital requirements, insurance or bonding, etc.). These common standards could be centrally administered by a single, newly created regulatory agency, or could be administered by existing regulatory authorities as part of their overall responsibilities (*e.g.*, the Departments of Treasury and Labor, the Federal Reserve Board, and the Securities and Exchange Commission).

∃ Alternatively, participating institutions could be subject to their existing regulatory regimes. In this context, the legislation could impose additional requirements that were deemed appropriate (*e.g.*, bonding or insurance requirements, net worth requirements, disclosure, permitted investments, etc.).

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78 Some would argue that this requirement would eliminate the need for the government-sponsored alternative. Under current law, these types of alternatives are required by Section 404(c) of ERISA (*i.e.*, self-directed accounts). To qualify as an "ERISA Section 404(c) Plan," the plan must offer a broad range of investment alternatives by providing the participant or beneficiary with a reasonable opportunity to: (A) materially affect the potential return on amounts in his individual account and the degree of risk to which such amounts are subject; (B) choose from at least three investment alternatives: (1) each of which is diversified; (2) each of which has materially different risk and return characteristics; (3) which in the aggregate, enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and (4) each of which when combined with investments in the other alternatives tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio; and (C) diversify so as to minimize the risk of large losses, taking into account the nature of the plan and the size of participants' or beneficiaries' accounts. <u>See</u> 29 C.F.R. § 2550-404c-1(b)(3).

79 For example, as described below, the rules might limit distributions based on the amount, intended use or source of funds being distributed. Administering these rules would be far easier if the beneficiary maintained one or more accounts with only one financial institution.

80 For example, private sponsors of IRAs, SEPs, SIMPLE Plans, Roth IRAs and Education IRAs must file a Form 5498 showing the annual receipt of contributions, rollovers, and recharacterizations for each IRA.

∃ From the standpoint of ongoing compliance, participating financial institutions and their CSA Funds could be monitored by existing regulatory authorities as part of their overall responsibilities (*e.g.*, the Departments of Treasury and Labor, the Federal Reserve Board, and the Securities and Exchange Commission).

∃ While we believe any such regulation would be inappropriate, it should be noted that this structure would also permit rules limiting and allocating administrative costs of CSA Investment Funds.[81]

Once again, we want to emphasize that this administrative structure provides substantial flexibility to Congress in addressing numerous policy issues (*e.g.*, bonding, insurance and/or net worth requirements applicable to CSA Funds and sponsoring institutions; limitations, if any, on permitted investments; age-based portfolio requirements; rules governing spousal rights; the protection of individuals' assets from creditors' claims; and disclosure requirements). Thus, while we believe that any such regulation should be kept to a minimum and that any new rules should be, to the extent possible, integrated with existing rules, the legislation authorizing CSA Funds could impose whatever regulatory requirements Congress deems appropriate.

Based on industry experience with 401(k) and IRA accounts, CSA Fund accounts should cost about $15-25 annually, depending on the amount and kind of service provided (*e.g.*, frequency of statements, frequency of free telephone inquiries, etc.).[82] For the reasons noted above, we suggest that each beneficiary maintain accounts with only one financial institution; however, if participants are permitted to elect to have multiple CSAs with different financial institutions, they should bear the costs of such choices.

D. *Summary*. As with the administrative aspects of funding, while the administrative issues related to managing CSAs are not glamorous, they are critical to the success of the program. It is clear that the private sector can and should play the primary role in this regard. However, it is also possible, and may be necessary in the context of a Universal or Refundable System, to provide for a back-up system of government-sponsored investment alternatives. Experience with the government-sponsored Thrift Savings Plan indicates that such an arrangement would be entirely feasible.

[81] The structure described above could be regulated quite heavily. For example: (i) financial institutions offering CSA Funds might be limited in allocating marketing costs to such Funds, or offering "bonuses" for individuals to shift their investments to a different offeror; (ii) CSA Fund sponsors could be required to allocate all costs within each fund on an asset, rather than fixed dollar per account basis; (iii) an asset-based charge could be levied on CSA Funds to defray the cost of administering government-sponsored CSA Funds; and (iv) CSA Funds could be required to accept CSAs above some asset value. While the structure described above could accommodate rules of this type, we want to emphasize our view that such regulation would not be appropriate, and that adequate disclosure rules would be far preferable.

[82] We have taken this estimate from Goldberg and Graetz at p. 22. While we have not updated that analysis, we believe that it properly reflects the costs that would be incurred to administer GCSA Funds.

III. Distributions from CSAs

A. *Policy Issues.* The final feature of a CSA program is the distribution of funds to beneficiaries. The rules governing distributions raise three primary issues: permitted use of CSA funds; rules to protect CSA assets; and rules governing distributions upon a beneficiary's death.

