Buffalo Law Review

Volume 49 | Number 2 Article 8

4-1-2001

The Limits of Saving

Pamela Perun
Urban Institute

Follow this and additional works at: https://digitalcommons.law.buffalo.edu/buffalolawreview

Part of the Retirement Security Law Commons

Recommended Citation
Pamela Perun, *The Limits of Saving*, 49 Buff. L. Rev. 873 (2001).
Available at: https://digitalcommons.law.buffalo.edu/buffalolawreview/vol49/iss2/8

This Symposium Article is brought to you for free and open access by the Law Journals at Digital Commons @ University at Buffalo School of Law. It has been accepted for inclusion in Buffalo Law Review by an authorized editor of Digital Commons @ University at Buffalo School of Law. For more information, please contact lawscholar@buffalo.edu.

The Limits of Saving

PAMELA PERUN†

Like Rip Van Winkle, baby boomers have awoken to find that they have aged. Their retirement is looming, and now it seems that *everyone* is worried about saving for it. The popular press, with the assistance of the financial services industry, has made saving for retirement a trendy topic. Financial planning advice and products devoted to retirement savings fill the daily newspaper, the media, and even the Internet.

When concerns over retirement income arise, we usually look to the private pension system for solutions.[1] Recently, Congress has been considering a set of proposals that increase the amount people can save through the private pension system by raising limits on contributions to defined contribution plans. The current limits have not been raised in several years. In fact, in many respects, they are much lower than they were in the early 1980s. These reform proposals would largely restore previous limits, reversing a twenty-year trend of restricting pension contributions in order to reduce federal budget deficits and distribute tax benefits more evenly.

---

† Consultant to the Urban Institute, Washington, D.C. This research was supported by a generous grant from the Andrew W. Mellon Foundation to the Retirement Project of the Urban Institute. The views expressed in this article are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders. This article was originally published as PAMELA PERUN, THE LIMITS OF SAVING, (Urban Inst., The Retirement Project, Occasional Paper No. 7, 2000), copyright © 2000 Urban Institute. The author wishes to thank Steven E. Stoft for his extraordinary efforts in creating the model used in this article and Rudolph G. Penner and C. Eugene Steuerle for their helpful comments on the analysis and prior versions of this article.

1. The term "private pension system" as used in this article includes all arrangements to produce retirement income authorized by the Internal Revenue Code, such as qualified plans, tax-sheltered annuities, plans based on individual retirement accounts, individual retirement accounts, and other deferred compensation arrangements. It does not include equity-based plans or arrangements such as stock option or stock purchase plans.

Many view these proposals as a means, in an era of budget surpluses, of reclaiming the private pension system's intended status. Raising contribution limits may also be an appropriate response to employers' growing belief that employees must assume more responsibility for their retirement income. Many employers, for example, have reduced their own contributions to defined contribution plans or terminated defined benefit plans, leaving employee savings to fill the gap. Others have shifted from outright contributions to matching contributions. But proposals to raise contribution limits are highly controversial. Although some people feel that the long-overdue changes will restore the pension system's ability to generate adequate retirement income after years of cutbacks and restrictions, others think the changes will provide extra tax benefits to wealthy Americans without substantially raising overall retirement savings.[2]

How might raising the limits on contributions to defined contribution plans affect individual retirement savings through the private pension system? Using a model of hypothetical lifetime savings, this article analyzes the reform proposals for a sample of defined contribution plans that permit individuals to choose how much to save for retirement every year.

The article argues that the reforms would do little to change the savings status quo in the private pension system. Any positive effect is found primarily among higher-income individuals and individuals who can afford extremely high savings rates under the raised limits. Some negative effects—perhaps due to model assumptions—are found among lower-income individuals who try to save at a high rate. Current contribution limits comfortably

2. *See* PETER R. ORSZAG ET AL., CENTER ON BUDGET AND POLICY PRIORITIES, PROPOSED PENSION CHANGES WOULD OVERWHELMINGLY BENEFIT CORPORATE EXECUTIVES AND OWNERS 1 (2000); PETER R. ORSZAG ET AL., CENTER ON BUDGET AND POLICY PRIORITIES, EXACERBATING INEQUITIES IN PENSION BENEFITS: AN ANALYSIS OF THE PENSION PROVISIONS IN THE TAX BILL 2 (1999), *available at* http://www.cbpp.org/10-8-99taxhtm; CITIZENS FOR TAX JUSTICE, SENATE GOP MINIMUM WAGE HIKE PROVIDES $75 BILLION IN UPPER-INCOME TAX BREAKS (Nov. 8, 1999), *available at* http://www.cbpp.org/html/mwsen.htm; IRIS J. LAV, CENTER ON BUDGET AND POLICY PRIORITIES, NICKLES MINIMUM WAGE BILL INCLUDES COSTLY TAX CUTS THAT COULD HARM LOWER-WAGE WORKERS 1-2 (1999), *available at* http://www.cbpp.org/11-8-99tax.htm.

accommodate more plausible savings rates for all income levels.

Consequently, the primary effect of the proposals is to enable higher-income individuals who would like—and can afford—to save more for retirement to do so with more federal tax dollars. The proposals do little to provide extra incentive to those who can afford to save more but do not. Nor do they provide additional benefits to those who can afford to save only a little or nothing at all. As a result, more constructive reforms of the private pension system, with greater potential to increase saving, are warranted. Ideally, such reforms would rationalize the number and types of plans available and help those left behind by today's private pension system.

I. THE STUDY

Evaluating reform proposals to the private pension system is a difficult task.[3] The complex system has many plan types, sources of funding, intricate rules, and special exceptions. In addition, the savings decisions that people make, regardless of their purpose, are not well understood. Therefore, it seems appropriate to test the reform proposals using a very simplified model of the private pension system. Because these proposals are designed to enable individuals to save more for retirement, this article focuses exclusively on each proposal's effect on plans permitting individuals to decide how much to save for retirement each year. For each plan, it compares hypothetical lifetime savings under current law (before reform) and proposed law for two different groups: those who save the maximum amount allowed each year ("maximizers") and those who save 5% of their pretax income each year ("steady savers").

This study does not attempt to analyze how much people should, or do, save for retirement. Nor does it assess

---

3. There are many variations of the reform proposals analyzed here. Several were included in the Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong., which was vetoed by President Clinton last fall, and were subsequently reintroduced in other bills in both the House of Representatives and the Senate. This model analyzes mainly the proposals that were referred to the House Ways and Means Committee in October 1999 as part of the Wage and Employment Growth Act of 1999. H.R. 3081, 106th Cong. There are no substantial differences across the various proposals now under consideration, and the model represents a fair cross-section of all the current proposals.

the impact of these proposals on increasing society's overall savings (which may be an independent policy goal). Even if there were an empirical basis for such analyses—none currently exists—this study has a different focus. It examines how much people *could* save in a lifetime, given certain propensities to save, and looks at limits in the current tax code versus those in the reform proposals. This analysis is solely concerned with savings and associated tax subsidies within a subset of private pension system plans; it does not take employer contributions or participation in multiple plans into account. In addition, no attempt is made to estimate or analyze the effects of savings in other forms—home ownership, equity investments, and rental income or similar sources—on income in retirement.

A. *The Retirement Plans*

The sample plans are all defined contribution plans. They include 401(k)s, 403(b)s, and 457s for employees; individual retirement accounts (IRAs) for employees whose employers do not have plans; and Simplified Employee Pensions (SEPs) and money purchase plans (MPPs) for self-employed individuals.[4]

The core set of plans—401(k), 403(b) and 457 plans—explicitly permit employees to decide (within tax code limits) how much to save for retirement every year, a relatively new feature in the private pension plan system. IRAs provide a similar savings arrangement. Self-employed individuals are included in the analysis because they have similarly flexible savings choices with MPPs, which are the most generous defined contribution plans, and SEPs, which are less generous but more popular.

B. *The Contribution Limits*

Table 1 describes the relevant limits on contributions for each sample plan under both current law and the proposed changes. Although each plan involves many limits, there are essentially three to keep in mind. The first, under I.R.C. § 401(a)(17), limits the amount of compensation that can be used to calculate contributions.[5]

---

4. *See* Appendix *infra* for brief histories and descriptions of each plan.
5. Limits are adjusted for inflation.

Table 1. Comparison of Relevant Limits			
	Contribution Limits	**Compensation Limits**	**Special Rules**
IRA	Lesser of $2000 or compensation	Compensation	Contribution deductible if no employer plan; if covered by a plan, contribution phased out between $32,000-$42,000 in income for single and $52,000-$62,000 for married individuals
401(k) Current Law	Lesser of $10,500 or 25% of compensation	$170,000	Average contributions by the highly paid limited to 125% of the average percent contributed by the non-highly paid, or whichever is lower: twice the percentage contributed by the non-highly paid or that percentage plus 2
Proposed Law	Lesser of $15,000 (by 2005) or 100% of compensation	$200,000 (in 2001)	
403(b) Current Law	Least of $10,500, 25% of compensation, or Maximum Exclusion Allowance (MEA) (20% of compensation times years of service minus prior contributions)	$170,000	N/A
Proposed Law	Lesser of $15,000 (by 2005) or 100% of compensation	$200,000 (in 2001)	
457 Current Law	Lesser of $8000 or 25% of compensation	None	Contributions calculated on the basis of compensation minus contributions
Proposed Law	Lesser of $15,000 (by 2005) or 50% of compensation	None	
SEP Current Law	Lesser of $30,000 or 13% of compensation	$170,000	Overall 15 % deductible limit on all contributions
Proposed Law	Lesser of $40,000 (by 2005) or 13% of compensation	$200,000 (in 2001)	For self-employed, contributions calculated on the basis of gross earnings minus contributions
MPP Current Law	Lesser of $30,000 or 20% of compensation	$170,000	For self-employed, contributions calculated on the basis of gross earnings minus contributions
Proposed Law	Lesser of $40,000 (by 2005) or 50% of compensation	$200,000 (in 2001)	

Where it applies, this limit for year 2000 is $170,000. The second, under I.R.C. § 415(c)(1), limits the amount that can be contributed to an individual account each year; where applicable, this limit is currently $30,000 or 25% of what a worker is paid (whichever is lower) and generally includes contributions from both employers and employees. The third, under I.R.C. §§ 402(g) and 457(b)(2), limits the amount that an individual can contribute to a 401(k), 403(b), or 457 plan. In year 2000, this limit is $10,500 for 401(k) plans and 403(b) plans and $8000 for 457 plans.

