Compensation & Benefits Review

Abstract

What are now callec … by the Employee Retirement Income … nsored Simplified Employee Pensions … Employees–IRAs (and 401(k)s) in 199… 27.1 trillion in all retirement plans. This article examines the role and importance of IRAs in the U.S. retirement system and the development of the different types of IRAs and their interaction with each other.

There are five main types of Individual Retirement Accounts (IRA): traditional, Roth, Simplified Employee Pensions (SEP), Salary Reduction SEP (SARSEP) and Savings Investment Match Plans for Employees (SIMPLE). As reported in Table 1, together they hold assets amounting to $9.2 trillion representing one-third (32.7%) of the $28.1 trillion held in all retirement savings in the United States. That is up from $2.6 trillion (22.6%) in 2000. That compares with $9.0 trillion (32.0%) for combined private sector and public sector defined-benefit (DB) plans and $7.7 trillion (27.4%) for defined-contribution (DC) plans. Another $2.2 trillion (7.8%) is held in non-IRA annuities.

Table 1. Total U.S. Retirement Market Assets, Selected Years 2000 to 2018 (assets in $ trillions).

Year	Annuities		DB plans[a]		DC plans		IRAs		Total retirement assets[b]
	Assets	% of total	Assets	% of total	Assets	% of total	Assets	% of total	
2000	0.9	7.8	5.0	43.5	3.0	26.1	2.6	22.6	11.5
2005	1.3	9.0	6.0	41.7	3.7	25.7	3.4	23.6	14.4

Year	Annuities		DB plans		DC plans		IRAs		Total retirement assets
	Assets	% of total	Assets	% of total	Assets	% of total	Assets	% of total	
2010	1.6	8.9	6.6	36.7	4.8	26.7	5.0	27.8	18.0
2015	2.0	8.3	8.1	33.6	6.5	27.0	7.5	31.1	24.1
2016	2.0	7.9	8.3	32.8	6.9	27.3	8.1	32.0	25.3
2017	2.2	7.8	9.1	32.3	7.7	27.3	9.2	32.6	28.2
2018 Q1	2.2	7.8	9.0	32.0	7.7	27.4	9.2	32.7	28.1

Note. DB = defined benefit; DC = defined contribution; IRAs = Individual Retirement Accounts; Q1 = first quarter.

Source. McGarth, C. (2018). U.S. retirement assets at $28 trillion in Q1 (according to latest release from the Investment Company Institute). *Pensions & Investments*. Retrieved from https://www.pionline.com/article/20180621/INTERACTIVE/180629958/u-s-retirement-assets-at-28-trillion-in-q1-little-changed-from-end-of-2017.

a
Includes private and public sector DB plans. Combined by author. [b]Calculated by author.

Traditional IRAs and Roth IRAs are established and funded by individuals. SEP-IRA, SARSEP-IRA and SIMPLE-IRA are sponsored by employers. SEP-IRAs are funded solely by employers. SARSEP- and SIMPLE-IRAs are funded by employee and employer contributions.

Background

IRAs did not emerge and evolve in isolation. Rather, they were a part of the shift of the U.S. retirement income system from predominantly DB pensions to predominantly DC plans.

What are now called “traditional IRAs” were created by the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406; ERISA) and became available in 1975.

ERISA did a lot of other things as well. It set minimum requirements for participation, vesting, funding, fiduciary responsibility and added extensive reporting requirements. It also created the Pension Benefit Guaranty Corporation to insure the benefits of private sector DB pension plans. The result was to greatly increase the employers’ cost and risk of sponsoring traditional DB pension plans. Private sector employers responded by replacing their DB pensions with DC retirement arrangements, especially Section 401(k) plans. The result was to shift some of the cost and most of the risk of providing retirement income from the employer to the employee. It also greatly increased the portability of retirement benefits.