1. Permitted Uses of CSA Funds. Along with issues relating to the structure of federal tax incentives, this is surely the most controversial CSA design issue.

(a) *One view is that CSAs should only be used to provide for retirement needs, supplementing Social Security and Medicare/Medicaid benefits.* The primary argument in favor of this approach is that the primary goal of CSAs is to provide an infrastructure for savings. Especially in the context of a Universal, Refundable System, requiring that funds be maintained until retirement is the best (and perhaps only) way to achieve this objective.

In addition, a Universal, Refundable System where distributions were permitted only for retirement uses or on death, would help assure that Social Security and Medicare/Medicaid will be adequately funded. Current projections show that both the Social Security and Medicare trust funds are insolvent – *i.e.*, will be unable to meet their future obligations as they come due. Moreover, the cost of Medicare and Medicaid are imposing substantial and growing demands on general revenues, there is increasing pressure on the Federal government to subsidize additional benefits for the elderly in the form of prescription drugs, and it seems likely that demands for subsidized long-term care will not be far behind. As reflected in Table I, *supra*, the potential impact of CSAs, if they are viewed as "pre-funding" these obligations, is quite substantial. Thus, assuming a funding structure of $1,000 at birth and $500 each of the next five years, and assuming a relatively conservative earnings rate of about 7%, the value of a CSA at age 65 would be almost $260,000.

(b) *The competing view is that beneficiaries should be allowed to use CSAs for other purposes*. Under this view, there are a variety of equally legitimate uses for CSA funds. Some would permit withdrawals for any purpose; others would limit withdrawals for specific uses. In general, these other uses fall in one of two categories: investment and need. Within the investment category, suggested uses include: (i) human capital (education and job training); (ii) capital assets (a first-time home); and (iii) income-related (a car for transportation to work or seed-money to start a business). Within the needs category, suggested uses include (i) unemployment, (ii) health care, (iii) disability, and (iv) retirement. Especially in the context of a Voluntary CSA Program, it is argued that individuals should be able to make their own decisions regarding the best use of their savings and that considerable flexibility is necessary to encourage contributions (*i.e.*, families are unlikely to put away their own money if they know that they cannot get it back for many, many years). In addition, the history of provisions that encourage retirement savings strongly suggests that Congress would likely provide "early access" to CSA funds. For example, individuals can withdraw funds from Section 401(k) plans, traditional IRAs, and Roth IRAs for any purpose upon payment of a penalty. In addition, individuals can withdraw funds from such accounts without paying a penalty upon disability or death and to cover certain costs associated with a qualified first-time home purchase, qualified medical expenses, health insurance premiums after becoming unemployed, and qualified higher education.[83] Attachment 1 summarizes withdrawal provisions governing various tax-favored savings vehicles.

In considering this question, it is worth referring back to Table 4 showing CSA account values at various ages. Assuming that they are funded with $1,000 at birth and $500 each of the next five years, the beneficiary's account value at 18 would be slightly over $10,000; at age 35, it would be around $35,000. The former would go a long way to funding post-secondary education costs at many institutions; the latter would go a long way to covering the cost of a first home. If CSA funding were limited to $1,000 at birth, these figures would be over $3,400 and around $11,000, respectively.

Not surprisingly, there are numerous disagreements among those who would permit withdrawals from CSAs prior to retirement. Some would oppose any restrictions on use; others would limit (or severely limit) uses. Some would limit uses to post-secondary education; some would permit withdrawals by parents and guardians for K-12 education. Some would permit withdrawals only by beneficiaries (effectively limiting distributions until beneficiaries reach some specified age); some would permit withdrawals on behalf of beneficiaries at any age. While undoubtedly not persuasive in the eyes of those who would permit withdrawals prior to retirement, it is worth noting that these issues would all avoided in a system that did not permit pre-retirement withdrawals for any purpose.

(c) *A third alternative would be to provide a hybrid system, with different distribution rules for different portions of CSAs*. There are any number of hybrid systems that could be implemented, depending on the goals and design of CSAs. In general, the rules could require that a portion of CSA fund be used only for retirement, while permitting some funds to be withdrawn or borrowed for certain purposes. For example, if the system provided for Universal CSAs with voluntary additional contributions, the rules could require that funds attributable to the former be used only for retirement, while funds attributable to voluntary contributions could be used for other purposes. The distinction could also be based on a dollar threshold or the source of funds (*e.g.*, contributions, earnings, account value, or tax benefits). As an administrative matter, a hybrid system could be implemented through parallel accounts; in the absence of such an arrangement, it would be necessary to specify rules to allocate income and changes in asset value among amounts available for different uses.