Among the plans, 457s are simpler than either 401(k)s or 403(b)s. Under current law, each employee can contribute a fixed amount—in year 2000, the lower of $8000 or 25%[6] of his or her salary—to a 457 plan. Both 401(k)s and 403(b)s are more complex. Special rules are designed to encourage low-paid employees to participate in 401(k)s. Under a 401(k) plan, the amount that highly paid employees (generally those earning at least $85,000 a year) can contribute as a group depends on how much low-paid employees contribute as a group. Rules governing 401(k) plans also restrict an employee's annual individual contributions to whichever is lower: a fixed amount ($10,500 in year 2000) or 25% of his or her compensation. While low-paid employees always have the option to contribute as much as they wish under this annual limit, highly paid employees may not be able to contribute as much as they wish if low-paid employees contribute too little to the plan.

The most complicated of the three plans are 403(b)s. They have the same annual individual contribution limit as 401(k) plans, but they also have an additional limit called a maximum exclusion allowance (MEA). In contrast to 401(k)s, which focus on contribution differentials between low-paid and highly paid employees, the MEA sets an individual cumulative ceiling on contributions; the ceiling must be tested annually.

Like 457s, IRAs are simple plans. Any individual without a plan at work can contribute up to $2,000 a year on a pretax basis. For self-employed individuals, SEPs and MPPs are relatively simple arrangements—provided, as is

6. According to the statute, the limit is actually one-third of compensation, but compensation is determined after subtracting contributions to the plan. Therefore, in effect, the limit is reduced to 25% of compensation.

assumed in this study, there are no other employees. As a general rule, an MPP permits a self-employed person with no employees to contribute whichever is smaller: $30,000 or 25% of his or her earnings. A self-employed person with no employees who is saving through a SEP is limited to an annual contribution of whichever is lower: $30,000 or 15% of his or her compensation. It is important to note that the "earned income" of self-employed individuals is computed including items such as plan contributions, and that one-half of self-employment taxes paid from gross earnings are deducted. This calculation essentially reduces the compensation limit to 20% for a MPP and 13% for a SEP.

The reform proposals would make the following changes:[7] (1) standardize the contribution limits in 401(k), 403(b), and 457 plans; (2) raise the cap on compensation from $170,000 to $200,000; (3) over a five year period, raise the dollar limit for contributions by employees in 401(k), 403(b), and 457 plans to $15,000; (4) raise the compensation limit from 25% to 100%; and (5) raise the limit on annual individual contributions from $30,000 to $40,000.

C. *The Model*

The model used in this study creates hypothetical patterns of retirement contributions, earnings, and distributions for six identical individuals, each of whom saves for retirement under only one of the six sample plans. For this article, the model analyzes two types of savers: maximizers (who save the maximum amount permitted under each plan each year) and steady savers (who save 5% of before-tax compensation each year).

Each individual is assumed to begin saving in 2001, the year he or she turns thirty-five. In order to simplify the

7. This article analyzes only the standard formula for contributions under each plan. The current law provides "catch-up" elections, which enable certain older employees to contribute additional amounts. *See* I.R.C. § 457 (1994 & Supp. III 1997); I.R.C. § 403(b) (1994 & Supp. IV 1998) *amended by* Pub. L. No. 106-554, 114 Stat. 2763 (2000). Certain types of employees are eligible for alternative contribution elections through § 403(b) plans. The reform proposals would eliminate the special § 403(b) elections, change the § 457 catch-up, and provide new, identical catch-up elections for individuals over fifty in 401(k), 403(b), and 457 plans. Because of the complexity of the relevant rules, this article does not examine the effect of these alternative contribution formulas under either current or proposed law.

analysis as much as possible, the model assumes that individuals save for retirement exclusively through the private pension system and through one type of plan during their work lives. To compute the value of a given plan and its tax benefits, the model also includes a control (a twin) who has no retirement plan. The model calculates the savings of the twin using the assumption that both twins are equally well-off in their pre-retirement years. That is, they both have the same "disposable income" after paying taxes and saving for retirement. For example, assume that one individual and his or her twin each have $40,000 in income in year one. The individual with a plan pays $6298 in income taxes after saving $2000 in his or her plan, leaving a disposable income of $31,702. The twin without a plan pays $6858 in income taxes and saves $1440, also leaving a disposable income of $31,702. Each individual (and his or her twin) continues to save in this way until reaching age sixty-five in 2031 and retiring. Distributions begin in the first year of retirement and continue for ten years.

Contributions are assumed to be invested 60% in equities (with a 7% real rate of return and a 9.4% nominal rate of return) and 40% in bonds (with a 3% real rate of return and a 5.4% nominal rate of return). Discount rates used in the study to calculate present values are a weighted average of these real rates of return. Twins are assumed to realize 30% of the equity portion of their portfolios each year, even in retirement. They pay capital gains taxes on realized amounts and reinvest the remainder in equities. Interest on the bond portion of their portfolios is taxed at ordinary income tax rates with the remainder reinvested in bonds. These parameters are fixed throughout each individual's life. For individual tax calculations, it is assumed that individuals are single and take the standard deduction each year. This, along with their earnings and their contributions to a plan, determines taxable income and thus their relevant tax bracket (i.e., marginal tax rate). Tax rates are assumed to remain consistent with current law, and tax brackets are adjusted annually for inflation under current rules. An annual increase in inflation of 2.4% is also assumed. Contribution, compensation, and other

limits under each plan are adjusted for inflation as prescribed under current law.[8]

D. *The Graphs*

The horizontal axis of each graph indicates compensation, defined as the level of income earned in 2001 (the initial year of savings) when each individual is thirty-five. In the discussion below, it is important to remember that the term "income" actually refers to income in the initial year of saving. All income profiles (rich and poor) are proportional so income in the initial year of saving is indicative of the individual's lifetime compensation level. For example, an individual with $40,000 in initial income is twice as rich (in terms of income) as an individual with $20,000 in initial income in the first year of saving and remains twice as rich every year thereafter.

For each of the six plans, individuals are simultaneously plotted across twenty-four income levels, beginning with the lowest-paid person (initial income of $10,000) and ending with an extremely highly paid person (initial income of $240,000). This income range covers three broad groups: individuals who are highly paid throughout their lifetimes, individuals who are never highly paid, and individuals who may or may not be highly paid in any given year.[9] Data points are presented in increments of $10,000, beginning at $10,000 and ending at $240,000. This model assumes that each individual has a 1% real increase in earnings over his or her lifetime, with a real income peak at age fifty. Each graph plots the six plans individually.

8. Under these assumptions, the world during the next forty years looks very much like it does today. No claim is made for their predictive ability. Income tax rates, rates of return, and inflation rates, for example, have varied widely in the past and are expected to do so in the future. Any major changes in such rates could change the results of the analysis substantially. These assumptions are merely intended to hold important variables to predictable changes as much as possible in order to make the effects of the reform proposals more apparent.

9. Pension law has no single standard for determining who is highly paid. One measure for 401(k) plans, is currently $85,000 a year in income as a cut-off point for some nondiscrimination testing purposes. I.R.C. § 414(q) (1994 & Supp. IV 1998). There is also an inferred measure that uses $170,000 (in 2000) as the compensation cut-off point for calculating contributions under most plans. *See* I.R.C. § 401(a)(17) (1994 & Supp. II 1996).

1. *Contributions*. The model computes two savings patterns, one for current law and another for the reform proposals, and then calculates the changes caused by the proposals. Current law is illustrated in the "before reform" graphs. The graphs labeled "changes" show the difference in lifetime savings due to the reform proposals, assuming that reforms are implemented.

2. *Subsidies*. The graphs illustrate the subsidies available to maximizers and steady savers before reform as well as the difference as a result of reform. Saving through the private pension system can provide substantial tax subsidies not available through other means of savings. The tax code provides three special provisions: plan contributions are made with pretax dollars, earnings on those contributions accumulate on a tax-free basis, and no taxes are paid on retirement benefits until payments are actually received. The first subsidy derives from the interplay between tax rates at the time of contribution and distribution: the greater the differential in tax rates, the greater the tax subsidy. In most situations, people will be in lower tax brackets during retirement than during their work lives. If so, they will save on taxes because their benefits will ultimately be taxed at lower rates. The second subsidy exists because taxes on contributions and earnings are deferred until benefits are distributed from the plan. This can provide an even more substantial tax benefit. The graphs consider the effect of the reform proposals on tax subsidies expressed as follows: total real subsidies, average percentage subsidies, and marginal subsidies.

II. CASE ONE: MAXIMIZERS

The analysis first examines the effects of increasing contribution limits by considering the most extreme savings profile, those belonging to maximizers. The following graphs illustrate the maximum total lifetime contributions and maximum value of various tax subsidies available through each plan under current law and after changes due to reform proposals. It is important to remember that although maximizers contribute the maximum amount deductible for tax purposes each year, theirs is not necessarily the optimal savings pattern for all individuals at all times.