Table 2 reports that the number of traditional DB pension plan declined from a peak of 170,172 in 1985 to 46,300 in 2016 (the most recent year for which data are available). Actually, the decline was much worse than that as a large number of DB plans were “frozen” (not open to new members and/or not accruing additional benefits).

Table 2. Number of DB, DC and 401(k) Plans, Active Participants and Asset Amounts Selected Years, 1985 to 2016.

Year	Defined-benefit plans	Defined-contribution plans	401(k) type Plans	401(k) plans as a percent of DC plans[a]
Number of plans				
1985	170,172	461,963	29,869	6.5
1995	69,492	623,912	200,813	32.2
2005	47,614	631,481	436,207	69.1
2015	45,672	648,252	546,896	84.4
2016	46,300	656,241	560,373	85.4
Number of active participants (in millions)				
1985	28.9	33.2	10.3	31.0
1995	23.4	42.2	27.8	65.9
2005	20.3	62.4	54.6	87.5

Year	Defined-benefit plans	Defined-contribution plans	401(k) type Plans	401(k) plans as a percent of DC plans
2015	14.4	78.1	65.3	83.6
2016	13.9	80.0	67.1	83.9
Assets (in $ billions)				
1985	826.1	426.6	143.9	33.8
1995	1402.1	1321.7	863.9	65.4
2005	2254.0	2807.6	2395.8	85.3
2015	2862.4	5292.1	4382.0	82.8
2016	2923.2	5691.7	4738.5	83.3

Note. DB = defined benefit; DC = defined contribution.

Source. U.S. Department of Labor. Employee Benefits Security Administration. (2018, December). Private Pension Plan Bulletin Historical Tables and Graphs 1975-2016. Retrieved from https://www.dol.gov/agencies/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan.

[a] Author’s calculations after rounding for participants and assets.

Over the same period (1985-2016), the number of DC plans increased from 461,963 to 656,241. Within that, the number of Section 401(k) plans (available since 1981) greatly increased from 29,869 in 1985 to 560,373 in 2016 (from 6.5% to 85.4% of all DC plans).

The number of active participants in DB plans declined from 28.9 million in 1985 to 13.9 million in 2016 while that of DC plans grew from 33.2 million to 80.0 million. During this period, 401(k) plan participants grew from 10.3 million (31.0% of total DC plans) to 67.1 million (83.9%).

Over the same period, asset values in DB plans continued to grow $826.1 billion to $2,923.2 billion ($2.9 trillion). This was due to the continuing funding requirements of ERISA. Assets in DC plans grew from $426.6 billion to $5,691.7 billion ($5.7 trillion).

Traditional and Roth IRAs are generally not covered by ERISA unless they receive rollover contributions from an ERISA-qualified plan such as 401(k) plan. SEP-IRAs, SARSEP-IRAs and SIMPLE-IRAs are covered by ERISA.

Traditional IRAs

The most common type of IRA is the traditional IRA created by the ERISA of 1974. IRAs have two primary purposes: (1) to provide tax-favored retirement savings opportunity for employees not covered by an employer-sponsored pension plan and (2) to preserve the tax-deferred status of assets in Internal Revenue Service (IRS)-qualified retirement savings plans through rollovers. IRAs were an instant success. In 1975, $1.4 billion had been contributed. By 1981, that amount had grown to $4.8 billion.[1]

Originally, employees were allowed to contribute up to the lesser of $1,500 per year or 15% of household income to an IRA. The Economic Recovery Tax Act of 1981 (Pub. L. 97-34) increased the contribution limit to the lesser of $2,000 or 100% of earned income. It also made IRAs available to all workers under the age of 70½, whether they had an employer-provided pension or not.

The Tax Reform Act of 1986 (Pub. L. 99-514) limited tax-deductible contributions for those with an employer-provided pension plan to individuals with income of $35,000 or less. For a couple filing jointly, the limit was $50,000. The Tax Reform Act also permitted a $250 contribution for a nonworking spouse. Table 3 reports the growth in contribution limits, nonworking spouse contributions and age-50-and-over catch-up contributions from 1974 through 2020.