2. Treatment of CSA Funds upon the Beneficiary's Death. If the beneficiary of a CSA dies before all of the funds have been distributed, what happens to the funds? This is not an insignificant issue. For example, of the 4,000,000 children born in this country each year, it is estimated that about 28,000 will not live to age 1, that about 35,000 will not live to age 5, that about 43,000 will not live to age 15, and that about 56,000 will not live to age 20.[84] One approach would be to treat the beneficiary as the owner of the funds in his or her CSA. In that event, the beneficiary (or, if the beneficiary is below a certain age, the beneficiary's legal guardian) would be able to determine how the funds are distributed through the beneficiary's

[83] See Code Section 72(t).

[84] National Vital Statistics Reports, Centers for Disease Control and Prevention, "Deaths: Final Data for 1998," p. 21 (July 24, 2000). As a practical matter, this data suggests that it may be appropriate to fund CSAs not earlier than the time a beneficiary reaches age 1.

estate. Under this approach, in the absence of any designation, the CSA funds would pass in accordance with state law provisions governing intestate succession. Allowing the beneficiary or the beneficiary's legal guardians to choose the recipient of the funds upon his or her death is consistent with the notion that beneficiaries own their CSAs and are best situated to make decisions regarding successor beneficiaries. This approach is also consistent with the goal of having CSAs encourage financial literacy because it requires that beneficiaries and their legal guardians attend to an additional aspect of financial planning.

A second approach would be for the government to impose certain limitations on how the funds are distributed. For example, the rules could require that the funds be rolled over into a CSA or other tax-favored account (*e.g.*, a 401(k) plan, Keogh, IRA, Roth IRA, or education savings account); the choice among these accounts could be mandated by statute or left to the beneficiary or the parents of minor children, with appropriate default rules if no selection was made. The rules could specify particular beneficiaries or identify a permitted class of beneficiaries, (again, with appropriate default rules if the beneficiary made no selection).[85]

B. *Protecting Accounts from Creditors and Hidden Taxes*. Before turning to the administration of various distribution rules, it is worth highlighting the need to address "coerced" distributions from CSAs. An issue that is common to all tax-favored savings arrangements is the extent to which those funds can be reached by creditors of the beneficiary.[86] For example, bankruptcy courts generally hold that IRAs are property subject to attachment under bankruptcy proceedings unless a state statute provides otherwise.[87] This is in contrast to qualified plans, which generally are protected from creditors under the anti-assignment and anti-alienation provisions of the Code and ERISA.[88] The IRS may levy upon IRAs, but will not do so unless the taxpayer "flagrantly disregards" demands for payment of unpaid taxes.[89] Arguably, these provisions may be adequate; and as evidenced by the current debate over Bankruptcy Reform, issues relating to creditors' rights and the protection of debtors are highly controversial. However, we believe that it would be desirable for any CSA legislation to provide for Federal pre-emption and uniform rules protecting CSAs from the reach of a beneficiary's creditors (including the IRS).

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[85] A third alternative, applicable only to the extent CSAs are funded by 100% tax credits and only to the extent those amounts cannot be withdrawn prior to retirement, would be to have amounts that have not been withdrawn revert to the Federal government. The only benefit of this approach (which we view as inconsistent with the basic goals of the CSA program) would be to reduce the overall cost of the program.

[86] Consistent with treating a CSA as the property of the beneficiary, funds maintained in that account could not under any circumstances be reached by creditors of third parties (including parents or others who contribute to the account).

[87] See, e.g., Velis v. Kardanis, 949 F. 2d 78 (3d Cir. 1991); In re Garrison, 108 B.R. 760 (N.D. Okla. 1989); In re Dalaimo (Bkrtcy. S.D. Cal., Case No. 86-7092-H11, June 30, 1988) (IRAs of retirees are exempt under California law protecting funds necessary for support); In re Seltzer, 104 F.3d 234 (9th Cir. 1996) (first $100,000 in IRA assets are exempt under Nevada statute).

[88] See Code Section 401(a)(13) and ERISA Section 206(d)(1). IRAs are not covered by these provisions.

[89] IRS Manual S536(14).5(1); Code Section 6334 (IRAs are not included among the property exempted from levy). While beyond the scope of this paper, we should note our view that this provision is ill-advised and should be changed.

