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The Retirement Savings Tax Credit: A Fact Sheet

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Summary

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) authorized a non-refundable tax credit of up to \$1,000 for eligible individuals who contribute to an IRA or an employer-sponsored retirement plan. The maximum credit is 50% of retirement contributions up to \$2,000. This credit can reduce the amount of taxes owed, but the tax credit itself is non-refundable. The maximum credit is the lesser of either \$1,000 or the tax that the individual would have owed without the credit. Eligibility is based on the taxpayer's adjusted gross income. The eligible income brackets are not indexed to inflation. Taxpayers under age 18 or who are full-time students are not eligible for the credit. The credit was first available in 2002, and as enacted in 2001, it would have expired after the 2006 tax year. H.R. 4 of the 109th Congress, as passed by the House of Representatives on July 28, 2006, and by the Senate on August 3, 2006, would make the retirement savings tax credit permanent.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) authorized a tax credit to encourage low- and moderate-income families and individuals to save for retirement.¹ Eligible taxpayers who contribute to an individual retirement account (IRA) or to an employer-sponsored plan that is qualified under §401, §403 or §457 of the tax code can receive a non-refundable tax credit of up to \$1,000. This credit is in addition to the tax deduction for contributing to a traditional IRA or to an employer-sponsored retirement plan. In determining the amount of the credit, neither the amount of any refundable tax credits for which the taxpayer is eligible nor the adoption credit are taken into consideration. The retirement savings credit was first available in 2002, and as enacted in 2001, it would have expired after the 2006 tax year. Section 812 of H.R. 4 of the 109th Congress, the Pension Protection Act, as passed by the House of Representatives on July 28, 2006, and by the Senate on August 3, 2006, would make the retirement savings tax credit permanent. H.R. 4 would not make the retirement savings tax credit refundable nor index the eligible income brackets to inflation.

Taxpayers claim the credit on their federal income tax returns. Taxpayers who contribute up to \$2,000 (for all plans combined) to a traditional IRA, a Roth IRA, or an

¹ The retirement savings tax credit is authorized in the Internal Revenue Code at 26 U.S.C., §25B.

employer-sponsored retirement plan receive a credit that reduces the amount of income tax they owe. The maximum credit is the lesser of \$1,000 or the amount of tax that would have been owed without the credit. The amount of the credit declines as income increases. For individuals with adjusted gross incomes (AGI) under \$15,000 and families with incomes under \$30,000, the credit is 50% of contributions up to \$2,000 for a maximum credit of \$1,000. (See **Table 1**.) Because the credit is based on AGI, it increases the net benefit of contributing to a retirement plan. For example, a married couple filing jointly with income of \$32,000 who contribute \$2,000 to a 401(k) plan would reduce their taxable income to \$30,000 and qualify for a \$1,000 tax credit. The net effect is that the \$2,000 contribution to the 401(k) plan costs them only \$1,000.

Table 1. Credit Amounts for the Savers' Credit

| Filing Status and Adjusted Gross Income | | | Amount of Credit |
|---|----------------------|-------------------------|--|
| Single | Head of Household | Married, Filing Jointly | |
| \$1 to \$15,000 | \$1 to \$22,500 | \$1 to \$30,000 | 50% of contribution up to \$2,000 (\$1,000 maximum credit) |
| \$15,001 to \$16,250 | \$22,501 to \$24,375 | \$30,001 to \$32,500 | 20% of contribution up to \$2,000 (\$400 maximum credit) |
| \$16,251 to \$25,000 | \$24,376 to \$37,500 | \$32,501 to \$50,000 | 10% of contribution up to \$2,000 (\$200 maximum credit) |
| More than \$25,000 | More than \$37,500 | More than \$50,000 | Zero |

The credit is not available to taxpayers under age 18 or to full-time students. If a worker or spouse receives a pre-retirement distribution from a retirement plan (such as a hardship withdrawal), any credit taken in that same year and in the two subsequent years will be reduced by the amount of the distribution. For example, if an individual took a \$1,000 hardship withdrawal in 2004 and qualified for a \$500 credit for that year, \$500 of the hardship withdrawal would offset the \$500 credit in 2004. The remaining \$500 of the hardship withdrawal would offset any credits (up to \$500) in 2005 and 2006. Because it is non-refundable, some families may not benefit from the retirement savings tax credit because they have no net income tax liability. Also, the credit may not be large enough to provide a savings incentive for families with incomes near the upper limits. For families in the highest income bracket that qualifies for the credit, the maximum credit is \$200 for a contribution of \$2,000. On the other hand, families that increase their saving to claim the retirement savings credit and who are eligible for the earned income tax credit (EITC) may increase the amount of the EITC for which they qualify.

Data from the IRS indicate that the retirement savings tax credit was claimed on more than 5 million tax returns — representing about 4% of all tax returns — filed each year from 2002 through 2005. The average credit on tax returns filed for tax year 2002 was \$200. The average retirement plan contribution on which the credit was claimed that year was \$1,200. Thus, the average credit for tax year 2002 was equal to about 17% of the average amount contributed to retirement plans by taxpayers who claimed the retirement savings credit.