Table 3. Traditional and Roth IRA Contribution Limits, Nonworking Spouse Contributions and Over Age 50 Catch-Up Contributions.

Years	IRA contribution limits ($)	Nonworking spouse contribution ($)	Over age 50 catch-up contribution ($)
1974-1976	1,500	—	—
1977-1981	1,500	250	—

Years	IRA contribution limits ($)	Nonworking spouse contribution ($)	Over age 50 catch-up contribution ($)
1982-1997	2,000	250	—
1998-2001	2,000	2,000	—
2002-2004	3,000	3,000	500
2005	4,000	4,000	500
2006-2007	4,000	4,000	1,000
2008-2012	5,000	5,000	1,000
2013-2018	5,500	5,500	1,000
2019-2020	6,000	6,000	1,000

Note. IRA = Individual Retirement Account.

Source. Historical IRA contribution limit. (2019). Retrieved from https://dqydj.com/historical0ira-contribution-limit.

As reported in Table 4, by 2000, 38.0 million U.S. households owned IRAs (35.7% of all households)—30.5 million of those owned traditional IRAs (28.7%). By 2010, 38.5 million households owned traditional IRAs (32.8%). Due to a change in the sampling methodology by the Investment Company Institute, those numbers declined to 33.2% and 26.0%, respectively, by 2018.

Table 4. U.S. Households Owning IRAs, Selected Years, 2000 to 2018.

Year	Any	Number of households with IRAs (millions)	Any	Share of households with IRAs (%)	Numb house (milli

Year	Number of households with IRAs (millions)				Share of households with IRAs (%)				Number of households (millions)
	Any	Traditional	Roth	Employer-sponsored[a]	Any	Traditional	Roth	Employer-sponsored[a]	
2000	38.0	30.5	9.8	7.2	35.7	28.7	9.2	6.6	106
2005	43.0	34.0	14.5	8.4	37.9	30.0	12.8	7.4	113
2010	48.6	38.5	19.5	9.4	41.1	32.8	16.6	8.0	117
2015[b]	40.2	30.4	20.3	6.7	32.3	24.4	16.3	5.4	124
2016[b]	42.5	32.1	21.9	6.7	32.3	24.4	16.3	5.4	124
2017[b]	43.9	35.1	24.9	7.6	34.8	27.8	19.7	6.0	126
2018[b]	42.6	33.2	22.5	7.5	33.4	26.0	17.6	5.9	127

Note. IRAs = Individual Retirement Accounts.

Source. Appendix to "The role of IRAs in U.S. Households Saving for Retirement, 2018". (2018, December). *Investment Company Institute Research Perspective, 24*(10). Figure A1. Retrieved from https://www.ici.org/pdf/per24-10.pdf

a
Employer-sponsored IRAs include Simplified Employee Pensions–IRAs, Salary Reduction Simplified Employee Pensions–IRAs and Savings Investment Match Plans for Employees–IRAs. [b]The lower incidence of IRA ownership beginning 2015 results from a change in the Investment Company Institute's sampling methodology.

Not everyone is allowed to contribute to an IRA. In 2020, single individuals with a "modified adjusted gross income" of $65,000 or less are allowed to contribute the full amount. For those with a modified adjusted gross income between $65,000 and $75,000, the amount allowed is reduced. Those earning more than $75,000 are not allowed to contribute. For married couples filing jointly, the earnings limits are $104,000 and $124,000. For couples filing separately, the limit is $10,000.[2]

Once an account owner turns 70½, he or she can no longer make contributions to a traditional IRA and must start taking "required minimum distributions" (RMD). The amount of the RMD is based on the amount of assets in the IRA and the life expectancy of its owner.

When the owner of the IRA dies, the plan may be inherited. If inherited by a spouse, he or she may continue to make contributions from earned income until age 70½ and then start taking RMDs. If inherited by anyone else, the funds must be withdrawn (and taxed) within 5 years.

