The Saver’s Credit: What Does It Do For Saving?

The saver’s credit is one of very few tax incentives to promote savings that targets low- and middle-income individuals. This paper explains how it can have a broader impact.

The Saver’s Credit Today

Tax advantages have long been given to employer-provided pensions, Individual Retirement Accounts (IRAs), and 401(k)-type plans. The preferential tax treatment for these vehicles is the exclusion or deduction of an individual’s contributions from his or her gross income and the deferral of taxes on earnings.

The current structure of retirement savings tax incentives is inefficient in two ways. First, the setup creates a mismatch between subsidy and need because the largest subsidies—which are directly related to the beneficiary’s marginal tax rate—go to the most affluent. Second, the structure does not effectively promote net savings since higher-income taxpayers, who already have savings, are more likely to be able to shift existing assets in response to the subsidy.

What is the Saver’s Credit?
The Retirement Savings Contribution Credit, or “saver’s credit,” was introduced in the Economic Growth and Tax Relief Reconciliation Act (EGTRRA, P.L. 107-16) of 2001. The tax credit allows filers with low and moderate incomes to reduce their federal income tax liability by making eligible contributions to a retirement or savings vehicle. It also allows them to receive a credit against their federal income tax. The first year taxpayers were able to claim the saver’s credit was 2002. The credit was set to expire at the end of 2006, but on August 17, 2006, President George W. Bush signed the Pension Protection Act of 2006 into law. This act makes the saver’s credit permanent and indexes the Adjusted Gross Income (AGI) thresholds for inflation.

The saver’s credit applies to a maximum annual eligible contribution of $2,000 for each individual who meets the eligibility criteria. As can be seen in Table 1, the credit rate varies with the filer’s AGI. Spouses who are filing jointly can claim the saver’s credit for each of their qualifying contributions.

Who Is Eligible?
To be eligible, the taxpayer has to make contributions to a qualifying retirement plan, his or her AGI has to be within certain limits (see Table 1), and the taxpayer needs to have a federal income tax liability against which the saver’s credit can be applied. The credit is nonrefundable, which means that the biggest impact the credit can have is to reduce the filer’s tax liability to zero, but the credit cannot result

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1 The authors would like to thank Janet McCubbin and two anonymous reviewers for their thoughtful and useful comments.
2 Technically, the value depends on the marginal rates faced by the taxpayer at the time of contribution and withdrawal, as well as the tax-free accumulation of funds. The tax value of a deductible contribution depends on the rate of return earned on the contribution, the amount of time the contribution is invested, and the differences, if any, between the tax rate applied to the contribution and the rate of tax applied to the distribution. Taxpayers may place a distinct value, beyond the calculated tax value, on having a reduction in taxes paid in the year of the contribution. See footnote 2 in William G. Gale, J. Mark Iwry, and Peter R. Orszag, The Saver’s Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans (Washington, DC: The Retirement Security Project, March 2005).
3 Gale, Iwry, and Orszag, 2005.
4 The thresholds for head of household filers are half way between those for married filing jointly filers and all other filers.
Table 1. Saver’s Credit Rates and Effective Matching Rates\(^1\) by Income Level
(Excludes head of household filing status)

<table>
<thead>
<tr>
<th>Adjusted Gross Income (AGI) Eligibility Thresholds</th>
<th>Credit and Effective Matching Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married, filing jointly</td>
<td></td>
</tr>
<tr>
<td>New for 2007 (^2)</td>
<td>Prior to 2007 (^3)</td>
</tr>
<tr>
<td>$0-31,000</td>
<td>$0-30,000</td>
</tr>
<tr>
<td>$31,001-34,000</td>
<td>$30,001-32,500</td>
</tr>
<tr>
<td>$34,001-52,000</td>
<td>$32,501-50,000</td>
</tr>
<tr>
<td>Over $52,000</td>
<td>Over $50,000</td>
</tr>
</tbody>
</table>


(1) We assumed in the calculations that the taxpayer has sufficient federal income tax liability to benefit from the nonrefundable credit shown, and left out the effects of any tax deductions or exclusions associated with the contributions or with any employer matching contributions.

