On the Uniform Taxation of Retirement Plans—Lessons from Canada's Registered Retirement Saving Plan (RRSP)

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Introduction

As the debate begins on fundamental tax reforms, many issues need to be addressed, including the minimum taxable income, personal deductions, and review of special corporate tax measures. Arguably, among the most important of these is the tax treatment of severance payments and pensions. The taxation system is critical to the resolution of important issues such as: (1) coping with changes in employment practices and work style diversification, (2) promoting insurance and savings for old age to supplement public pensions, and (3) ensuring the neutrality of savings products and pension plans.

1. Retirement Income Deductions are Outdated

Major changes are occurring in the employment and wage structure—job separations are increasing due to corporate restructuring, while companies are extending employment periods in response to the higher benefit eligibility age for public pensions.

However, the tax treatment of severance payments and pensions has failed to respond to these changes. At present, retirement income is treated differently from ordinary wage or salary income. As Figure 1 shows, the retirement income deduction is applied to lump-sum severance payments (including lump sums from pension plans). As for pension plans, corporate contributions to the Employees' Pension Fund (EPF) are treated as a deductible expense, and investment gains are also nontaxable. In contrast, while contributions to tax qualified pension plans (TQP) and defined contribution (DC) plans (including individual contributions) are tax deductible, investment gains will become subject to the special corporate tax when the tax is unfrozen.

In addition, pension benefits are subject to the pension deduction. Thus using the old-age deduction and other deductions, elderly households (couples age 65 and over) with no other income can enjoy up to 3.49 million yen in nontaxable income (Figure 2).

Figure 1　Present Tax Provisions for Retirement Income

Lump-sum severance payment	Corporate pension plan (EPF, TQP, new DP plan, corporate DC plan)	Annuity (life insurance, DC plan)
・Retirement income deduction applies at time of payment	<u>Contributions</u> ・Corporate contribution is a deductible expense * ・Social insurance premium deduction applies to individual contributions to EPF; life insurance premium deduction applies to other DB plans	・For life insurance annuities, tax deduction applies to contributions up to ¥100,000/year
→ Tax is levied on one-half of gross income less deduction	<u>Investment gains</u> ・Employees' Pension Fund is nontaxable ** ・Other corporate pensions are subject to special corporate tax (that remains frozen to end of fiscal 2002)	・For individual DC plan, tax deduction applies to contributions up to ¥180,000/year
<u>Deduction</u> ¥400,000/year for first 20 years of service, ¥700,000/year thereafter	<u>Withdrawal</u> *** ・Treated as misc. income; pension deduction applies (see Figure 2) ・Retirement income deduction applies to lump sum	

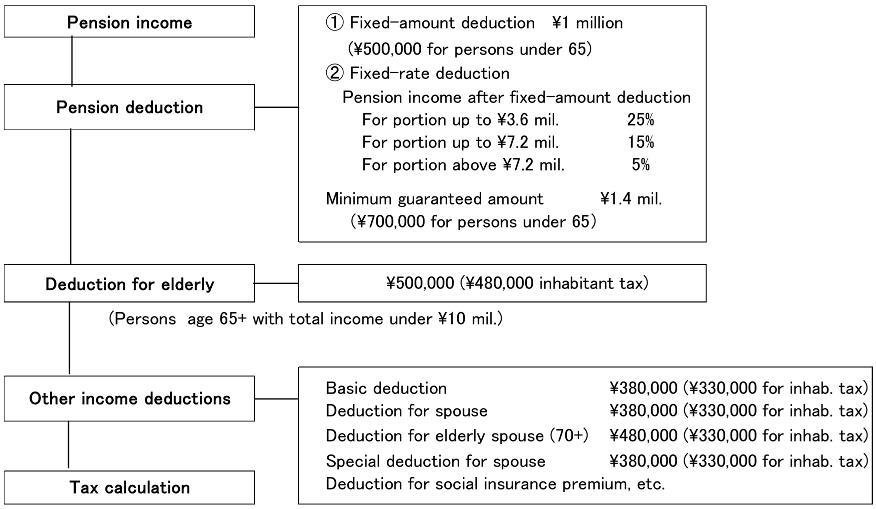
Notes: * No maximum for defined benefit plan. Maximum for corporate DC plan is ¥216,000 if another DB plan exists, and ¥432,000 if not.
** However, the tax exemption applies only to gains generated from assets up to 2.7 times the assets necessary to pay substitutional benefit.
*** For the National Pension Fund, individual contributions and investment gains are nontaxable, and the pension deduction applies to benefits.

Strict adherence to the income distinctions creates several problems. First, consider the distinction between wage income and severance payment. While the retirement income deduction applies to severance payments, if the employer uses severance payment funds to increase current wages, payments are taxable as wage income. Thus even if companies offer employees the option of earning higher cash wages in place of the severance payment, employees will agree only if the tax disadvantage is corrected.

