Trends in 401(k) and IRA Contribution Activity, 1999-2002--Results from a Panel of Matched Tax Returns and Information Documents

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By combining individual tax returns (Form 1040) and information returns (such as Forms W-2 and 5498) in one panel database, the Statistics of Income (SOI) Division has made it possible to study trends in contributions by individual taxpayers over time to Individual Retirement Arrangements (IRA's), as well as the participation in other types of retirement plans. Using a simple random panel of over 71,000 individual taxpayers who filed for Tax Years 1999 through 2002, this paper will analyze persistency in taxpayers' contribution activities in traditional IRA's and in 401(k) plans. Several possible factors affecting persistency will be considered, including age, marital status, gender, and income.

All of the analysis in this paper is limited to those taxpayers who filed for all 4 years in the study--1999–2002. In the case of joint returns, primary and secondary taxpayers were considered separately. Weighted, the file represents 143.2 million taxpayers, about 81 percent of the original 177.0 million who filed for 1999. Changes in marital status or marriage partners did not affect inclusion in the study--as long as an individual was represented as a taxpayer on a return for all 4 years, he or she could be included in the panel.

▶ Taxpayers' Use of Traditional IRA's

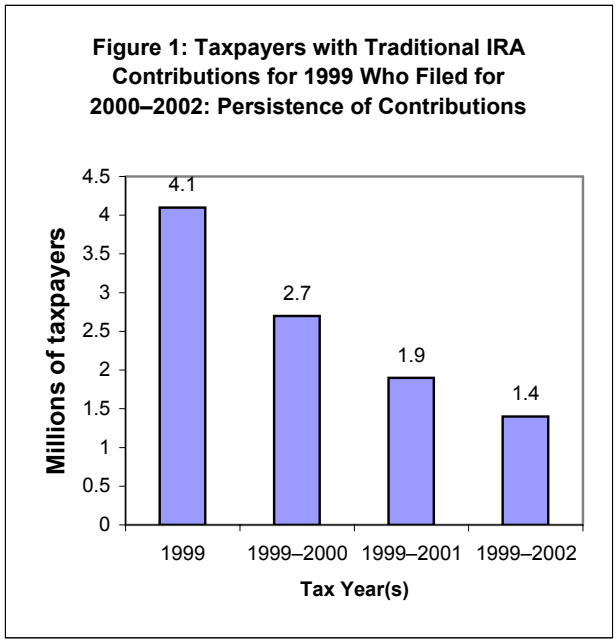
At yearend 2002, nearly 50 million taxpayers held a total of $2.5 trillion in IRA assets. The bulk of these were traditional IRA's: 40 million taxpayers with $2.3 trillion in assets. Traditional IRA's may be contributory and/or the result of rollovers from qualified employer-sponsored retirement plans. This paper focuses on contribution activity among taxpayers in the 1999–2002 panel dataset.

▶ Definition of Traditional IRA Plans

Individual Retirement Arrangements (IRA's) were created by the Employee Retirement Income Security Act (ERISA) of 1974. These first IRA's, termed traditional IRA's, were still the principal type of IRA's held by most taxpayers in 2002. In general, contributions to traditional IRA's could be made by individuals who received taxable compensation (e.g., wages, salaries, commissions, self-employment income). For 1999 through 2001, the limit was generally the lesser of $2,000 or the individual's taxable compensation. For 2002, the maximum contribution amount was raised to $3,000 for taxpayers under age 50, $3,500 for those age 50 or older (the extra $500 being a "catch-up" contribution; both catch-up contributions and the higher limits were legislated by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)). Additional restrictions based on age, coverage by a retirement plan at work, income, and filing status limit the amount that could be contributed on a tax-deductible basis in any particular tax year. In general, taxpayers less than 70½ years of age who were not covered by a retirement plan at work could make a traditional IRA contribution that would be deductible on their income tax returns. However, households with an individual covered by a qualified pension plan at work generally found this deduction limited based on income level and filing status (see Internal Revenue Service, Publication 590, for an explanation of the rules).