A second issue that is gaining increased attention relates to the so-called "hidden tax on savings" that is imposed by various government and private sector means tested programs.[90] While the problem is pervasive, one common illustration is the asset test applied to Medicaid benefits – and the widely marketed strategy whereby individuals are encouraged to "get rid of" their assets in order to qualify for government subsidies.[91] This same issue arises in the context of CSAs, and is made more complex because the CSA beneficiary may be a dependant who is supported by parents or other family members. Presumably, legislation could limit the circumstances under which CSA balances would be taken into account in determining eligibility of either the beneficiary or third parties for government-sponsored means tested programs.[92]

Similar questions arise with respect to means tested programs administered by the private sector – in particular, the scholarship programs of tax exempt educational institutions. For example, if CSA balances were taken into account on a dollar-for-dollar basis in allocating scholarship funds, the effect would be a 100% tax on those accounts.[93] While this issue has not been addressed to date in legislation, and is beyond the scope of this paper, we believe it is a serious and growing problem that threatens to undermine all wealth creation policies targeted at low and middle income families. One approach that could be considered in the context of CSAs would be to provide that CSA funds could not be taken into account by educational institutions in determining financial aid. This requirement could be policed by imposing a substantial excise tax for any violation.

The situation is more complex if funds can be withdrawn from CSAs to pay for schooling. Some would argue that if CSAs can be used for that purpose, they can legitimately be taken into account in allocating financial aid. The response is this would convert a permitted use to a mandatory use and convert CSAs to a disguised subsidy for post-secondary schools. That is, if a dollar-for-dollar off-set were imposed in determining financial aid (*e.g.*, if a beneficiary had a CSA balance of $5,000, his or her scholarship would be reduced by $5,000), then the practical effect would be to require use of the CSA to pay for education. In turn, CSAs would become little more than a transfer payment from the Federal government to post-secondary schools.[94]

C. *Distributions for Lifetime Uses*. If individuals are allowed to withdraw funds from their CSAs for designated purposes prior to retirement (*e.g.*, to pay for college, buy a home or start a business), administrators of CSAs will need to implement mechanisms to ensure that

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[90] A comparable "hidden tax" is also imposed on income in the context of means tested programs (including tax benefits that are phased-out), that can result in extremely high effective tax rates.

[91] See e.g., 42 U.S.C.A. § 1382(a) (imposing asset limitations on Medicaid recipients); 42 U.S.C.A. § 1382b(a) (excluding certain assets from the asset limitation test); 42 U.S.C.A. § 1320a-7b(a)(6) (making it a federal crime in certain situations to transfer assets causing Medicaid ineligibility); Jan Ellen Rein, "Misinformation and Self-Deception in Recent Long Term Care Policy Trends,"12 J.L. & Pol. 195 (1996) (discussing Medicaid planning).

[92] Like many of the matters discussed here, this issue is more complex than might first appear. In particular, it implicates the questions discussed below regarding permitted uses. For example, if CSAs can be used for education, should they be taken into account in administering Pell grants? If they can be used to meet pre-retirement health care needs, should they be taken into account in administering the Medicaid program?

[93] The same applies to all assets that are taken into account in determining financial aid – including tax advantaged arrangements such as IRAs, 401(k)s, and medical savings accounts.

[94] The impact of this transfer payment would be difficult to predict. For example, in a Universal, Refundable System with Phase-Outs, it is arguable that one effect might be to hold down tuition costs, thereby benefitting upper income families.

the funds are withdrawn for proper purposes. As noted above, most tax favored savings arrangements already permit (or require) distributions for purposes other than retirement. For example, individuals can withdraw funds from Section 401(k) plans, traditional IRAs, and Roth IRAs without paying a penalty upon disability or death and to cover certain costs associated with a qualified first-time home purchase, qualified medical expenses, health insurance premiums after becoming unemployed, and qualified higher education.[95] Since the sponsors of these arrangements would also likely be the sponsors of CSAs, rules governing lifetime withdrawals from CSAs could be integrated with existing systems. Likewise, from the standpoint of compliance, the IRS could make use of the same procedures that it uses in monitoring withdrawals from other restricted accounts.[96]

Under a system of government-sponsored CSA Investment Funds, it would be possible for the government to contract out the monitoring of distributions along with all other aspects of account management. Alternatively, beneficiaries could be required to transfer their accounts to Investment Funds sponsored by the private sector. We recommend this latter approach for several reasons: (i) it would minimize the administrative costs of government-sponsored CSA Funds; (ii) it would minimize the risk of government intrusion in the private activities of beneficiaries; (iii) it would provide beneficiaries with an added incentive to participate in the private sector; and (iv) it might deter "impulse" withdrawals by those invested in GCSAs (the administrative step of changing investments, especially if permitted only at certain times, and restrictions imposed by private sector sponsors on newly opened CSAs, are two potential barriers).

Any system that required sponsors to oversee distributions would likely impose additional administrative costs. There are several ways to deal with these costs. One approach would simply permit the private markets to sort out this issue, as they have done in similar situations under current law. A second approach would be to regulate various aspects of lifetime withdrawals in a manner consistent with CSA policy goals. For example, if one objective were to discourage withdrawals while not prohibiting them (*i.e.*, cause beneficiaries to "think twice" before making use of their savings), it would be possible to require that CSA Investment Fund sponsors charge beneficiaries a fee for withdrawals, permit withdrawals only at certain times (*e.g.*, quarterly), or require advance notice of planned withdrawals (*e.g.*, 60 days).

