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Tax Law Changes Increase Deferred Compensation Limits

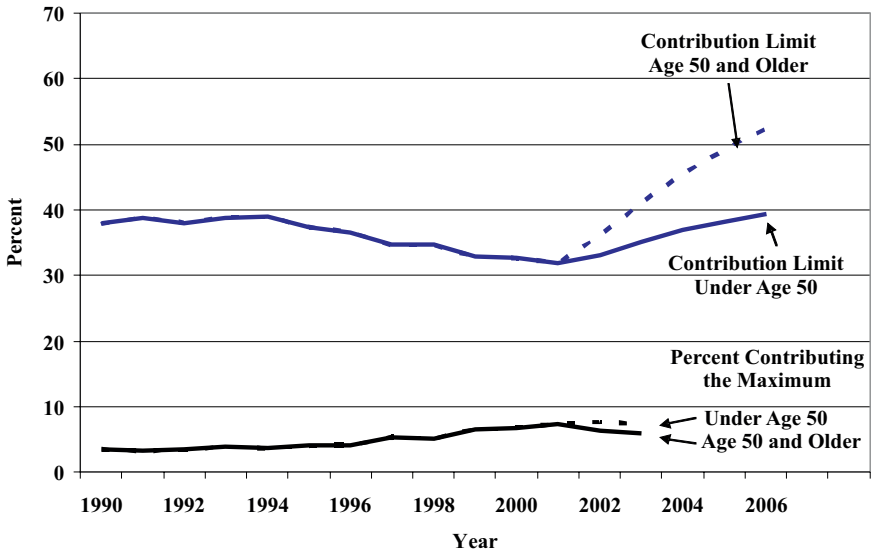
By Karen E. Smith and Eric J. Toder

The President's Advisory Panel on Federal Tax Reform proposes to expand greatly the amount individuals can contribute to tax-free savings accounts. Under its proposal, married couples would be able to save $40,000 per year in tax-free accounts. That increase in individual contributions is in addition to amounts employees may now contribute to employer-sponsored 401(k) plans and other tax-deferred accounts (DC plans).

Recent tax legislation has significantly increased the maximum amount that employees may contribute to employer-sponsored DC plans. The dollar limit on employee contributions lagged behind the growth in average earnings during the 1990s, declining from 39 percent of average earnings ($7,797) in 1990 to 32 percent of average earnings ($10,500) in 2001, but has been increasing every year since then and will reach 39 percent of earnings in 2006 ($15,000). Employees over age 50 may make additional "catch-up" contributions, which will amount to $5,000 by 2006, raising the total dollar limit for them to 52 percent of average earnings. (See chart below.)

While the amount employees may contribute to DC plans is rising, very few employees contribute the maximum allowable amount. Of those participating in plans, less than 4 percent contributed the maximum amount in 1990. The share of maximum contributors rose to more than 7 percent in 2001, but the share dropped back to 6 percent in 2003, as many employees did not take advantage of the catch-up provision. Additional increases in the contribution limit are likely to reduce further the share of those who contribute the maximum.

Contribution Limits as a Percent of the Average Wage and Percent of Participants Contributing the Max (With and Without "Catch-Up") by Year



Source: Internal Revenue Code, various years. Urban Institute tabulations of 1996 SIPP linked to the Social Security Administration Detailed Earnings File. *See also* Janette Kawachi, Karen E. Smith, and Eric J. Toder, "Making Maximum Use of Tax Deferred Retirement Accounts," report submitted to Boston College Center for Retirement Research, December 2005.

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