(2) These are the new inflation-indexed thresholds for 2007.

in a tax refund. In the case of a potential credit that exceeds a filer’s tax liability, the amount in excess of the tax liability is neither credited nor refunded.

Additionally, the taxpayer must be age 18 or older before the end of the taxable year. The filer cannot be a full-time student or be claimed as a dependent on another taxpayer’s return.

**Contribution Requirements**
The filer must make eligible contributions in order to apply the saver’s credit to his or her tax return. The type of savings vehicles qualifying for the credit include:

- A traditional or Roth IRA,
- A 401(k) plan (including a SIMPLE 401(k)) or a Roth 401(k),
- A section 403(b) annuity,
- A governmental 457 plan,
- A SIMPLE IRA plan,
- A salary reduction SEP,
- A section 501(c)(18) plan, or
- A tax-qualified retirement plan.\(^5\)

In addition, a total eligible contribution must be reduced by any distributions from any of these same plans in the current year, two previous years, and following year, except for rollovers, even if the distribution is not taxable.

**AGI Limits**
Compared to the AGI thresholds for joint filers, the saver’s credit thresholds for single taxpayers are 50 percent lower (see Table 1). The AGI ranges for the credit determine general eligibility as well as the “credit rate” that applies to each filer. The credit rate is the percentage of the qualified contributions that are credited and applied against the federal income tax liability.

**How Does It Work?**
The credit rate in 2007 is multiplied by the total eligible contributions, up to $2,000, and the

product is the maximum tax credit that can be subtracted from the filer’s liability. As Table 1 shows, for a single person with an AGI from $0 to $15,500, a 50 percent credit rate is applied. For a single individual with an AGI from $15,501 to $17,000, the credit rate is 20 percent, and for a single person with an AGI from $17,001 to $26,000, it is 10 percent.

The maximum contribution of $2,000 for a qualifying filer with an AGI in the lowest range would receive a 50 percent credit of $1,000, which could offset as much as $1,000 in income tax liability (see Table 1). In effect, the “cost” to the individual of the $2,000 contribution is $1,000, which is “matched” by the $1,000 tax credit. As opposed to the credit rate, the matching rate for this filer is 100 percent. However, the maximum eligible contribution could be less than $2,000 once it is reduced by any qualifying distributions (taxable distributions and Roth distributions regardless of taxable/nontaxable status) from qualifying retirement plans.

Some Detailed Examples

Julie is a single filer. She has an AGI of $15,500 and made an eligible contribution of $2,000. Her AGI allows Julie to receive a credit rate of 50 percent, so her maximum tax credit is $1,000. Since a tax credit means that she can apply $1 of the credit to $1 of tax liability, it is equivalent to receiving a $1,000 match on a $2,000 contribution. This match can be used to reduce Julie’s tax liability and can only be maximized if her liability is equal to or greater than $1,000. If she claims the standard deduction, her tax liability is only $705, so she cannot utilize the maximum credit amount. She could only receive the addition $295 if the credit were refundable.

Karen is a single filer and has an AGI of $15,501. She is therefore eligible for a credit rate of only 20 percent. Since she also has an eligible contribution of $2,000, her saver’s credit is worth 20 percent of $2,000, or $400 that can be used to reduce Karen’s tax liability. Effectively, Karen has contributed $1,600 with a $400 match by the federal government to give her an after-tax match rate of 25 percent.

Due to the drop from the 50 percent credit rate to the 20 percent credit rate, the additional dollar of her income above Julie’s results in a reduction of $600 in the maximum tax credit for Karen, when compared to Julie’s hypothetical maximum (although Julie only realized a $705 credit).