D. *Distributions that Supplement Social Security Benefits*. As a preliminary matter, there is a policy question of what portion of a CSA should beneficiaries be required to annuitize on retirement. The law could impose no mandatory annuitization requirements, or could require: (i) all CSA funds must be annuitized; (ii) CSA funds must be annuitized to the extent necessary to provide some minimum income level (when combined with other Social Security benefits); or (iii) limited annuitization alternatives (*e.g.*, for funding of joint-and-survivor long-term care coverage).

95 See Code Section 72(t).

96 For example, private sponsors of IRAs, SEPs, SIMPLE Plans, Roth IRAs and education IRAs must file a Form 1099-R showing annual distributions, conversions and rollovers from such accounts. Under the Form 1099-R, the private sponsor is required to indicate whether the distribution is subject to tax or eligible for an exemption.

There are two options for administering the distribution of CSA funds used to supplement Social Security benefits. These options can accommodate wide range of policy options regarding distributions. They are workable if a CSA can be used for other purposes and beneficiaries are permitted (but not required) to use amounts remaining in the CSA when the beneficiary reaches retirement age to supplement social security. They are equally workable if the entire amount of a CSA must be used to supplement Social Security.

1. *Social Security-Sponsored Annuity Option.* Under this alternative, an individual's CSA funds would be transferred to Social Security when the individual first begins receiving Social Security benefits.[97] The amount of the individual's Social Security benefits would be increased based on the value of the individual's CSA. In other words, the government would decide what amount of annuity to pay for a given CSA accumulation. The primary virtue of this alternative is its simplicity. From the individual's perspective, it requires no choices or decisions. The individual will receive only one monthly payment, and will deal with only one party making payments (the Social Security Administration). From the government's perspective, the only additional administrative costs occur at the outset: collecting the CSA funds and making the appropriate adjustment to Social Security payments.

Social Security could implement this alternative by contracting out all aspects of the program (other than processing beneficiary payments) to the private sector. The private sector would set the annuity amount (with indexing for inflation) and bear investment and mortality risks. We believe that contracting out is a better alternative than having Social Security directly administer CSA-funded annuities. Contracting out to the private sector under rules that protect against companies segmenting longevity risks permits the CSA assets to realize a higher rate of return,[98] market to resolve pricing issues[99] and minimizes the adverse impact of a government-run system on the private annuities market. The government's role would be limited to setting appropriate annuity specifications, processing payments, and regulating and supervising the private sector financial institutions responsible for the program.

In this regard, it is important to note that a market structure is already in place to implement this system. Thus, for example, most defined contribution plans offer annuity options which are provided by insurance carriers (rather than the plan itself).[100]

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97 If CSAs are used to supplement Social Security benefits, there are a number of timing options for when a beneficiary can first gain access to the funds in his or her account. If the Social Security-Sponsored Annuity Option described in the text is adopted, then, for simplicity reasons, we believe that CSAs should first be accessible when the beneficiary begins to receive Social Security benefits. Other timing options include: (i) at the normal Social Security retirement age (or when they qualify for Social Security disability payments); (ii) at the beneficiary's election, any time after they first begin collecting Social Security benefits (*i.e.*, permit continued accumulations); or (iii) before they begin collecting Social Security benefits.

98 If the government directly administered the program, the implicit return on post-retirement CSAs would be limited to the return on Treasury obligations.

99 For example, if the government did not contract out, what return would the government assume on the funds it received from the individuals CSA and would the government be permitted to invest those funds in the same way that private insurers invest premiums? Moreover, who would bear the risks if the government underprices its annuity (taxpayers or beneficiaries) and what mechanism would be used to implement the allocation of risks?

100 For an extensive discussion of this issue, see James Poterba and Mark Warshawsky, <u>The Costs of Annuitizing Retirement Payouts from Individual Accounts</u>, prepared for the Conference on Administrative Costs of Individual

2. *Private Market Annuity Options.* Individuals and their beneficiaries could also be permitted to purchase private annuity options so long as problems of adverse selection and risk segmentation are addressed. Permitting individuals and their beneficiaries to avail themselves of the wider range of annuity alternatives available from the private sector offers several advantages. For example, (i) a family may prefer a joint and survivor annuity with a pattern of payments that differs from pay-outs under Social Security; (ii) a family may prefer annuity payments that cover a disabled child or elderly parents; (iii) a worker may want to retire early, with a "retirement gap" annuity that runs for a term of years, until Social Security benefits begin. Moreover, by allowing individuals to take advantage of private sector options, it will be possible to maintain a Social Security Annuity Option as a simple, low cost, easy-to-understand alternative.