▶ Persistency in Traditional IRA Contributions

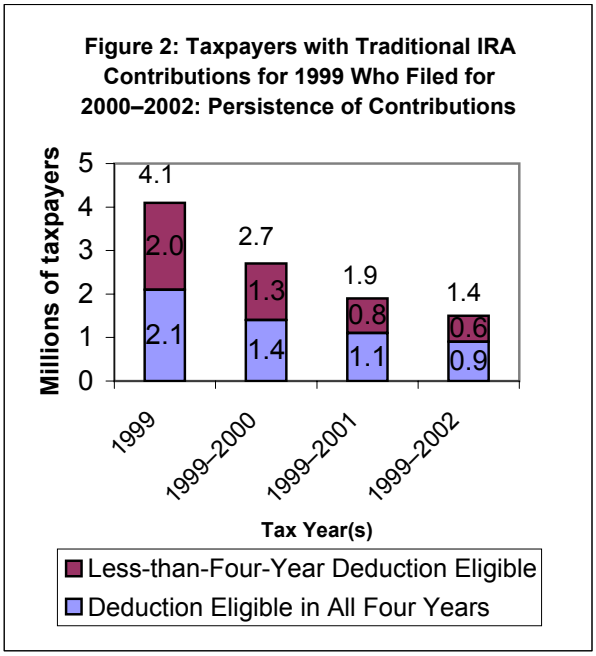
Figure 1 shows that 4.1 million of the taxpayers represented by the 1999–2002 panel dataset made contributions to traditional IRA plans for Tax Year 1999. Earlier papers explored some of the characteristics of individuals making IRA contributions in a given year (see Sailer, Gurka, and Holden (2003); and Sailer and Holden (2005)). This paper will explore the persistence of the 1999 traditional IRA contributors in following years. Figure 1 shows that, for 2000, only 2.7 million of the 1999 participants made contributions. By 2001, only 1.9 million persisted, and, by 2002, the participation was down to 1.4 million--34.8 percent of the original contributors in 1999.

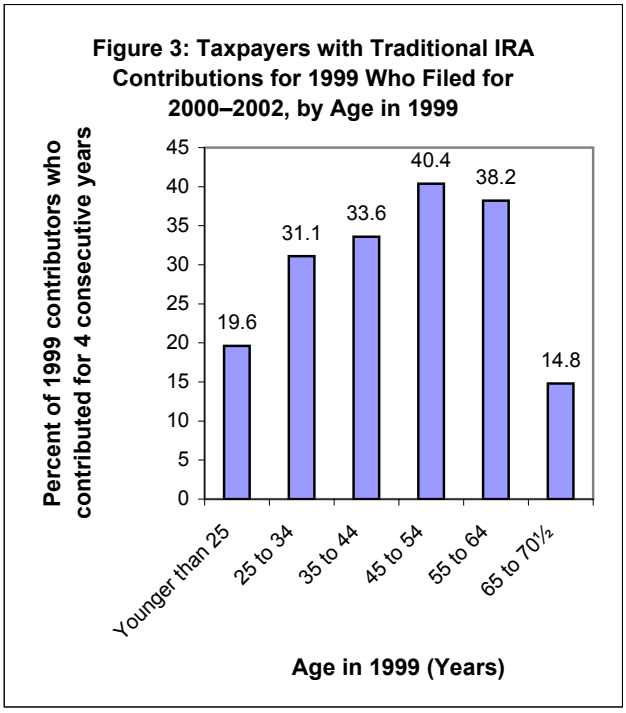


One possible reason for dropping out of the IRA savings program could be that some taxpayers lost the immediate tax incentive of being able to deduct the amount contributed. As discussed earlier, taxpayers who were covered by employer-provided pension plans had income limits above which IRA contributions could not be deducted. Contributions could still be made by taxpayers who exceeded the income limitation, but the immediate tax benefit of a deduction would not be available. Nevertheless, income generated by the IRA investment remains nontaxable until it was withdrawn in either event.

Figure 2 divides taxpayers into two groups: Those who were eligible for the deduction in all 4 years, and those who were not eligible in at least 1 year. It shows that the persistency rate for those who were continuously deduction-eligible was higher than for those who were not--42.7 percent versus 27.1 percent in the fourth year, respectively.