Sarah is a single filer. She has an AGI of $17,001 and receives a credit rate of 10 percent on her $2,000 in eligible contributions, or $200 that can be used to reduce Sarah’s tax liability. She has an after-tax cost of $1,800 for her contribution and a $200 match. Therefore, her after-tax effective match rate is 11 percent. Due to the drop from the 20 percent credit rate to the 10 percent credit rate, this additional dollar of income above the threshold for the 20 percent credit results in a tax credit reduction of $200 for Sarah, when compared to Karen. These abrupt drops could be lessened by phasing the credit out more smoothly and by increasing the income limits, which would increase the number of households eligible for the 50 percent match rate.\(^6\)

If Sarah had a husband who had the same AGI as she and also made $2,000 in eligible contributions, they would be able to file for two credits on their joint tax return. If their AGI was twice that of Sarah’s alone, or $34,002, their credit rate would still be 10 percent. Sarah and her spouse would each be able to claim a $200 credit for a total of $400 in tax credits. Their combined after-tax cost in contributions would be $3,600 with a $400 match, so their effective after-tax match rate would still be 11 percent.

Interaction with the Child Tax Credit

Since the saver’s credit is nonrefundable, a filer must have a federal tax liability greater than zero to be able to utilize the credit. When a filer has a relatively low tax liability, she may be unable to use the full saver’s credit despite being eligible

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for it. In addition, the saver’s credit overlaps with other tax credits and also makes it difficult for filers who may be eligible for both to utilize the full saver’s credit if they have a small tax liability.

Since this interaction particularly affects filers who claim both the saver’s credit and the child tax credit, there is less incentive to utilize the saver’s credit for filers who claim the child tax credit. The child tax credit is made up of two parts, a nonrefundable child tax credit and an “additional child tax credit”—which is refundable. The refundable portion of the child tax credit is for certain individuals who get less than the full amount of the child tax credit. For the purposes of this discussion, we are concerned mainly with the nonrefundable child tax credit.

Since more than 47 percent of all tax filers in 2002 claimed the child tax credit, this interaction could affect a large number of taxpayers. All else being equal, the saver’s credit is less effective at reaching taxpayers with children than filers without children. Although a filer may claim the saver’s credit on the tax return, he or she may receive no real advantage from doing so. A field experiment with H&R Block found that about 20 percent of filers with a positive saver’s credit on their 1040 income tax form did not receive a net benefit from it because of the child tax credit. In essence, a filer with limited tax liability would see each dollar of the nonrefundable child tax credit reduce the saver’s credit by a dollar.

How Does This Interaction Occur?
There is a sequence of interdependent calculations for the saver’s credit and the nonrefundable child tax credit when filing the 1040 tax form. So while technically these nonrefundable credits are applied to the filer’s liability simultaneously, the sequence of interrelated calculations results in a de facto order in which the credits are applied. This is known as stacking. The saver’s credit is, in effect, stacked after the nonrefundable child tax credit and before the refundable portion of the child tax credit.

In fact, the saver’s credit overlaps with four other nonrefundable credits: the foreign tax credit, the credit for child and dependent care expenses, the credit for the elderly and the disabled, and the education credits. If the filer’s tax liability is less than the maximum eligible saver’s credit after applying these four “competing” credits, then the saver’s credit is not fully utilized. For example, if a filer has a $500 tax liability after applying these four credits but would otherwise be eligible for a $1,000 saver’s credit, only $500 of the saver’s credit can be used and the rest is forfeited. Also, if a tax liability is reduced to zero after the application of the four credits, then the saver’s credit is not applied at all.

If filers are eligible for a nonrefundable child tax credit in excess of their tax liability, then they may also be eligible for the refundable portion of the child tax credit. A filer who is eligible for both the nonrefundable child credit and the saver’s credit may see a very small change, or even no change at all, in the tax liability that is attributable solely to the saver’s credit.

Improving the Saver’s Credit

What Did We Learn the First Year? In 2002, the first year that the credit could be claimed, approximately 5.3 million filers claimed more than $1 billion in saver’s credits. Although 2002 was too early for definitive evidence of a behavioral response to this tax incentive, it is useful to see who participated in the first year and who did not.

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10 Using the 2002 data requires also using the lower pre-2007 AGI thresholds.
Analysis of the first year of the saver’s credit indicates that it reached a modest number of taxpayers. However, the following results suggest that it was an underutilized vehicle for encouraging the targeted population to save.