It would be necessary to regulate the institutions offering private market annuities in exchange for CSA balances with regard to segmentation of longevity risks, safety and soundness, and disclosure.[101] Because insurance has been regulated historically at the state level, there is no existing Federal regime to regulate annuities. For this reason, a threshold decision is whether to rely on the existing state-based structure, create a new Federal structure, or create a hybrid system of Federal standards for qualifying annuities, enforced by the states.

E. *Distributions to Help Meet Retiree Health Care Needs.* At present, there is general agreement that health care policy, especially as it relates to the elderly, is in desperate need of reform – and no agreement on what reforms make sense. It is therefore difficult to anticipate how to structure CSAs to help meet retiree health care needs. For example, using CSAs to supplement Social Security could provide additional funds to pay costs not covered by whatever health care reforms are enacted in the years ahead. Alternatively, CSA balances could be used to pre-pay supplemental insurance to cover health care costs not otherwise covered by a reformed health care system. Regardless, however, it seems clear that using CSAs to pre-fund retiree health care costs could play a significant role in health care reform.

Conclusion

Two conclusions emerge from the foregoing discussion. First, CSAs pose numerous difficult and contentious design issues – in particular, should they be Universal or Voluntary; should they be Refundable; and what rules should govern distributions? Second, no matter how those issues are resolved, a workable and administrable system of CSAs could be implemented.

Retirement Accounts as Part of Social Security Reform, sponsored by the National Bureau of Economic Research on December 4, 1998, in Cambridge.

[101] Likewise, policy considerations may place constraints on the types of annuities that can be offered. For example, annuities might be required to provide (i) benefits parallel to existing Social Security benefits (*e.g.*, inflation-adjusted; joint-and-survivor annuities, with reduced payments to the survivor); (ii) benefits parallel to the qualified plan/IRA rules (account balance divided by life expectancy); (iii) a number of other qualities (*e.g.*, the ability to include other beneficiaries under joint-and-survivor annuities; no reduction in payments to survivor; varied payment streams; term certain, on early retirement). In addition, it may be appropriate to impose some kind of minimum guarantee requirement on participating carriers to deal with credit and performance risks.

From the standpoint of fiscal, social and tax policy, a strong case can be made for Universal CSAs covering all children (*i.e.*, a refundable credit with no phase-out), under a system that permits voluntary additional contributions, is administered primarily but not exclusively by the private sector, and imposes substantial restrictions on some (but not all) CSA funds. While variations on this policy have enjoyed some bi-partisan support, it raises contentious policy issues that have been difficult to resolve. Refundability is not a popular concept in Congress, among either Republicans or Democrats. Phased-out tax benefits have become a staple of the Democratic party, with only token resistence among Republicans. Congress has had bi-partisan difficulty imposing and maintaining restrictions on withdrawals from tax-favored savings accounts, and the two parties are in open conflict over whether tax-favored savings can be used for K-12 education and home schooling. Under these circumstances, the political barriers to a broad-based CSA Program are formidable. In contrast, Voluntary CSAs (with phase-outs and no refundability), administered entirely by the private sector and with limited restrictions on withdrawals, are consistent with much of the legislation to encourage savings that has been enacted during the past two decades.

One question this suggests is whether Voluntary CSAs would be a reasonable step in the direction of more inclusive asset building policies – or would they simply exacerbate the widening disparity in wealth. There are certain to be many different views with respect to the former, and we have little to add to that debate.

A second question is whether agreement could be reached on Universal CSAs covering all children – and what steps would be needed to reach that result. With respect to the latter, however, it is clear that the primary barriers relate to (i) the refundability issue; (ii) disagreements over permitted use of funds; and (iii) administrative concerns. While the refundability debate cannot be resolved on normative grounds, we believe that considerations of tax policy and tax administration argue strongly for a refundable system in the CSA context, and recommend that addition work in this area be pursued. With respect to disagreement over use of funds, we believe that political consensus could be more easily reached on a program that substantially (or completely) restricts uses prior to age 62, and that the primary stumbling block is among traditional advocates for low-income families. With respect to administrative concerns, it seems clear that it would be relatively easy to implement a broad-based system of CSAs; indeed, such a system could provide a platform for substantial tax simplification in other areas. The primary challenge on the administrative side would be to obtain agreement among affected financial institutions.