Traditional IRAs and DC plans are closely linked. 84% of the growth in new traditional IRAs is the result of rollovers from DC plans, especially 401(k) plans. Meanwhile, 70% of the growth in new Roth IRAs is the result of participant contributions.[3] If a 401(k) or other tax-deferred DC plan is rolled into a Roth IRA, the participant would have to pay income taxes on the amount rolled over. For large mature DC plans, that is usually prohibitive.

Roth IRAs

Roth IRAs were created by the Taxpayer Relief Act of 1997 (Pub. L. 105-34). They are named after Senator William V. Roth (R-DE). Contributions are not tax deductible. They are made with after-tax dollars. However, assets in the plan grow tax free. Money may be withdrawn from a Roth IRA after the age of 59½ without penalty and tax free. There are no RMDs after age 70½.

Roth IRAs are usually more attractive to participants. By contributing after-tax dollars, they can, in effect, contribute more dollars that then grow at a compounding rate. When the funds in a Roth IRA are eventually withdrawn from the plan, they are not taxed.

As indicated in Table 4, the number of U.S. households with Roth IRAs grew from 9.8 million in 2000 (9.2% of all households) to 22.5 million (17.6%) in 2018. That is a growth rate of 130.0%, which compares with 8.9% for traditional IRAs. *Note*: This statement does not take into account the change in sampling methodology by the Investment Company Institute beginning 2015.

Contribution limits for traditional IRAs and Roth IRAs and other requirements are the same. Their distinction is the tax treatment of contributions.

Traditional IRAs and Roth IRAs are established and funded by individuals. We now turn to employer-sponsored SEP-IRAs, SARSEP-IRAs and SIMPLE-IRAs. As reported in Table 4, these plans combined represent a smaller and relatively stable number of plans.

SEP-IRAs

SEP-IRAs were created by the Revenue Act of 1978 (Pub. L. 95-600). Their purpose is to encourage the creation of IRAs by small businesses and the self-employed. They have much higher contribution limits than traditional or Roth IRAs. Only the employer funds the SEP-IRA. There are no employee contributions allowed.

Any employer (or self-employed person) can establish an SEP-IRA. This is done by either using IRS Form 5305-SEP Contribution Agreement; an IRS-approved prototype SEP provided by a bank, insurance company or other IRS-approved financial institution; or an IRS-approved individually designed SEP document. If the employer chooses to allow each participating employee to choose his or her financial institution, IRS Form 5304-SEP is used.

The employer must provide each eligible employee with a copy of the SEP document. The employer must also set up an SEP-IRA account for each eligible employee at a financial institution. The employee owns and controls the SEP-IRA. All participating employees (including the employer) must receive the same percentage of salary as a contribution. The employer may change the contribution amount in response to business conditions.

In 2019, the maximum contribution limit to an SEP-IRA was 25% of earned income to a maximum of $56,000. They are the same thing. The maximum compensation used for SEP calculations is $280,000 minus the maximum contribution ($56,000) is $224,000 ($224,000 × 0.25 = $56,000).

An eligible employee is anyone aged 21 years or older, who has worked for the employer for at least 3 of the past 5 years and has earned at least $600 per year (in 2016-2019). The employer may adopt less restrictive requirements.

Employees who are excluded are those covered by a collective-bargaining agreement that includes a retirement plan, those who have not yet met the plan's minimum age and service requirements and nonresident aliens with no U.S. income.[4]

I could find no data on the number or percent of households with SEP-IRAs. However, the Investment Company Institute publishes data on "Employer-sponsored IRAs" that includes SEP-IRAs, SARSEP-IRAs and SIMPLE-IRAs. They are reported in Table 4. In 2000, there were 7.2 million households with such employer-sponsored IRAs representing 6.6% of all households. By 2018, those numbers were 7.5 million and 5.9%, respectively. The number of households had increased.