- About 28 million taxpayers were eligible for the Saver’s Credit in 2002 (defining eligibility as age 18 or older, having positive earnings, not a full-time student, not a dependent, and having positive tax liability). But only about 30 percent of the eligibles (8.5 million) made net contributions to a qualifying account. 11
- Somewhat more than 60 percent (5.3 million) of the 8.5 million tax returns eligible for the saver’s credit, and with a qualifying contribution, claimed the credit. 12
- An estimated 2.7 million additional taxpayers, could have reduced their tax liability by $496 million by claiming the saver’s credit. 13
- Of 5.3 million filers who claimed the saver’s credit, more than two-thirds (3.6 million) claimed the lowest credit rate (which is 10 percent). 14
- Almost 43 percent of taxpayers who claimed the saver’s credit at the 50 percent credit rate did not have a large enough income tax liability to receive the full credit for which they were eligible, due to the nonrefundability of this credit (as in the case of “Julie” above). 15
- Qualified taxpayers were 70 percent more likely to claim the saver’s credit if they had their taxes figured by a professional preparer or with computer software. 16

2004 Data by Age 17
Changes to the saver’s credit may have had an impact on older taxpayers, since 31 percent of returns claiming the saver’s credit were from filers age 50 and older (in 2004, the latest year for which we have data by age). This is a slightly smaller proportion than the 35 percent of returns overall that were filed by taxpayers in this age range, but it represented more than 1.6 million returns of 50+ filers who claimed the credit in 2004. Additionally, 41 percent of saver’s credit dollars were claimed by filers 50 and older.

Older filers were less likely to use this credit than younger filers. About 7 percent of returns claiming the saver’s credit and about 6 percent of saver’s credit dollars were claimed by filers age 65 and older. If claimants age 50 and older remain so few in subsequent years, public education and expansion of the credit may help to increase participation.

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11 After subtracting pension or IRA distributions that would make them ineligible.
12 Peter Brady and Warren B. Hrung, “Assessing the Effectiveness of the Saver’s Credit: Preliminary Evidence from the First Year,” Paper prepared for the National Tax Association Annual Conference, Miami, FL, November 16-18, 2005. An eligible person is defined as a non-dependent, non-student, over age 18 with positive earnings, and having positive tax liability.
14 Ibid.
15 Ibid.
16 Ibid.
Table 2. Income Tax Filers Age 50 and Older¹ Who Claimed the Saver's Credit by AGI Class, 2004

<table>
<thead>
<tr>
<th>AGI Classes</th>
<th>Percent of Returns</th>
<th>Percent of Dollars Claimed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $10,000</td>
<td>0.6</td>
<td>0.1</td>
</tr>
<tr>
<td>$10,000-$19,999</td>
<td>15.3</td>
<td>13.1</td>
</tr>
<tr>
<td>$20,000-$29,999</td>
<td>29.2</td>
<td>43.6</td>
</tr>
<tr>
<td>$30,000-$39,000</td>
<td>26.4</td>
<td>20.5</td>
</tr>
<tr>
<td>$40,000-$49,999</td>
<td>28.4</td>
<td>22.6</td>
</tr>
<tr>
<td>$50,000 or more</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>99.9</td>
<td>99.9</td>
</tr>
</tbody>
</table>


(1) Those with an AGI of more than $50,000 were not eligible to use the saver’s credit (these data use the pre-2007 AGI thresholds).

(2) Numbers do not sum to 100 percent due to rounding.

2004 Data by Age and AGI ¹⁸

The breakdown by AGI of filers 50 and older claiming the saver’s credit is shown in Table 2 above. The lowest AGI class makes up the smallest portion – less than one percent – of both older credit filers and percentage of dollars claimed. These low numbers in the under $10,000 AGI category reflect the need for filers to have a positive tax liability in order to utilize the credit.