Attachment 1: Summary of Various Federal Tax-Favored Savings Programs and Tax Incentive Programs

Program	Contributions/Growth	Phase-Out Range	Distributions
401(k) Plans	Employees can elect to have up to the lesser of $10,500 or 15% of their compensation contributed to a 401(k) plan without income recognition. Total annual contributions to a 401(k) plan cannot exceed the lesser of $30,000 or 25% of the participant's compensation. Employees can make additional contributions and employers can make matching contributions with after-tax dollars (*i.e.*, the employee is taxed on the amount of the contribution). Assets in a 401(k) plan grow tax-free while held in the trust.	No phase-out range, but contributions are capped.	Pre-tax contributions can be withdrawn before age 59½ in the event of disability, hardship (including for example, the education of a dependant, the purchase of a primary residence, and major medical expenses which are not covered by insurance), or separation from service. Hardship withdrawals are subject to income tax and a 10% penalty.
Deductible Individual Retirement Accounts (IRAs) (Code Section 219)	Annual contribution cannot exceed the lesser of $2,000 or the taxpayer's compensation. Contributions can be made until the taxpayer reaches age 70½. Taxpayer may deduct the contribution from gross income up to the maximum allowable contribution. Contributions in excess of the maximum allowable annual contribution are subject to a 6% excise tax each year they remain in the IRA. Assets in a deductible IRA grow tax-free while held in the trust.	Between $32,000 and $42,000 for single individuals. Between $52,000 and 62,000 for married individuals filing jointly.	Distributions are includible in gross income. Distributions prior to age 59½ are subject to a 10% early withdrawal tax unless withdrawn for: (i) distributions to the beneficiaries or estate of a deceased IRA owner, (ii) disability, (iii) substantially equal periodic payments, (iv) a qualified first-time home purchase, (v) certain medical expenses, (vi) health insurance premiums after becoming unemployed, (vii) qualified higher education, or (viii) a levy. At age 70½, there are required minimum distributions; failure to distribute results in penalties.
Nondeductible IRAs	Same as deductible IRA, except the taxpayer cannot deduct contributions from gross income.	No phase-out range, but contributions are capped.	Same as deductible IRA.

Program	Contributions/Growth	Phase-Out Range	Distributions
Roth IRAs (Code Section 408A)	Same as deductible IRA, except (i) the taxpayer cannot deduct contributions from gross income and (ii) contributions can be made after the taxpayer reaches age 70½.	Between $95,000 and $110,000 for single individuals. Between $150,000 and $160,000 for married individuals filing jointly.	Distributions are not includible in gross income if they are made (i) after the individual reached age 59½, (ii) on or after the death of the individual, (iii) on account of the individual being disabled, or (iv) for first-time home buyer expenses up to $10,000. To be tax-free, all distributions must occur at least five years after the first contribution to the Roth IRA. Distributions that do not satisfy these requirements may be subject to a 10% early withdrawal tax.
SIMPLE IRAs (Code Section 408(p))	The maximum annual amount of salary reduction contributions is $6,000. The IRS can adjust this amount by $500 increments to reflect changes in the cost of living. An employer must make a matching contribution equal to 100% of the employee's salary reduction contribution; however, the maximum permitted matching contribution is limited to 3% of the employee's compensation (with exceptions allowing for a smaller percentage on occasion). Alternatively, an employer can elect to make nonelective contributions equal to 2% of the employees compensation (taking into account up to $160,000 of the employee's compensation). Contributions to a SIMPLE IRA are excludible from federal income tax and are not subject to income tax withholding. However, salary reduction contributions to a SIMPLE IRA are subject to tax under FICA and FUTA. Contributions in excess of the maximum allowable annual contribution are subject to a 6% excise tax each year they remain in the SIMPLE IRA. Assets in a SIMPLE IRA grow tax-free while held in the trust.	A SIMPLE Plan can exclude employees if they did not receive at least $5,000 in compensation during any two preceding years or are not reasonably expected to receive at least $5,000 in compensation in the year in which contributions are made.	Same as for traditional IRAs, except that if the early withdrawal tax applies during the two year period that starts on the first day that contributions are made into a taxpayer's SIMPLE IRA, the rate of the early withdrawal tax is increased from 10% to 25%.

Program	Contributions/Growth	Phase-Out Range	Distributions
SEP Arrangements (Code Section 408(k))	Contributions to a SEP are excluded from federal income, FICA and FUTA taxes. The maximum amount that can be contributed by an employer is the lessor of (i) 15% of the employee's compensation (not including the SEP contribution) or (ii) $30,000. Contributions in excess of the maximum allowable annual contribution are subject to a 6% excise tax each year they remain in the SEP. Assets in a SEP grow tax-free while held in the trust.	No phase-out range, but contributions are capped.	Same as for traditional IRAs.
Education IRAs (Code Section 530)	Maximum contribution of $500 per beneficiary per year until age 18. Contributions to education IRAs are nondeductible. Contributions in excess of the maximum allowable annual contribution are subject to a 6% excise tax each year they remain in the education IRA. Assets in an education IRA grow tax-free while held in the trust.	Between $95,000 and $110,000 for single individuals. Between $150,000 and $160,000 for married individuals filing jointly.	Distributions are tax-free for qualified higher education expenses (including, for example, room and board, tuition, fees, books, supplies and equipment). A 10% penalty tax applies for distributions that are not used for educational expenses, unless (i) made to a beneficiary or estate after the death of the designated beneficiary, (ii) due to the disability of the designated beneficiary, or (iii) on account of a scholarship, allowance or similar payments. Any balance remaining when a beneficiary becomes 30-years old must be distributed within 30 days and the earnings portion of such distribution is included in the beneficiary's gross income and subject to the 10% penalty. There are no tax consequences if: (i) amounts in an education IRA are rolled into an education IRA for another beneficiary of the same family or (ii) the beneficiary of an education IRA is changed to a family member of the old beneficiary.