A. *Contributions*

As the analysis below indicates, there are instances when some maximizers would actually be better off contributing less. Figures 1 and 2 illustrate the maximum total contributions (in 2001 dollars) associated with each plan.

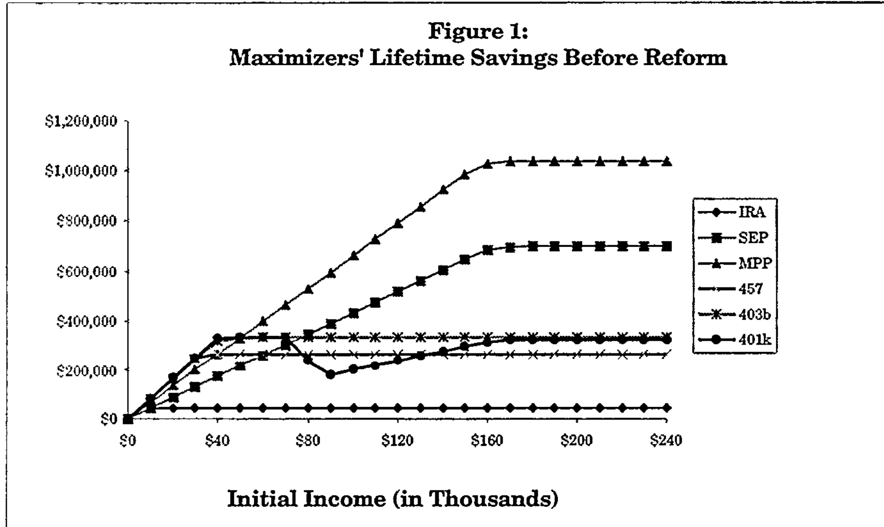


Figure 1: Maximizers' Lifetime Savings Before Reform

1. *Before Reform.* In Figure 1, the plans can be grouped into three levels: (1) IRAs; (2) 457s, 403(b)s, and 401(k)s; and (3) SEPs and MPPs. IRAs provide maximizers with the most limited ability to save for retirement. After thirty years of saving, the majority of maximizers have contributed only about $44,000, taking inflation into account, toward their retirement. Discounting this $44,000 by the real rate of return gives a present value of about $25,000. When earnings on those contributions are taken into account, most maximizers with IRAs have accumulations of about $125,000 in real dollars at age sixty-five. On the other hand, SEPs and MPPs provide self-employed maximizers with the greatest ability to save. The amount these maximizers can contribute increases up to $160,000 in income, at which point compensation limits curb contributions. The most maximizers can contribute is about $700,000 through a SEP and about $1,000,000 through a MPP ($350,000 and $525,000, respectively, in

present value). When earnings are taken into consideration, maximizers with SEPs and MPPs and $10,000 in initial income have account accumulations at age sixty-five of about $100,000 and $170,000, respectively. Maximizers with these plans at initial income levels of $160,000 and greater have account accumulations of $1.7 million and $2.6 million, respectively.

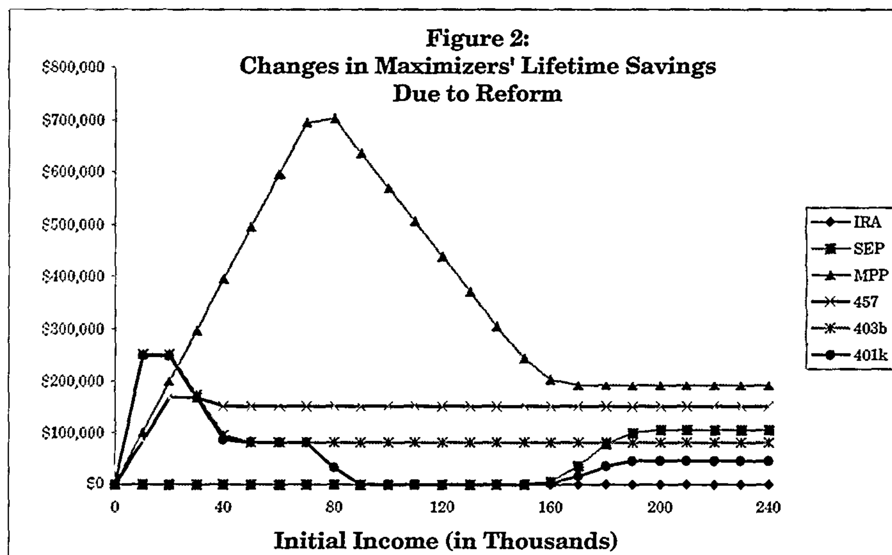
Contributions for maximizers with 401(k), 403(b), or 457 plans also flatten out, but at the much lower level of roughly $40,000 in initial income. At these income levels, the 25% of compensation limit restricts contributions to less than the flat dollar limit ($10,500 for 403(b) and 401(k) plans and $8000 for 457 plans). At higher income levels, the flat dollar limit effectively restricts contributions. A third limit, applicable only to 401(k) plans, restricts contributions by maximizers in the $70,000 to $120,000 initial income range.[10] Maximum lifetime contributions by retirement are about $320,000 (401(k) plans), $330,000 (403(b) plans), and $260,000 (457 plans). The present value of those contributions is about $160,000, $170,000 and $130,000, respectively. Account accumulations at age sixty-five in real terms are about $820,000, $844,000 and $670,000.

2. *Reform Results.* The primary effect of the reform proposals is to make MPP, the most generous plan, even more generous. Even the poorest maximizers with MPPs, those earning $10,000 in initial income, can increase their lifetime contributions by about $100,000. Largely because they can increase contributions to 50% of income (up to a maximum of $40,000), those in the income range of $30,000

---

10. Under these special rules, the amount highly paid individuals (generally, over $85,000 in income) as a group can contribute depends on how much low-paid individuals contribute as a group. To calculate contributions to 401(k) plans, assumptions have to be made about low-paid employees contribution rates. This model assumes that they save, on average, 4% annually. This restricts the contributions of highly paid employees to 4% plus the differential permitted by law. Prior analysis indicates that if the low-paid contribute 10% or more as a group, highly paid contributions are not restricted. But that was felt to be an unreasonably high figure. For simplicity's sake, these calculations assume that no highly paid person can contribute more than the average amount contributed by the low-paid plus the differential permitted by law. In an actual 401(k) plan with many participants, the amount contributed by the highly paid must be within legal limits on a group basis only. So not all highly paid individuals are held to the group average. This model therefore overstates somewhat the effect of these restrictions on highly paid individuals.

to $150,000 can contribute substantially more. Those with initial incomes of $80,000 benefit the most and can increase their lifetime contributions by about $700,000. Account accumulations at retirement for all maximizers who earn $80,000 are about $3.1 million, an increase of at least 80%. Maximizers with SEPs are not so fortunate. They benefit only from the increase in the plan compensation limit from $170,000 to $200,000. Those formerly affected by that limit increase their lifetime contributions by about $100,000. The reform proposals make no change to IRAs, the least generous plan.



A secondary effect of the reform proposals is to make 401(k), 403(b), and 457 plans far more uniform. First, the maximum exclusion allowance, effective only for 403(b) plans, and the 25%-of-compensation limit (for all but 457 plans) no longer apply. This primarily benefits low-paid individuals (those earning less than $40,000 in initial income). For example, maximizers at the $10,000 initial income level benefit the most, since they can contribute roughly an additional $80,000 to a 457 plan and $250,000 to a 403(b) plan or 401(k) plan. Second, the same contribution cap—increased substantially to $15,000 annually—applies to all three plans.

Maximizers with 457 plans benefit the most, largely because their dollar contribution limit almost doubles; the

other two plans experience about a 50% increase in the limit. Maximizers with 457 plans and incomes above $40,000 increase their contributions by about $150,000; those with 403(b) plans contribute only about an additional $80,000. Because of the special 401(k) nondiscrimination rules,[11] maximizers with 401(k) plans and incomes between $80,000 and $140,000 do not participate in these increases. They are considered to be highly paid employees, and their contributions are subject to the additional limit of the amount contributed on average by low-paid employees (assumed in this model to be 4%) plus the differential permitted by law. But those with initial income levels below $70,000 are on a par with maximizers with 403(b) plans. When account accumulations are considered, a variety of maximizers—those with 457 plans and incomes over $30,000, 403(b) plans and incomes over $10,000, or 401(k) plans and incomes between $20,000 and $80,000—end up with the same amount, about $1 million (roughly three to four times their accumulations under current law). These are substantial increases, but their maximum accumulations are still only one-third to one-half of those possible with an SEP or MPP.

B. *Total Real Subsidies*

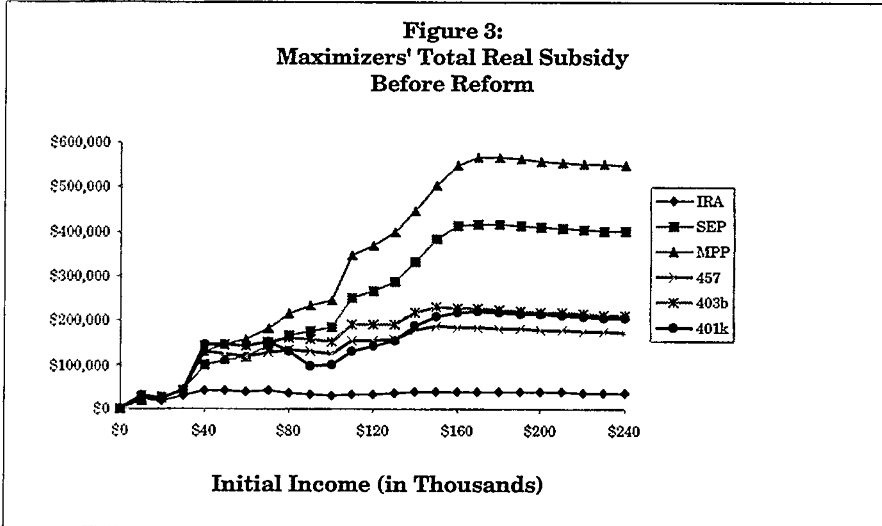
Figures 3 and 4 illustrate the amount of real after-tax dollars that maximizers receive as a tax subsidy through participation in the private pension system in comparison with their twins who have no plan. More explicitly, these figures show the difference in tax dollars paid on retirement accumulations by two identical individuals, one who saves through the private pension system and receives its special tax subsidies and one who saves through more conventional means, such as a brokerage or savings account, and pays taxes on those savings every year under standard tax rules. The figures indicate how many more dollars the individuals in each plan at each income level have available to spend in retirement compared to their twins.