SARSEP-IRAs

SARSEP-IRAs were created by the Tax Reform Act of 1986. They are funded by employee elective deferrals and employer incentive contributions.

An employer could establish a SARSEP-IRA by using either IRS Form 5305-SEP or an IRS-approved prototype offered by financial institution. Contributions are deposited in each participating employee's SEP-IRA account with a bank, insurance company or other approved financial institution.

After the passage of the Small Business and Jobs Protection Act of 1996 (Pub. L. 104-188; SBJPA), no new SARSEP-IRAs were allowed to be established. However, existing SARSEP-IRAs may continue to operate. Employees hired in 1997 or after must be allowed to participate in a these "grandfathered" SARSEP-IRA plans.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16) changed many of the IRS requirements and limits for IRAs, including SARSEP-IRAs. An updated model plan (IRS Form 5305A-SEP) must have been adopted by the end of 2002.

Only private sector employers with 25 or fewer employees may continue to operate a SARSEP-IRA and only if at least 50% of eligible employees choose to make salary reduction elective contributions. While I could find no data on the number of SARSEP-IRAs, given the propensity of small business to go out of business or to grow beyond the 25-employee limit, their numbers must be dwindling. New SARSEP-IRAs were replaced by SIMPLE-IRAs beginning in 1997.[5]

SIMPLE-IRAs

The SBJPA of 1996 created the SIMPLE-IRA. As its name implies, such plans involve employee-elective deferrals and employer-matching contributions. They may be adopted by employers with 100 or fewer employees.

A SIMPLE-IRA is set up by using IRS Form 5305-SIMPLE if the employer chooses the financial institution to receive the contributions or by using an IRS-approved prototype offered by banks, insurance companies and other approved financial institutions. Form 5304-SIMPLE is used if each participating employee is permitted to choose the financial institution.

Employees earning at least $5,000 in the preceding year and expected to earn at least $5,000 in the current year are eligible to participate in a SIMPLE-IRA. The employer may exclude employees covered by a collective-bargaining agreement that includes a pension plan and nonresident aliens with no U.S. income.

Employees could contribute 100% of earned income up to a maximum of $13,000 in 2019 ($13,500 in 2020) indexed. Employers can choose to make either a nonelective 2%-of-compensation contribution for all eligible employees (regardless of whether the employee makes an elective deferral) or an optional 3%-of-compensation matching contribution for participating employees only.

If the employer makes a 2% nonelective contribution, the maximum income amount allowed is $280,000. Therefore, the maximum employer contribution would be $280,000 × 0.02 = $5,600.

There was also an age-50-and-over catch-up contribution of up to $3,000 for 2019 (indexed). This compares with $1,000 for traditional and Roth IRAs.

The employer can reduce the 3% matching contribution, provided it is not reduced below 1% and that it is not reduced for more than 2 years out of a 5-year period. The affected employees must be given reasonable timely notification.[6]

SIMPLE-401(k)s

The SBJPA of 1996 also created (safe-harbor) 401(k) plans. Their requirements are very similar to SIMPLE-IRAs: 100-employee limit, employer obligated to make a 2% nonelective contribution for all eligible employees or a 3% matching contribution for participating employees and so on.[7]

One important difference is that under a SIMPLE-401(k) the employer must file a Form 5500. That is quite a burden. However, the employer does not have to perform nondiscrimination or top-heavy testing. This makes SIMPLE-401(k) plans less burdensome than regular 401(k)s but more burdensome than SIMPLE-IRAs. I therefore doubt that there are many SIMPLE-401(k) plans.

Appraisal

IRAs are important part of the U.S. retirement system. Traditional IRAs have become especially important as a vehicle to preserve the tax-deferred status of assets in DC plans, especially 401(k) plans.

Roth IRAs, with their after-tax contributions, have become increasingly important as a vehicle for new contributions.