The largest percentage (29 percent) of saver’s credit returns filed by those 50 and older occurred in the $20,000 to $29,999 AGI class. These returns totaled 44 percent of all saver’s credit dollars claimed on returns by taxpayers 50 and older.

Taxpayers with an AGI $30,000 to $39,999 and $40,000 to $49,999 together accounted for 55 percent of filers age 50 and older claiming the credit, although only 43 percent of the credit dollars. The proportionately smaller dollar amounts are to be expected since the credit rate drops off dramatically from 50 to 20 percent at an AGI of $30,001 (see Table 1).

These estimates show that the credit is not as effective as it could be if it were refundable. Taxpayers in the two lowest AGI categories, while they do have the highest effective match rate, would benefit from a refundable credit, more education on the saver’s credit, and assistance with tax preparation.

Recent Trends

The saver’s credit took effect in 2002, so we now have four years of experience with this provision of the tax law. Figure 1 shows the number of filing units that have claimed the credit annually over the period, and the amount of total credit dollars that have been received as a result of tax filers claiming the credit, by adjusted gross income class.

The saver’s credit has been taken up by about 5.3 million filing units in each of the four years of its existence, but that number has declined, albeit very slightly, over the 4-year period. The amount of credit dollars claimed has also declined over time, from $1.06 billion to $940 million in nominal dollars, a decline of roughly 11 percent from 2002 to 2005.

¹⁸ Ibid.
Ideas for Further Reform

The saver’s credit helps correct the “upside down” tax incentive structure for retirement saving\(^\text{19}\) and it may be an effective tool for creating new retirement savings. However, the data suggest that the saver’s credit is underutilized since only 30 percent of those eligible for it make saving contributions, and only 60 percent of those actually claim the credit. The credit could have a bigger impact if the improvements discussed below were made.

Make It Refundable

At least half of the taxpayers eligible for the saver’s credit could benefit from making the credit refundable.\(^\text{20}\) This includes filers who do not have positive income tax liabilities and those whose saver’s credit is limited by an income tax liability smaller than their maximum eligible credit. In addition to ensuring that filers who are eligible have the ability to use the saver’s credit, making it refundable would go a long way toward addressing the problems caused by interactions with other nonrefundable credits, such as being crowded out by the child care credit.

Making the credit refundable would cost about $2 to $3 billion per year.\(^\text{21}\) Another solution would be to better coordinate the saver’s credit with the partially refundable child tax credit. Stacking the saver’s credit before the child credits would cost about $500 million per year.\(^\text{22}\) Variations of direct tax refundability have also been proposed; the credit could be refunded in various ways to bolster savings (such as by making the credit a government matching contribution that is deposited directly into a retirement account).

Expand the Saver’s Credit

A number of other changes could be made to improve the saver’s credit and broaden

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\(^{19}\) Gale, Iwry, and Orszag, 2004.  
\(^{20}\) Brady and Hrung, 2005.  
\(^{21}\) Gale, Iwry, and Orszag, 2004.  
\(^{22}\) Ibid.
participation and eligibility. Eligibility could be expanded by changing the credit rates, changing the income thresholds, or changing how the credit rate is phased out. As seen in the detailed examples, the current drops in credit rates result in fairly severe reductions in credit amounts triggered by an additional $1 in income.

Instead, the credit rate could decline gradually, and the AGI thresholds, which are now indexed, could also be increased in order to encourage more middle-income filers to utilize the credit. Phasing out the credit rate from 50 percent to zero over a $10,000 range of AGI, keeping the income cut-offs for single filers and heads of households in the same proportion to the joint filer thresholds, and extending the 50 percent rate to joint filers with an AGI of $50,000 would cost about $5 billion per year. Each $10,000 extension above $50,000 would cost another $3 to $5 billion per year.

**Conclusion**

The saver’s credit has great potential to effectively target a retirement savings tax incentive to low- and middle-income taxpayers, including a substantial number of filers over age 50. Congress could continue to improve the credit by making it refundable, expanding eligibility, smoothing the credit rate drops, and supporting public education efforts in order to maximize the use of this incentive to save.

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23 Ibid.
24 Ibid.