1. *Before Reform*. Figure 3 illustrates the general relationship between contributions and subsidies. Generally, individuals who contribute more receive a larger

---

11. *See supra* note 10.

subsidy. However, this does not necessarily mean that the richest contributors receive the greatest dollar amount. For example, an individual with $170,000 in initial income would receive a subsidy of about $40,000 from an IRA, $420,000 from a SEP, $570,000 from an MPP, $185,000 from a 457 plan, $225,000 from a 403(b) plan and $220,000 from a 401(k) plan. Comparable subsidy figures for an individual with an initial income of $240,000 are $35,000, $400,000, $550,000, $175,000, $210,000, and $205,000 respectively.



Due to the interaction of plan limits on contributions, the greatest subsidies accrue to those in the more generous plans and to whom those plans are most generous. For example, maximizers with SEPs or MPPs, the most generous plans, generally receive the greatest subsidies. People saving through SEPs receive subsidies that range from a low of about $17,000 (if their initial income is $10,000) to a high of about $400,000 (if their initial income is over $160,000). Comparable amounts for those with MPPs are a low of about $24,000 to a high of around $560,000. The experience of maximizers with IRAs further illustrates this relationship. Their contributions are a uniform dollar amount, independent of income, and their subsidies are almost uniform as well. All maximizers with IRAs in income levels over $30,000 receive about $40,000 in subsidy. Maximizers with 457, 403(b), and 401(k) plans

receive very similar subsidies because their plan limits are very similar. However, because 401(k) plans are often less generous to those at income levels between $80,000 and $120,000, subsidies for these maximizers lag behind those of their peers with other plans.

Figure 3 also illustrates the general relationship between tax brackets and tax subsidies. The amount the federal government forgoes in taxes on retirement plan savings depends on the differential in tax rates during employment and in retirement. Even if individuals are in the same tax bracket during retirement, individuals in higher tax brackets during employment will receive larger dollar subsidies on their savings because the government forgives more in taxes. Figure 3, for example, indicates that subsidies for all maximizers show a pronounced increase at about $40,000 in initial income. They increase by about one-third for IRAs, double for SEPs, and at least triple for all other plans. A second but less pronounced increase occurs at around $110,000 to $130,000 in initial income. This increase is most apparent in SEPs, MPPs, 457 plans, and 403(b) plans, where subsidies increase by about 35% for SEPs, 40% for MPPs, and about 25% for 457s and 403(b)s. These increases occur close to bend points in tax brackets, thus illustrating that individuals in higher tax brackets receive greater subsidies than those who are relatively close in income levels but in a lower tax bracket during employment. The contributions made by these individuals are similar, but the tax subsidy received often is not.

2. *Reform Results*. As Figure 4 indicates, the reform proposals decrease the dollar subsidy received by many of the poorest maximizers (for example, those with initial income levels of $10,000 to $40,000.) Maximizers at these income levels with IRAs and SEPs receive no additional subsidies; those in the other plans actually receive negative subsidies. Maximizers with 403(b) and 401(k) plans receive about $85,000 less (a loss of about $55,000) if they have $10,000 in initial income, and about $40,000 less (a loss of about $18,000) if they have $20,000 in initial income. Under current law, contributions by individuals are capped at $10,500 or 25% of compensation, but the reform proposals eliminate the 25% cap in most plans. As a result, most maximizers contribute the flat dollar amount that, at these income levels, comprises most of their taxable income, so

they pay very little in tax during employment. In retirement, however, they receive substantial distributions that are taxed, often at high rates. They do not receive tax benefits from the private pension system and might be better off not participating at all. This illustrates that the strategy for maximizing savings modeled in this article is not the optimal strategy for these individuals. These negative subsidies, however, may be attributable to the assumed ten year distribution schedule. If maximizers took distributions over a period of fifteen to twenty years, the amount included in income every year would be smaller and the negative subsidy might then diminish or disappear.

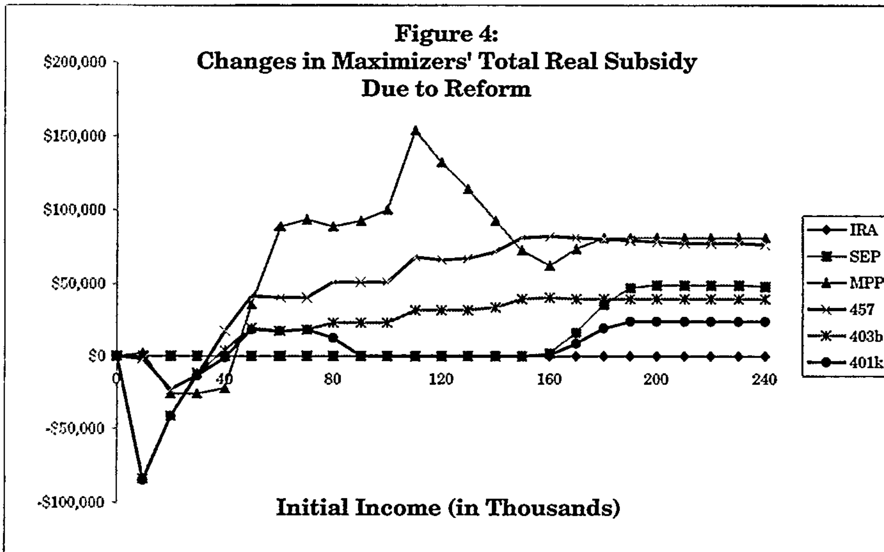


**Figure 4:
Changes in Maximizers' Total Real Subsidy
Due to Reform**

Other maximizers profit from the more generous contribution limits. Again, those favored by the more generous plans receive the greatest subsidy increase in terms of dollars. Maximizers with MPPs and initial income levels between roughly $110,000 and $130,000 are the primary winners: They receive $100,000 to $150,000 in additional subsidies. Maximizers with 457 plans also generally do better than those with 403(b) or 401(k) plans because they receive the greatest increase in contribution limits. Maximizers with IRAs, of course, receive no additional subsidy because their contribution limits are unchanged. Maximizers with SEPs receive additional subsidies—but only where the increased limit on

compensation takes effect at income levels above $160,000. Their maximum additional subsidy amount is about $50,000.

C. *Average Subsidy Rates*

Figures 5 and 6 examine a more relative measure of the subsidies available to participants in the private pension system. The vertical axis in both figures indicates the percentage of retirement dollars received by individuals in each plan (when compared with their twins whose retirement dollars are generated through more conventional means of saving, such as a savings or brokerage account) that are attributable to the tax benefits of the private pension system.

1. *Before Reform.* Figure 5 illustrates two primary effects. First, it is in many respects the inverse of Figures 1 and 3. Perhaps surprisingly, maximizers with IRAs, the least generous plans, receive the highest average subsidies at all income levels. Maximizers with MPPs, the most generous plans, receive the smallest average subsidies at all but the lowest income levels. This relationship reflects an interaction between contribution differentials across the plans and tax rate differentials. Individuals with IRAs, for example, can only contribute $2000 each year. That amount is unlikely to reduce their taxes substantially or to lower their tax bracket during employment, allowing them to receive the maximum available subsidy. Individuals in other plans can make more substantial contributions, which will lower their taxes and perhaps their tax brackets during employment and therefore their ultimate tax subsidy.

Second, richer maximizers get a much higher average subsidy rate than poorer maximizers, independent of plan type. This effect occurs in all plans, although Figure 5 exhibits increases in subsidy rates (at the tax bracket bend points) similar to those shown in Figure 3. For example, maximizers with incomes below $40,000 generally receive average subsidies below 20%, or twenty cents on the dollar. Average subsidies (except for maximizers with IRAs) for those with incomes between $40,000 and $130,000 are in the mid-20% to mid-30% ranges, or about twenty-five to thirty-five cents on the dollar; for those in the highest income levels, average subsidies are in the mid-30% to mid-

40% ranges, or about thirty-five to forty-five cents on the dollar.