Employer-sponsored SEP-IRAs and SIMPLE-IRAs (and to a declining extent "grandfathered" SARSEP-IRAs) have allowed small employers (and the self-employed) to provide retirement benefits without the considerable administrative burden and cost of a qualified pension plan. Combined, traditional, Roth and employer-sponsored IRAs represent a large and integral part of the U.S. retirement income system.

As indicated in Table 5, total IRAs hold a significant and growing portion of retirement plan assets in the United States. They have grown from $1.3 trillion in 1995 to $8.8 trillion in 2018. As a percentage of total retirement plan assets, they have grown from 18.8% to 32.5%. Over the same period, assets in DC plans (most important 401(k)s) have increased from $1.7 trillion to $7.5 trillion or from 24.6% to 27.7% of total retirement plan assets. This compares with combined private and public sector DB plans (and non-IRA annuities), which have grown from $3.9 trillion to $10.7 trillion. However, as a percentage of total retirement assets, they have declined from 56.5% to 39.5%. This decline reflects the contraction and virtual disappearance of traditional active DB pension plans in the U.S. private sector.

Table 5. Amount and Percentage of Total U.S. Retirement Plan Assets at End of Selected Years ($ Trillions).

Year	All IRAs[a]		DC plans[b]		DB plans[c]		Total retirement plan assets
	Assets	% of total	Assets	% of total	Assets	% of total	
1995	1.3	18.8	1.7	24.6	3.9	56.5	6.9
2000	2.6	22.4	3.0	25.9	6.0	51.7	11.6
2005	3.4	23.6	3.7	25.7	7.2	50.0	14.4
2010	5.0	27.8	4.8	26.7	8.2	45.6	18.0
2015	7.5	31.3	6.5	27.1	10.1	42.1	24.0
2016	8.1	31.9	6.9	27.2	10.4	40.9	25.4
2017	9.2	32.4	7.8	27.5	11.4	40.1	28.4
2018	8.8	32.5	7.5	27.7	10.7	39.5	27.1

Note. IRAs = Individual Retirement Accounts; DC = defined contribution; DB = defined benefit.

Source. Investment Company Institute. (2019). *2019 Investment company fact book: A review of trends and activities in the investment company industry* (Figure 8.5, p. 159). Retrieved from https://www.ici.org/2019_factbook_pdf

[a]
Includes traditional, Roth and employer-sponsored IRAs (Simplified Employee Pensions, Salary Reduction Simplified Employee Pensions and Savings Investment Match Plans for Employees). [b]Include private employer-sponsored DC plans (including 401(k) plans, 403(b) plans, 457 plans and Federal Employee Retiree System Thrift Savings Plan. [c]Includes private sector DB pension plans, federal, state and local government DB plans and all fixed and variable annuities held outside retirement plans and IRAs.

Conclusion

The shift of the private sector retirement system from one based predominately on traditional DB pension plans to one based mainly on DC plans would not have been workable without IRAs. Traditional IRAs are essential for preserving the tax-deferred status of assets in DC plans upon job change or retirement. They, and increasingly Roth IRAs, allow individuals to save for retirement or augment employer-sponsored retirement income arrangements. This adds greatly to the retirement security of millions of American families.

SEP-IRAs and SIMPLE-IRAs allow small employers without another pension plan to provide a retirement income plan without the administrative hassle and considerable cost of a regular ERISA-covered pension arrangement. This allows them to compete for and retain high-quality employees.

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Footnotes

1. History of Individual Retirement Ar-rangements. (2017). *Financial Ducks in a Row* (p. 1). https://financialducksinarow.com

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2. Internal Revenue Service. (2019). *IRA deduction limits*. https://www.irs.gov/retirement-plans/ira-deduction-limits

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Biographies

John G. Kilgour, PhD, is a longtime and frequent contributor to *Compensation & Benefits Review*. He holds a BA in economics from the University of Connecticut (1966) and an MILR (1968) and a PhD (1972) from Cornell University. He taught compensation and benefits and related courses for 30-plus years and held several administrative positions at California State University, East Bay, from which he fully retired in 2005.

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