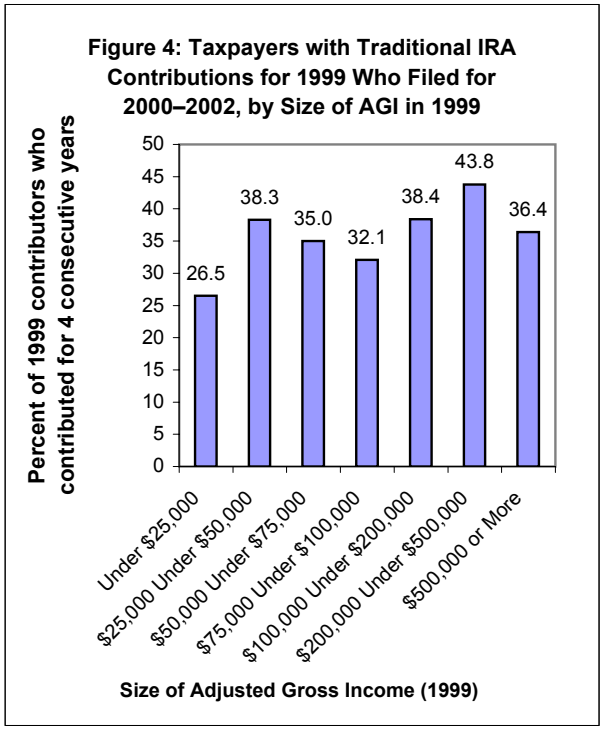
Further research showed that marital status and gender were not significant factors in determining persistency of traditional IRA contributions. Age of taxpayer, however, did make a difference. Persistency rose steadily from 19.6 percent for taxpayers under age 25 in the beginning year to 40.4 percent for taxpayers in the 45-to-54 age group, then fell off at higher ages (Figure 3). Since age 70½ is the cutoff age for making traditional IRA contributions, no persistency was possible above that age.





Size of adjusted gross income (the best indicator of total household income on the tax return) also made a difference although, somewhat unexpectedly, the distribution proved to be bimodal, with the "Under $25,000,"

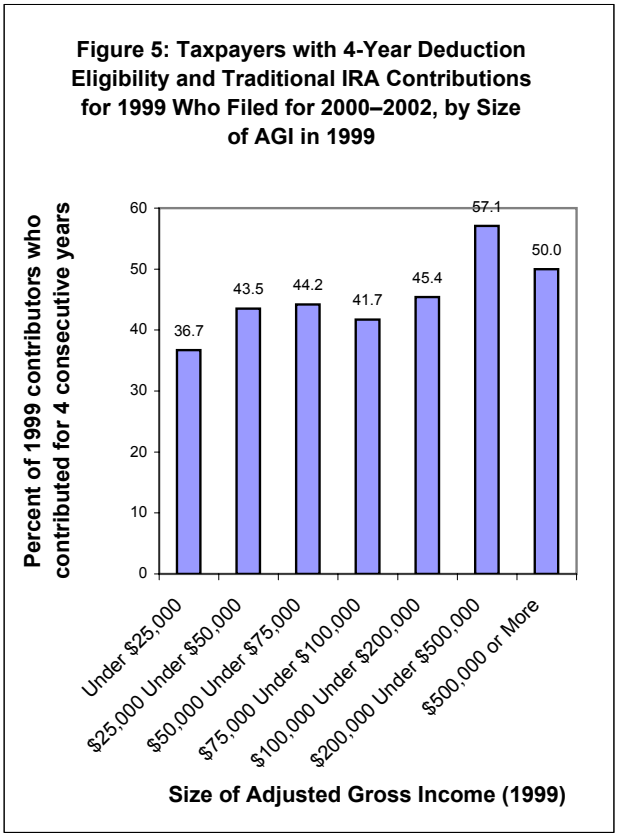
the "$75,000 under $100,000," and the "$500,000 or more" income classes showing lower persistency rates (Figure 4). Persistency is most difficult for lower-income taxpayers, and, given the many other investment



opportunities for those with high incomes, perhaps not that relevant for higher-income taxpayers. The lower persistency rates in the middle of the distribution may be related to the phaseout of the deductibility of traditional IRA contributions for some taxpayers at those levels. When only taxpayers who were eligible for IRA deductions in all 4 years were considered, persistency was higher across all income groups and did not vary as much among the lower-to-middle income groups (Figure 5).