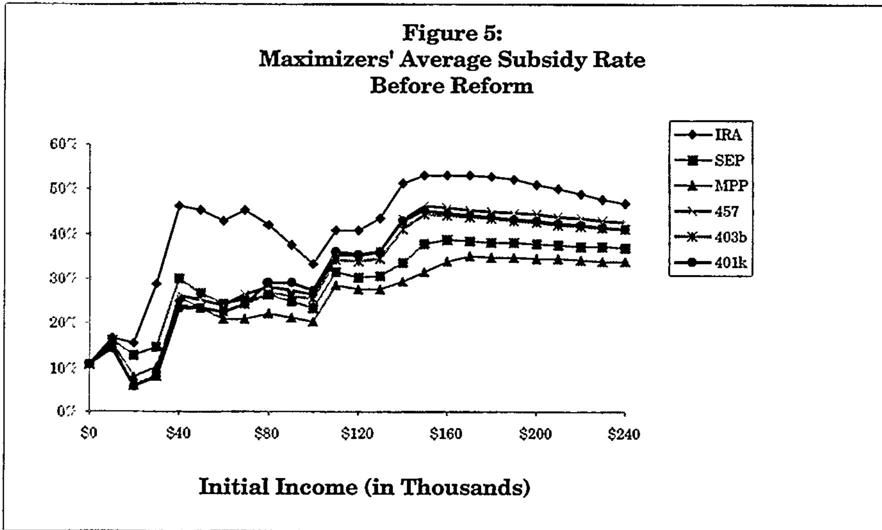


Figure 5: Maximizers' Average Subsidy Rate Before Reform

In general, the differences between tax rates in employment and retirement play the key role in producing the tax subsidies available through the private pension system. Differences in contribution amounts play a limited role, primarily as a component in the tax bracket effect. Tax deferral is also an important factor. If tax rates in employment and retirement were the same, individuals would still receive subsidized savings through the private pension system. Those savings would be at a lower, but more uniform, rate across income levels. For example, individuals who make below $20,000 annually receive average subsidy rates of about 15%, while those at higher income levels receive between 30% and 36%. In addition, differences based on contribution amounts disappear as individuals within equivalent income levels receive the same average subsidy rate, independent of plan types. The only exceptions to this rule are maximizers with IRAs, who still receive a slightly greater (by 1% to 2%) subsidy than would be available under all other plans.

2. *Reform Results.* Figure 6 indicates that the reform proposals either have no effect on or actually decrease the average subsidy rate available to maximizers. The larger

contributions permitted under the proposals decrease the tax bracket effect and tax subsidies, though most of the decreases are modest (less than negative 5%). The poorest maximizers can lose the benefit of the tax bracket effect entirely. For example, maximizers with 403(b) and 401(k) plans at income levels of $10,000 to $20,000 actually receive negative subsidies. Their increased contributions eliminate most or all of their taxable income during employment, but they face large tax bills on substantial plan distributions later. Again, a longer distribution schedule might eliminate or diminish the size of these negative subsidies.

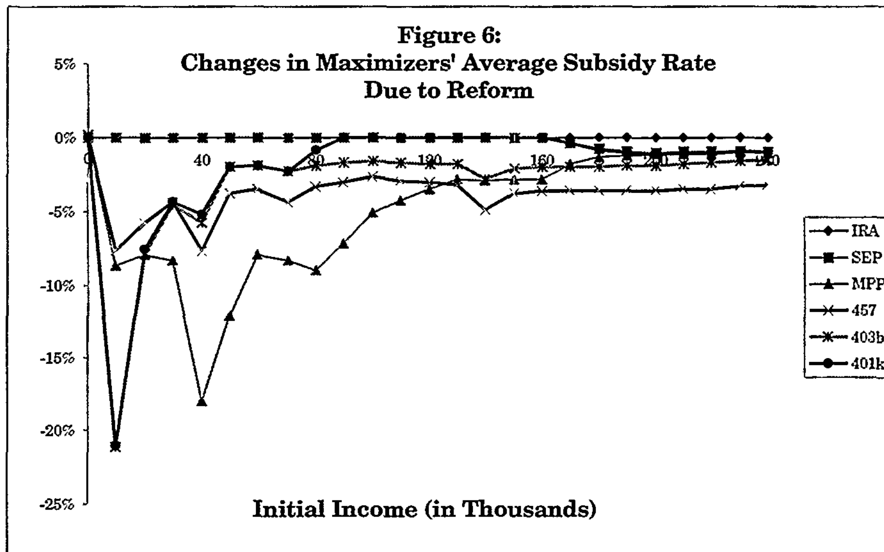


Figure 6: Changes in Maximizers' Average Subsidy Rate Due to Reform

D. *Marginal Subsidy Rates*

Figures 7 and 8 illustrate another relative measure of subsidies available through participation in the private pension system. The vertical axis in both figures indicates the additional, or marginal, subsidy a maximizer could obtain by contributing (if possible) one additional dollar to a plan. As was the case with the previous analyses, it is important to remember that these calculations illustrate the different tax subsidies for savings available to two identical individuals, one who saves through the private pension system and receives its special tax subsidies and one who saves through more conventional means, such as a brokerage or savings account, and pays taxes on those

savings every year under standard tax rules. The figures indicate how much of a tax subsidy the individuals in each plan at each income level receive as compared to their twins for saving just one additional dollar.

1. *Before Reform.* Figure 7 tells a story similar to that of Figure 6. Maximizers with IRAs receive the most generous marginal subsidies, while those with MPPs generally receive the least generous. For example, a maximizer with an IRA at the $150,000 to $160,000 income level receives the most generous subsidy, 53%, or fifty-three cents per additional dollar of saving. Richer maximizers generally receive higher marginal subsidies than poorer maximizers. Maximizers with all plans (except IRAs) at income levels above $160,000 receive between twenty-five to forty cents in tax subsidy for each additional dollar saved; those at income levels between $50,000 and $100,000 receive between fifteen and twenty-five cents per additional dollar.

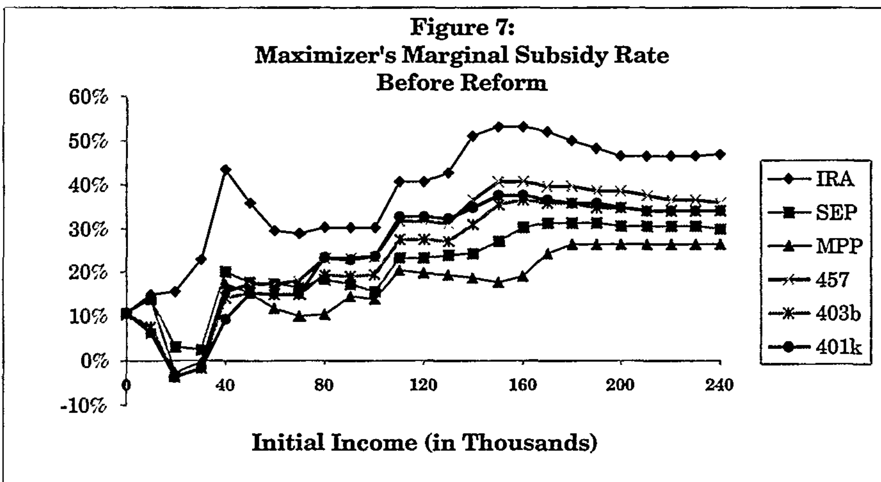


Figure 7 reveals that even under current law, some of the poorest maximizers receive negative subsidies. Maximizers with all plans but SEPs and IRAs at income levels between $20,000 and $40,000 receive marginal subsidies of between negative 2% and negative 4%. This means that they pay an extra two to four cents in tax for each additional dollar saved. Contributions by these maximizers are most often affected by the 25%-of-

compensation limit, suggesting that the limits at these income levels may already be too generous. These maximizers would do better, from a tax perspective, *not* to save through the private pension system. Lengthening the distribution schedule might make these negative subsidies disappear but it is unlikely to substantially increase them.

2. *Reform Results*. Figure 8 illustrates that the reform proposals have no effect (or only a modest negative effect) on the marginal subsidies of most maximizers. Yet, the poorest maximizers are the ones most adversely affected. Maximizers with initial incomes between $10,000 and $40,000 with all plans but IRAs and SEPs now receive a negative subsidy under the reform proposals. In most cases, the negative subsidy is modest. However, this is not true for maximizers with initial incomes of $10,000 with 403(b)s and 401(k)s. Under current law, they receive marginal subsidies of eight and six cents on the dollar, respectively. Under the reform proposals, they receive a subsidy of more than negative 100%, which translates into more than one additional dollar in taxes for every additional dollar saved.

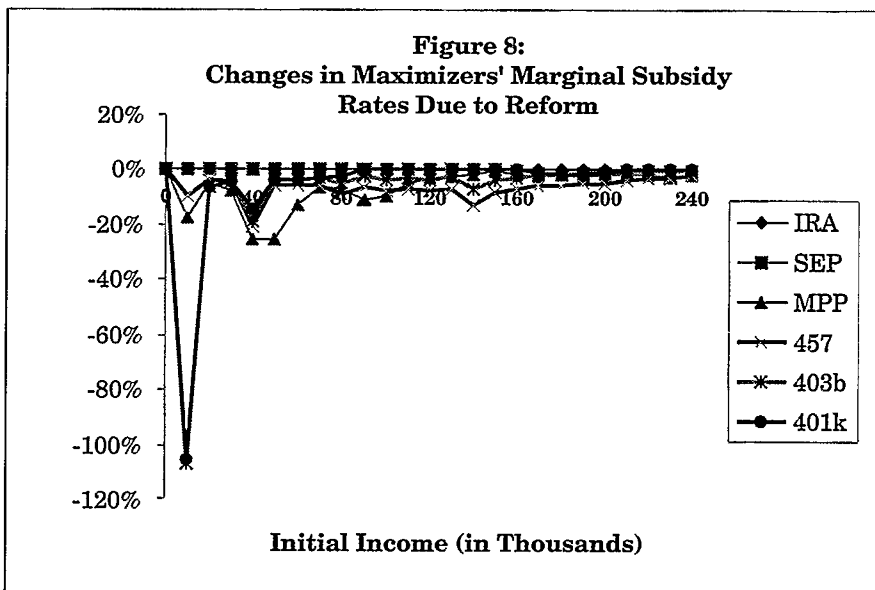


Figure 8: Changes in Maximizers' Marginal Subsidy Rates Due to Reform

This result is obtained because the former 25%-of-contribution limit no longer applies under the reform proposals, enabling these individuals to save 100% of their

incomes. Under current law, these maximizers contribute about $80,000 over their lifetimes. Under the reform proposals they are able (theoretically at least) to contribute an additional $250,000. The tax effect of these changes is that under current law these maximizers pay little or no tax on their incomes while they work and little or no tax on their savings in retirement. Under the reform proposals, they also pay no tax on their incomes while they work but they pay tax at a high rate on their savings in retirement because they have accumulated such substantial amounts that their yearly distributions put them in the highest tax brackets.