Program	Contributions/Growth	Phase-Out Range	Distributions
Medical Savings Accounts (Code Section 220)	Maximum annual contributions equal to the lesser of 65% of the annual deductible for self-only coverage (75% for family coverage) or the individual's compensation. Taxpayers may deduct the contribution from gross income up to the maximum allowable contribution. Contributions in excess of the maximum allowable annual contribution are subject to a 6% excise tax each year they remain in the medical savings account. Assets in an medical savings account grow tax-free while held in the trust.	No phase-out range based on compensation.	Distributions for qualified medical expenses are not included in gross income. Distributions that are not for qualified medical expenses are included in gross income and subject to an additional tax of 15%, unless (i) distributed upon death or disability of the beneficiary, or (ii) distributed after the beneficiary reaches the age for medicare eligibility.
Qualified State Tuition Programs (Code Section 529)	Contributions to a qualified state tuition program are nondeductible. A qualified state tuition program must provide adequate safeguards to prevent contributions in excess of those necessary to provide for qualified higher education expenses.	No phase-out range, but contributions are capped.	Distributions from a qualified state tuition program are generally included in the distributee's income. A qualified state tuition program must impose more than a de minimis penalty on any refund of earnings from the account which are not used for qualified higher education expenses of the beneficiary, made on account of death or disability of the beneficiary, or made on account of a scholarship, allowance or certain similar payments.
Deduction for Dependents (Code Section 151)	$2,000 per dependent.	Between $126,600 and $249,100 for single individuals. Between $189,950 and $312,450 for married individuals filing jointly.	N/A

Program	Contributions/Growth	Phase-Out Range	Distributions
Child Care Credits (Code Section 24)	$500 credit per year for each dependent child under age 17.	Starting at $75,000 for single individuals. Starting at $110,000 married individuals filing jointly. The credit is reduced by $50 for each $1,000 (or fraction thereof, of modified adjusted gross income over the threshold levels).	N/A
Earned Income Tax Credit (Code Section 32)	The credit is based on a percentage of earned income. The credit is refundable.	The credit phase-in is $0-$4,610 for no children; $0-$6,920 for one child; and $0-$9,720 for two or children. The credit phase-out is $5,770-$10,380 for no children; $12,690-$27,413 for one child; and $12,690-$31,152 for two or more children.	N/A
Deductible Interest on Student Loans (Code Section 221)	Credit up to $2,000 ($2,500 beginning in 2001) for interest paid on a qualified loan for higher education.	Between $40,000 and $55,000 for single individuals. Between $60,000 and $75,000 for married individuals filing jointly.	N/A

Program	Contributions/Growth	Phase-Out Range	Distributions
Adoption Credit and Exclusion (Code Sections 23 and 137)	Credit of up to $5,000 ($6,000 in the case of a child with special needs) for qualified adoption expenses. Employers can pay up to $5,000 ($6,000 in the case of a child with special needs) of qualified adoption expenses in connection with the adoption of a child by an employee without such amounts being included in the employee's gross income.	Between $75,000 and $115,000.	N/A
HOPE Credit (Code Section 25A)	Credit of 100% of the first $1,000, plus 50% of the next $1,000 of qualified tuition and related expenses paid for post-secondary education.	Between $40,000 and $50,000 for single individuals. Between $80,000 and $100,000 for married individuals filing jointly.	N/A
Lifetime Learning Credit (Code Section 25A)	Credit of 20% of qualified tuition and related expenses, capped at $10,000 ($5000 beginning in 2003).	Between $40,000 and $50,000 for single individuals. Between $80,000 and $100,000 for married individuals filing jointly.	N/A
Exclusion of Interest from Education Savings Bonds (Code Section 135)	Certain income from the redemption of a qualified U.S. savings bond is not included in income if the taxpayer pays qualified higher education expenses during the same year.	Between $54,100 and $69,100 for single individuals. Between $81,100 and $111,100 for married individuals filing jointly.	N/A