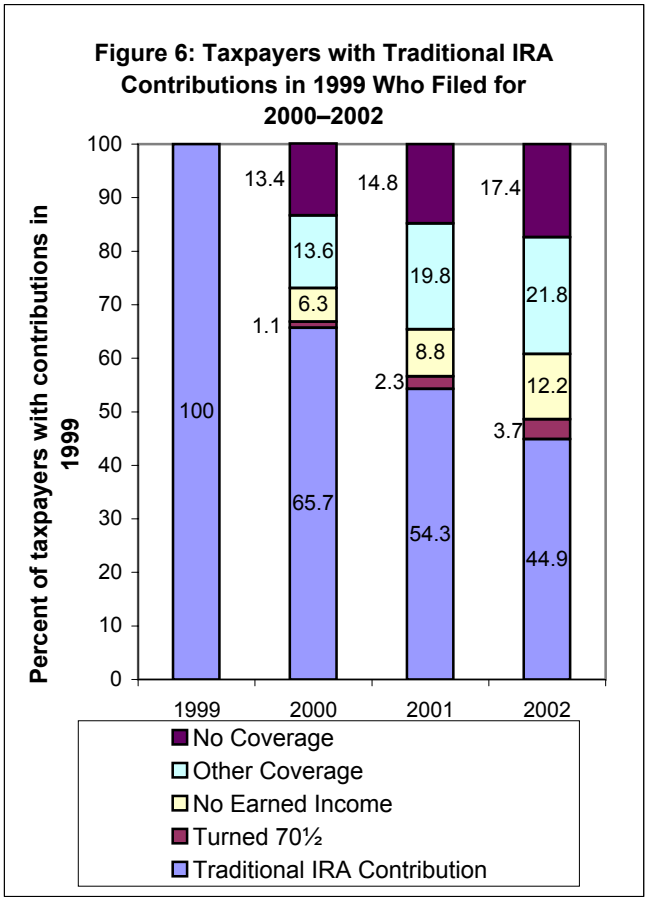
▶ Reasons for Leaving the Program

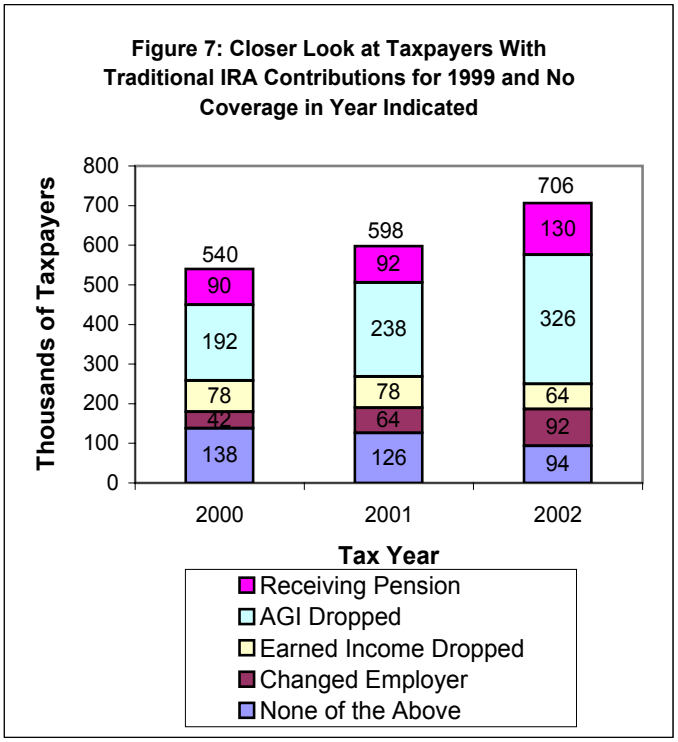
In Figure 6, several factors are considered that may have caused taxpayers who contributed to traditional IRA plans in Tax Year 1999 not to contribute in subsequent years. As mentioned previously, reaching age 70½ disqualifies a taxpayer from making contributions.



By 2002, some 3.7 percent of the 1999 contributors were no longer eligible to contribute due to their ages. Also in 2002, some 12.2 percent no longer had earned income (salaries and wages or self-employment income) and thus were ineligible. A total of 21.8 percent of the 1999 IRA contributors still met the basic age and income requirements, but had opted to save for retirement under different plans--401(k) plans, Roth IRAs, SEP or SIMPLE IRA plans--or had coverage under another employer-sponsored retirement plan. This left 17.4 percent of the 1999 contributors who were not contributing to any pension plan, even though they appeared to be eligible to do so.