These results indicate that the reform proposals really do not benefit low income maximizers. Their incomes are too small to receive any substantial benefit from the tax subsidies enjoyed by higher-income individuals through the private pension system. Enabling them to save more only worsens their tax position. This analysis illustrates that maximizers who receive negative subsidies would be better off not taking advantage of these higher contribution limits. They should instead emulate their twins and increase their savings outside the private pension system.

III. CASE TWO: STEADY SAVERS

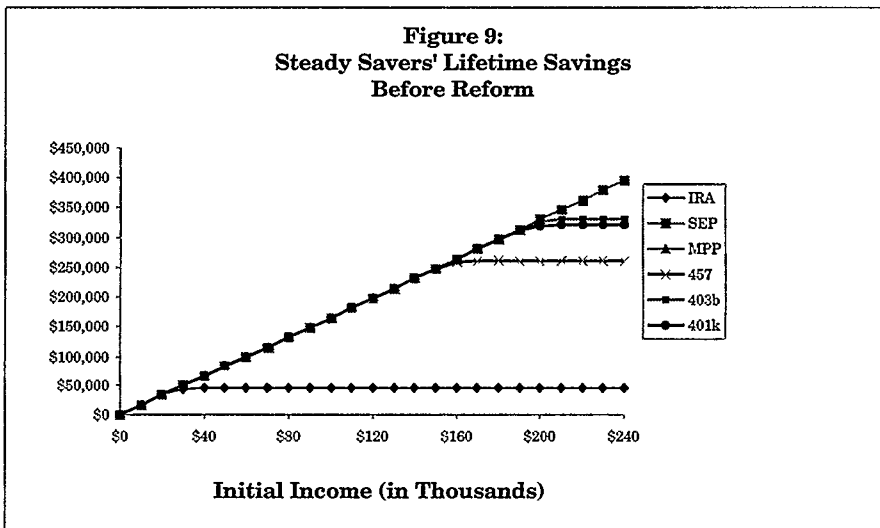
Obviously, few people wish to save, or are even capable of saving, the maximum amount permitted under the private pension system each year. Most people save far less than do maximizers. This section of the article analyzes a more plausible and reasonable savings profile. It examines the experience of steady savers, those who contribute 5% of their earnings to a plan annually.

A. *Contributions*

Figures 9 and 10 illustrate the total contributions made to each plan by age sixty-five. Again, dollar amounts on the vertical axis are expressed in 2001 dollars, contributions are calculated for the thirty year period between ages thirty-five and sixty-five, and the horizontal axis indicates compensation in the first year of savings (age thirty-five).

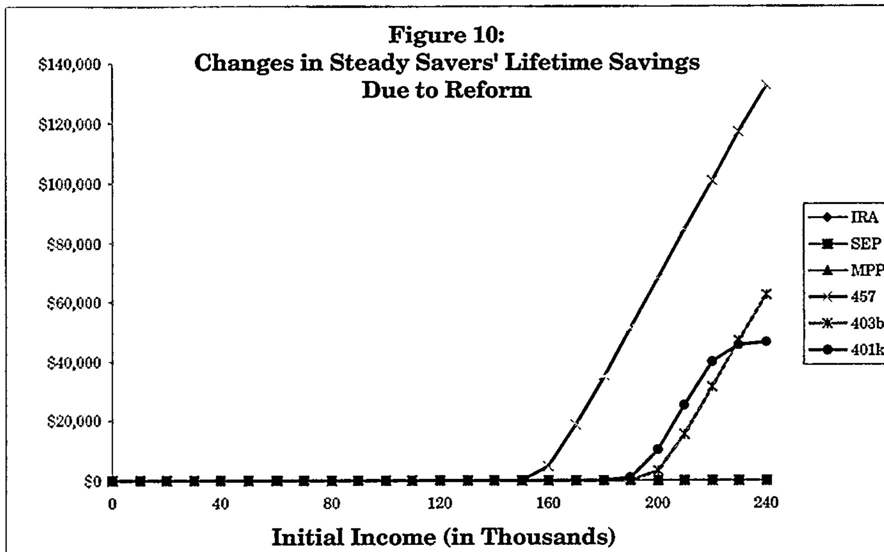
1. *Before Reform.* Figure 9 indicates a generally positive and linear relationship between income levels and contributions among steady savers. In addition, there is little variation across the plans. At income levels under $160,000, steady savers with all plans except IRAs contribute the same amount. The special nondiscrimination rules that apply to 401(k) plans, often reducing contributions by those earning between $80,000 and $120,000, have no effect on steady savers. Steady savers with 401(k) plans at these income levels contribute just as much as their peers. Steady savers with IRAs and incomes at or over $40,000, however, contribute the same amount. At those income levels, steady savers become maximizers as the contribution limit takes effect.

Figure 9:
Steady Savers' Lifetime Savings
Before Reform



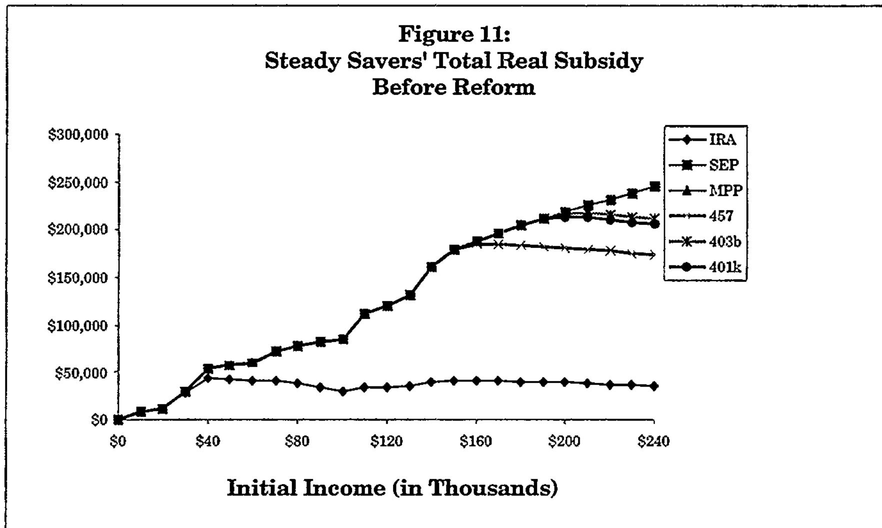
At about $160,000 in income, the remaining plans begin to diverge as the specific limits applicable to 457s, 403(b)s, and 401(k)s start to take effect. Steady savers with 457 plans reach plan limits at an income of about $150,000 a year because 5% of this level of compensation is $7500, about the annual dollar limit under 457 plans. Steady savers with 403(b) and 401(k) plans do not reach plan limits until about $200,000 in income, at which point the annual dollar limit of about $10,000 begins to take effect. Steady savers with MPPs or SEPs, even at about $240,000 a year, never reach maximum plan limits.

Because of this relative uniformity across plan types, the maximum contributions by age sixty-five are very similar for each plan. Steady savers with SEPs and MPPs contribute about $400,000 (about $200,000 in present value terms), those with 403(b)s and 401(k)s contribute about $330,000 (about $160,000 in present value terms) and those with 457s contribute about $260,000 (about $130,000 in present value terms). When earnings are taken into account, steady savers arrive at retirement with maximum account accumulations of about $1 million (SEPs and MPPs), $850,000 (403[b] plans), $820,000 (401[k] plans), and $670,000 (457 plans). Steady savers with IRAs arrive at retirement exactly as did maximizers with IRAs—with about $44,000 in maximum contributions and account accumulations of $125,000.



2. *Reform Results*. Figure 10 indicates that the reform proposals benefit only steady savers at the highest income levels with 457, 403(b) and 401(k) plans, largely because of the increase in the flat dollar limit that becomes available to more steady savers. Steady savers with 457 plans are the largest beneficiaries of these changes, contributing close to an additional $20,000 at $160,00 in initial income and an additional $130,000 at $240,000 in initial income. When earnings are taken into account, the effect of these changes is that steady savers with 457 and 403(b) plans have about the same maximum account accumulation of close to $1

million, as do steady savers with SEPs and MPPs; those with 401(k) plans have over $900,000.

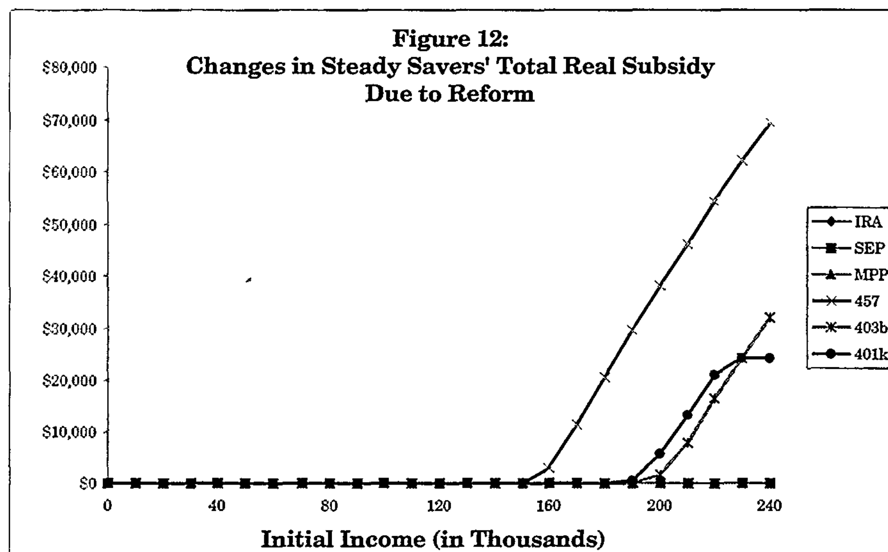


B. *Total Real Subsidies*

Figure 11 indicates the total dollars received by steady savers as a tax subsidy under current law, and Figure 12 indicates how the reform proposals affect those amounts.

