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The Saver's Credit

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The 2001 tax act created a "saver's credit" that provides saving incentives for households with moderate income. The saver's credit provides a matching tax credit for contributions made to IRAs and 401(k) plans. The eligible contributions are limited to $2,000. Joint filers with income of $30,000 or less, and single filers with income of $15,000 or less, are eligible for a maximum 50 percent tax credit. (A 50 percent tax credit is the equivalent of a 100 percent match on an after-tax basis.)

The credit is not refundable. Therefore, despite the apparent generosity of the 50 percent credit rate, it does not result in any additional incentive to save for many tax-filing units in the relevant income range. The table shows that 57 million returns have incomes low enough to qualify for the 50 percent credit. Only one-fifth of these returns, however, could benefit from the credit if they contributed to an IRA or 401(k) because the credit is nonrefundable. Only 64,000 (or slightly more than 1 out of every 1,000) of the returns that qualify based on income could receive the maximum possible credit ($1,000 per person) if they made the maximum eligible contribution.

For filers with higher incomes, the credit phases down quickly to 20 percent and then 10 percent before being eliminated at $50,000 in income for joint filers (and $25,000 for single filers). The result of the steep declines in the credit rate can be massive marginal tax rates for savers. For example, consider a married couple with income of $30,000 in 2003 and no children. Assume the couple claims the standard deduction and one spouse makes a $2,000 contribution. After the saver's credit, the couple's income tax liability would be about $700. If one spouse earned an extra dollar, however, the couple's income tax liability after the credit would increase to about $1,300 — an increase in taxes of about $600 for an increase in income of $1.

Table 1: Returns That May Benefit From the 50 Percent Saver's Credit by Filing Status
Current Law, Tax Year 2003

	Returns by Filing Status (thousands)[1]				
	Single	**Married Filing Jointly**	**Head of Household**	**Other**	**Total**
(A) Total returns	59,108	56,083	21,242	2,526	138,959
(B) Returns eligible for 50 percent credit based on income[2]	27,402	15,938	13,121	567	57,029
(C) Returns that would receive *any* benefit from 50 percent credit[3]	6,757	3,238	1,187	232	11,414
As share of those eligible based on income (= C/B)	24.7%	20.3%	9%	41%	20%
(D) Returns that would benefit in full from 50 percent credit for maximum allowed contribution[4]	2	3	60	0	64
As share of those eligible based on income (=D/B)	0%	0%	0.5%	0%	0.1%

Source: Urban-Brookings Tax Policy Center Microsimulation model (version 0503-1).
[1]Includes both filing and nonfiling units. Returns of individuals who are dependents of other taxpayers are excluded from the analysis.
[2]Eligible returns exclude filing units above the relevant AGI threshold and those claimed as dependents on other tax returns.
[3]Returns that would receive any benefit from the saver's credit are eligible and would experience some reduction in taxes as a result of the credit if a contribution were made to an approved retirement account.
[4]Returns that would benefit in full from the 50 percent saver's credit for the maximum allowable contribution are eligible and would experience a reduction in taxes equal to the size of the credit if the maximum contribution were made to an approved retirement account.

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