The motivation of taxpayers who stopped contributing to retirement plans is, of course, a matter of speculation. But the matched database of tax returns and information documents does contain information that supports somewhat informed speculation. Looking at the taxpayers who stopped contributing between





1999 and each of the 3 succeeding years, Figure 7 shows that between 90,000 and 130,000 of these individuals, depending on the year, had started making withdrawals from their pension plans (information reported on Form 1099-R). So, while they were still receiving earned income, they were presumably semiretired and no longer felt the need to build up their pension reserves. A substantial number of these taxpayers were not receiving pension income, but had experienced a drop in adjusted gross income since 1999, and may not have felt able to afford pension plan contributions. By 2002, these taxpayers numbered 326,000--over half the individuals who had stopped making pension contributions. A smaller number of taxpayers (64,000 for 2002) did not have a drop in overall income, but did have a drop in salaries and wages (earned income), which may have had a similar effect. And another 92,000 of these taxpayers changed employers between 1999 and 2002, or changed from employee to self-employed individuals--changes which may have disrupted their contribution patterns.

▶ Taxpayers' Use of 401(k) Plans

At yearend 2002, nationwide, 401(k) plans had accumulated $1.5 trillion in assets (see Investment Company Institute (August 2005)). This paper uses information from individuals' W-2 forms in conjunction with the Individual Tax Return (Form 1040) to analyze taxpayer contributions to 401(k) plans among taxpayers in the 1999–2002 panel dataset.

▶ Definition of 401(k) Plans

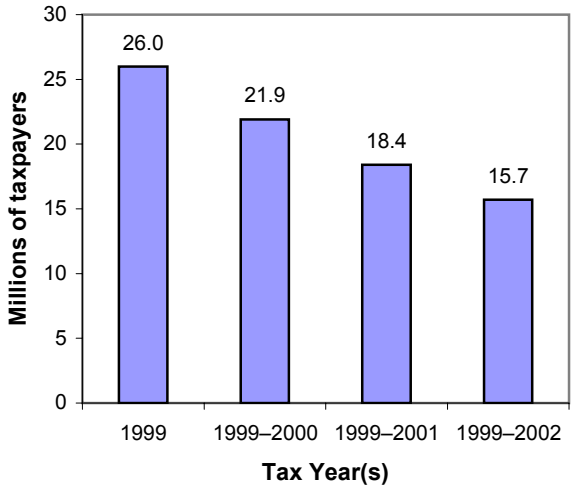
The key provision of 401(k) plans, which are a type of employer-sponsored defined contribution plan, is the ability to defer salaries by making before-tax contributions (deferrals) to an account maintained in the given participant's name. In most instances, the participant directs the investment of the account assets, which grow tax-free until they are withdrawn. In many cases, the plan sponsor may make a matching contribution (for example, contributing 50 cents for every dollar the participant contributes up to 6 percent of salary; for a detailed analysis of 401(k) plan participant contribution activity, see Holden and VanDerhei (October 2001)).

Contribution limits in 401(k) plans are higher than in IRA's. In Tax Year 1999, the participant deferral limit in 401(k) plans was $10,000 ($10,500 in 2000 and 2001, and $11,000 in 2002). "Catch-up" contributions were also permitted in 401(k) plans starting in 2002 under EGTRRA.

▶ Persistency in 401(k) Contributions

A comparison of persistency in 401(k) contributions (Figure 8) to that for the traditional IRA contributions (Figure 1) shows that persistency of contributors to 401(k) plans is much higher. Over 60 percent of contributors to 401(k) plans in 1999 contributed for the following 3 years as well--as compared to 34.8 percent for contributors to IRA plans.

Figure 8: Taxpayers with 401(k) Contributions for 1999 Who Filed for 2000–2002: Persistence of Contributions



▶ Future Research

The Statistics of Income Division is developing a larger, stratified panel, which will contain data for over 140,000 individual taxpayers. The data shown in this article will be rerun from this larger panel when it becomes available. In addition, further analysis of taxpayers with 401(k) contributions in 1999 and not in later years will be explored.

▶ Note

The views in this paper are those of the authors and do not reflect those of the Investment Company Institute or its members, nor are they the official positions of the Internal Revenue Service. Any errors are solely the responsibility of the authors.

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