1. *Before Reform.* Figure 11 also indicates a generally linear, positive relationship between dollar subsidies and income levels through about $150,000 in initial income. This reflects the fact, previously seen in Figure 9, that steady savers have uniform contributions across plans within these income intervals. Subsidies for steady savers with 457, 403(b), and 401(k) plans increase linearly until they reach their unique plan limits, when both contributions and dollar subsidies begin to taper off. Contribution limits never affect steady savers with SEPs or MPPs. Steady savers with IRAs, as always, are the exception. At the three lowest income levels, they receive dollar subsidies similar to those of other plans, but they start falling behind at $40,000 in initial income.

2. *Reform Results*. The reform proposals affect only those steady savers at higher income levels (above $160,000) and only those with 457, 403(b), and 401(k) plans, as indicated in Figure 12. Steady savers at the highest income level receive about an additional $70,000 in subsidies if they have a 457 plan, $30,000 if they have a 403(b) plan, and $25,000 if they have an IRA.



C. *Average Subsidy Rates*

Figure 13 illustrates the average subsidy rates received by steady savers under current law, and Figure 14 indicates how the reform proposals affect those rates.

1. *Before Reform*. The average subsidy rates received by steady savers are not very different from those received by maximizers. Again, steady savers with IRAs generally receive the highest subsidy rates, and subsidy rates rise with income levels. Steady savers with IRAs and income levels between $140,000 and $190,000 receive the greatest subsidy, fifty-three cents on the dollar. The other steady savers show the same pattern of average subsidy but receive subsidy rates of about 10% less, depending on income level. In addition, when average subsidy rates are tested in a world without tax brackets, steady savers' average subsidy rates are identical to those received by maximizers across plan types and income levels. The only

real difference is that steady savers do not show the variability in rate by plan type that maximizers do. Steady savers with all plans other than IRAs receive the same average subsidy rate at the same income level.

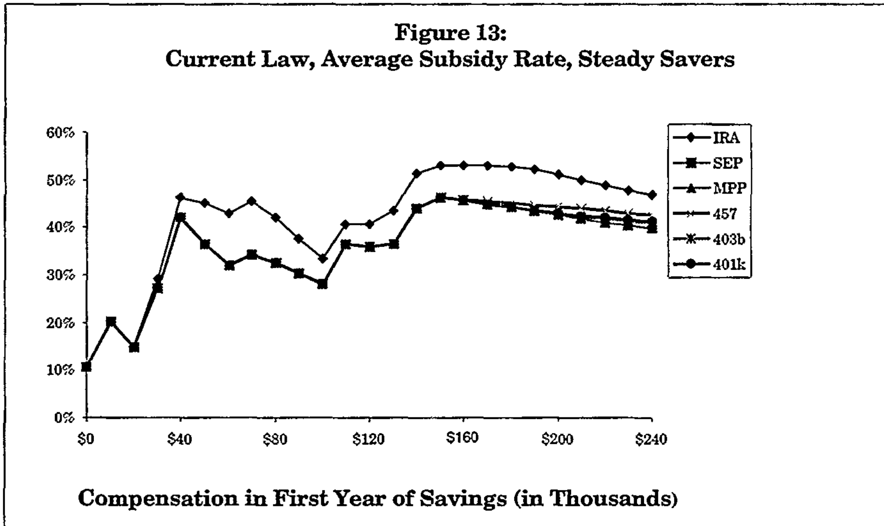


Figure 13:
Current Law, Average Subsidy Rate, Steady Savers

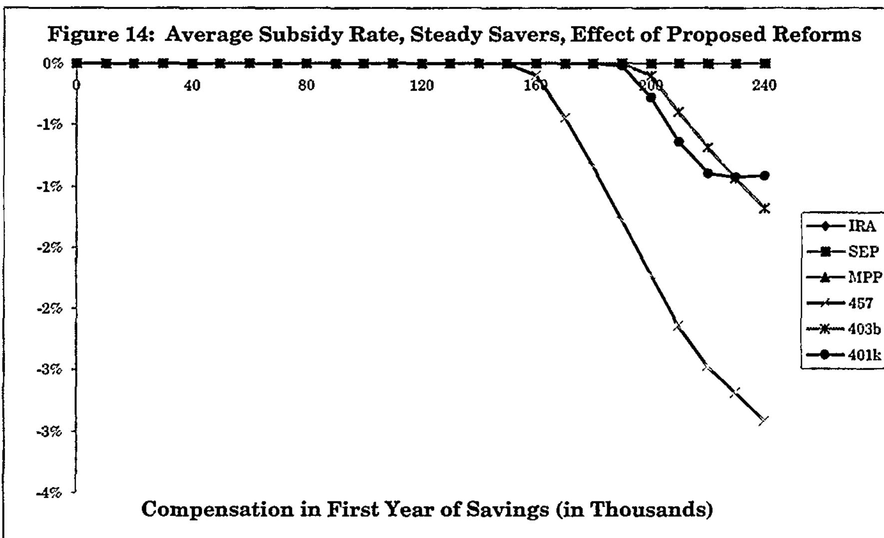


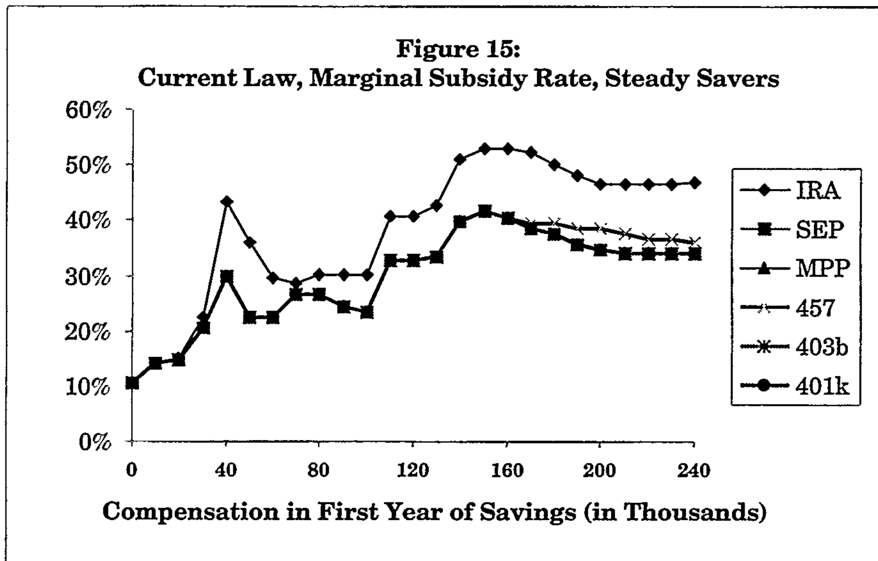
Figure 14: Average Subsidy Rate, Steady Savers, Effect of Proposed Reforms

2. *Reform Results.* The reform proposals affect only those steady savers at the highest income levels and only those with 457, 403(b), and 401(k) plans. Figure 14 indicates some decrease in average subsidy rates among

steady savers in those plans with incomes above $170,000, but the decreases are quite modest (3% or less).

D. *Marginal Subsidy Rates*

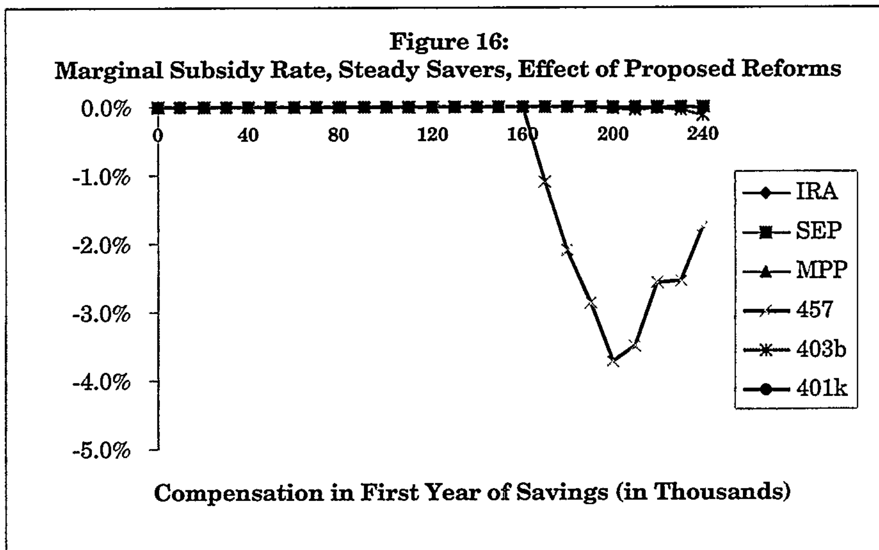
Figure 15 illustrates the additional, or marginal, subsidy a steady saver could obtain by contributing one additional dollar of savings to a plan under current law in comparison to his or her twin who saves outside the private pension system. Figure 16 indicates the effect of the reform proposals on the marginal subsidies received by steady savers.



1. *Before Reform.* Although steady savers exhibit the same general trend in marginal subsidy rates as maximizers, there is at least one important difference: As Figure 15 illustrates, there are no negative marginal subsidy rates. This means that all steady savers, including those at the lowest income levels, receive some tax benefit from saving through the private pension system. In addition, the marginal subsidy is almost identical across all plans at each income level (steady savers with IRAs are the exception). At incomes over $170,000, there is some divergence, as the marginal subsidy rate for steady savers with 457 plans remains essentially flat while all others

begin to decrease. Steady savers with IRAs exhibit the same pattern as the other plans, but in all income levels above $30,000 they receive a 6% to 14% greater marginal subsidy. But, as was true of maximizers, wealthier steady savers generally receive greater marginal subsidy rates than poorer steady savers. For example, most steady savers with incomes above $140,000 receive about thirty to fifty cents in subsidy for each additional dollar saved, while those with incomes between $30,000 and $100,000 receive twenty to thirty cents in subsidy. In contrast, steady savers with incomes below $20,000 receive marginal subsidies of about ten to fifteen cents.

2. *Reform Results*. As was the case with the other subsidies, the reform proposals have no significant effect on the marginal subsidies received by steady savers. Only steady savers with 457 plans and incomes over $170,000 experience any change; in their case, it is a negative but very modest change (between negative 1% and negative 4%).



CONCLUSIONS

Although this study tested the effects of the reform proposals on a very simple model of saving through the private pension system, its results suggest several findings

that can be more broadly applied. First, the reform proposals will primarily benefit those individuals who wish to and are capable of saving a large portion of their incomes. On their face, the proposals also appear to benefit low-income savers by lifting the 25%-of-compensation limit, which is the most important restriction on their contributions in several plans today. However, most low-income savers cannot afford to take advantage of the increased limits offered by the reform proposals. Even if they could, many would be better off from a tax perspective saving outside rather than inside the pension system. The current limits comfortably accommodate reasonable, plausible rates of saving for both low and higher income individuals today. Second, the reform proposals will not increase the average or marginal tax subsidies for savings obtainable through the private pension system. In fact, they may very well decrease those subsidies, particularly for individuals at the lowest income levels, but only for those who save more than they could have saved before. Third, the reform proposals *will* increase the absolute amount of dollars received in tax subsidies. This means that the magnitude of federal tax dollars devoted to the private pension system will increase but that the pattern of distribution of those dollars across income groups will largely remain the same.

The proposals help those who would like and can afford to save more for retirement. They do little to provide additional incentive to those who can afford to save more but do not. They also provide no additional incentives to those who can afford to save only a little or nothing at all. Much political capital has already been expended on these proposals, and more will be necessary to make them law. From a political cost-benefit perspective, it is reasonable to ask whether they are worth the expense. These proposals do not attempt to make fundamental changes in the structure or operation of the system, both of which are needed to reform the private pension system.[12]

The private pension system should be made more effective for those who are left out or left behind by the current system. Low-income savers are often left out of a

12. For a more extensive discussion of these issues, see PAMELA PERUN & EUGENE STEUERLE, URBAN INSTITUTE, ERISA AT 50: A NEW MODEL FOR THE PENSION SYSTEM 1-10 (2000).

pension system that is based solely on tax system incentives and subsidies. They do not earn enough and cannot contribute enough to receive much benefit from the incentives and subsidies in place today. It is extremely unlikely that they would or could increase their savings to take advantage of the reform proposal increases. This study suggests that they might be better off saving through more conventional means than through the private pension system. Helping low-income savers is difficult and may require some federal assistance in the form of matching contributions.[13] But this is certainly a more worthy effort than providing additional federal tax dollars to help those who can already save a large amount.

IRAs are also in need of reform. Employees who have no employer plan, even for their own savings, have certainly been left behind in the current system. A modest increase in IRA contribution limits seems easier to justify that the large increases in other plans found in the reform proposals. Yet there is some resistance to raising IRA contribution limits. The theory is that employers, particularly small ones, who can make substantial contributions to IRAs for themselves will be less inclined to sponsor a qualified plan where they must make contributions for their employees. But today's low IRA limits have not solved the problem of employer plan sponsorship. This is a complicated issue that needs to be addressed. In the meantime, these employees deserve greater access to the tax benefits of the private pension system.

The primary issue for policymakers is the current pension system's many different savings plans and rules. Although the reform proposals help make plans more consistent, they do not attempt the long-overdue step of rationalizing the employee savings system. It no longer makes sense for employee savings plans to be subject to different rules based upon the tax attributes of the employer. For example, even though the reform proposals standardize contribution rules, the plans will continue to differ in important respects. Currently, they differ in their ability to offer loans, hardship distributions, and rollovers to IRAs, as well as in the standards of fiduciary

13. PAMELA PERUN, MATCHING PRIVATE SAVING WITH FEDERAL DOLLARS: USA ACCOUNTS AND OTHER SUBSIDIES FOR SAVING (1999).

responsibility imposed on those who handle and invest contributions by employees. These differences add to the administrative burden of a plan, and standardizing these rules could encourage more employers to provide plans for their employees. Other differences have even greater consequences. Most employers now require their employees to take more responsibility for their own retirement savings. Providing plans that promote participation by low-income workers is critical. If the evidence indicates that the nondiscrimination rules for 401(k)s are effective in getting low-income workers to save, it might be worthwhile to extend those rules to all employee savings plans, even at the cost of more legal and administrative complexity.

Appendix

HISTORY & DESCRIPTION OF SAVINGS PLANS

A. *Savings Plans for Employees*

Savings plans for employees, a relatively new addition to the private pension system, permit employees to decide how much to save for retirement each year within tax code limits and, usually, how those savings will be invested. Employers often provide matching contributions (not taken into account in this analysis) to 401(k) plans to encourage more savings by low-paid employees.

401(k) Plans

The most popular employee savings plans are 401(k)s. For technical legal reasons, a 401(k) plan must be part of a larger defined contribution plan, either a stock bonus plan or profit-sharing plan. They are qualified plans, belonging to the largest and oldest family of plans satisfying the requirements of I.R.C. § 401(a). The tax code has provided favorable tax treatment for such plans since the 1920s. Formally created in 1978, 401(k) plans became widely used only in the early 1980s after the resolution of various legal issues. They are typically sponsored by for-profit employers. Since 1997, tax-exempt employers have once again been able to sponsor such plans, but few do because 403(b) plans are so much simpler. Government employers may not sponsor 401(k) plans, which are very difficult to administer because they are subject to complicated annual testing procedures designed to ensure that highly paid employees do not contribute significantly more than low-paid employees. In addition, 401(k) plans are subject to the Employee Retirement Income Security Act of 1974 (ERISA) and must comply with its reporting, disclosure, prohibited-transaction, and fiduciary liability requirements.

403(b) Plans

Only tax-exempt charities; educational, scientific, or similar entities organized under I.R.C. §501(c)(3); or public

schools may offer 403(b) plans, often called tax-deferred or tax-sheltered annuities. Tax-sheltered annuities were initially authorized under I.R.C. § 403 in 1942, and 403(b) arrangements for employee contributions became available in 1958. These are not qualified plans, since they are not regulated by I.R.C. § 401(a), but they receive essentially the same tax treatment. If the 403(b) plan is structured without employer contributions, as is the case in this analysis, it is not subject to ERISA. In addition, the employees, not the plan or the employer, are responsible for ensuring their own compliance with the tax code limits.

457 Plans

The 457 plan, primarily sponsored by state and local government employers, was enacted in 1978 under I.R.C. § 457 as part of an effort to set more uniform standards for employee savings arrangements. These plans are part of a family of plans known as nonqualified deferred compensation plans. They also are not qualified plans, but they have similar tax benefits to qualified plans. They are not subject to ERISA.

IRAs

IRAs were created in 1974 under I.R.C. § 408. Employees without an employer-sponsored plan or with incomes below certain limits may make tax-deductible contributions to a traditional IRA. Others may make after-tax contributions to a traditional IRA or the new Roth IRA. Contributions to all IRAs by a single individual are subject to a $2,000 annual limit. Under a traditional IRA—but not a Roth IRA—benefits attributable to tax-deductible contributions, earnings, and earnings on after-tax contributions are taxable when received. IRAs are not usually subject to ERISA, and contributors are responsible for complying with savings limits.

B. *Savings Plans for the Self-Employed*

Since 1962, the tax code has permitted self-employed individuals (such as unincorporated businesses, sole proprietorships, and farmers) to sponsor retirement plans. Until the early 1980s, these plans were subject to tighter

limits on contributions and benefits and more restrictive provisions than corporate retirement plans. Self-employed individuals are treated as "employers," even if they have no employees, so that they can choose from among the many different types of plans available. Their decision about how much to contribute each year on their own behalf is the functional equivalent of an employee's decision in a 401(k)-type plan. Most choose one of the qualified defined contribution plans described below.

Money Purchase Pension Plans (MPPs)

A money purchase plan is a qualified defined contribution plan that permits larger contributions than a profit-sharing plan, its primary alternative. Employers contribute to MPPs annually, according to a fixed contribution formula, while contributions to a profit-sharing plan are discretionary. Because they cover only self-employed people and their spouses, MPPs are not subject to ERISA.

Simplified Employee Pension Plans (SEPs)

A self-employed person can also choose an IRA-based SEP, created in 1978 under I.R.C. § 408(k). These plans are easier to administer than qualified plans. Their contribution and deduction limits are similar to those of qualified profit-sharing plans. SEPs are not subject to ERISA if the only participants are self-employed people and their spouses.