If employment is extended past the normal retirement age of 60, any wages paid out of severance payment funds are taxable as wage income, thus again reducing the actual after-tax amount. Some companies offer extended employment after age 60 along with a severance payment at age 60, enabling employees to use the retirement income deduction despite continuing to work. The difference in timing between these two cases should not be relevant for tax purposes. We expect that this inconsistency will prompt employers and employees to seek ways to arbitrarily allocate compensation and minimize the tax burden using both the retirement income deduction and earned income deduction.

Second, while the employer's contributions to corporate DB plans are tax deductible as expenses, a nontaxable limit is applied to contributions to DC plans (corporate and individual). Moreover, individual contributions to a pension plan or individual DC plan are deductible only up to 100,000 yen and 180,000 yen per year, respectively.

Figure 2 Tax Treatment of Pension Benefits



Source: Government Tax Commission

(For Reference) Comparison of Minimum Taxable Household Income

(¥ million)

	Single	Married	
		Without elderly spouse	With elderly spouse
Public pension recipient (65 and over)	2.342	3.346	3.488
Public pension recipient (under 65)	1.110	2.137	2.279
Wage earner	1.107	2.095	

Third, inequities exist in income from plan assets. At present, due to the suspension of the special corporate tax, all investment gains in corporate plans are nontaxable. But if a person retires early due to corporate restructuring, for example, and decides to put the lump-sum severance payment (paid out of book reserve) or lump-sum withdrawal from the corporate pension into another retirement plan, investment gains on these savings are taxable.

The new Defined Contribution Pension Law allows companies to transfer plan assets from defined benefit plans to defined contribution plans. Once the assets have been transferred, employees who change jobs can transfer their plan assets to their new employer’s DC plan or to an individual account at the National Pension Fund Association, and investment gains are nontaxable.

However, if the employer has a DB plan, employees who are separated form their job before retirement and receive a lump sum cannot contribute that amount to a DC plan. This is another glaring inconsistency—that plan assets can be transferred by the company, but not by the individual.

In addition, the cash balance plan, which is allowed under the Defined Benefit Corporate Pension Law of 2001, resembles the DC plan in that employees can always check their account balance and benefit amount. However, if employees change jobs, the lump sum they receive cannot be rolled over from cash balance plans into a DC plan.

As described above, inconsistencies in tax treatment arise due to distinctions between wage income and severance payment, and between corporate and individual pension plans. However, whether the company accumulates plan assets and pays out severance payments and pensions, or employees save for retirement on their own, should have no bearing on the tax outcome. The fact that the type of income can affect tax treatment obstructs the neutrality of employers and employees regarding decisions on length of employment and compensation.

2. Proposal for a Uniform Contribution Limit with Carryover

A simple solution to this inconsistency is to make severance payments and pension contributions all taxable as employee income. But doing so would not address another issue regarding the tax treatment of pensions and severance payments—helping people prepare for retirement on their own. Corporate severance payment and pension plans can serve as a complement to the troubled public pension system. Indeed, the development of corporate plans would reduce people's retirement anxieties as well as the burden of public pensions. For this reason, it is common in Europe and the U.S. to defer taxation of retirement plans by making contributions tax exempt, investment gains tax exempt, and benefits taxable (abbreviated as EET in Figure 3).

In terms of tax theory, the EET approach is not that of a comprehensive income tax on all increases in assets at the time of increase, but is instead based on the concept of a consumption tax applied when assets are dissaved. With regard to pension contributions and plan assets, since (1) the future benefit amount is unknown, and (2) in many cases the employer and not employee makes contributions, the consumption tax approach represented by EET is well suited.

Since applying the EET approach would instantly eliminate the present inconsistencies in tax treatment, all deductions for contributions and investment gains should be made uniform regardless of the funding source or savings and investment vehicle. On the other hand, since all benefits should be taxable, the retirement income deduction should be abolished and the pension deduction no longer applied.

Figure 3　Tax Treatment of Retirement Benefits in Industrialized Countries

Country	Taxation	Description
U.S.	EET	Maximum nontaxable limit exists for contributions. Also, employee contributions to DB plan are taxable (but contributions are rare).
England	EET	DB plan contributions are completely tax deferred. DC plan contributions have a nontaxable limit. Benefits are taxable except for lump sums.
Germany *	TET	Employer's contributions are taxable as wages, worker's contributions are tax-deferred. Lower tax rates are applied only to interest portion of benefits. (Under book reserve system, employer's contributions are tax deferred, and benefits are taxed at ordinary tax rate.
Canada	EET	Maximum nontaxable limit for contributions was reduced in 1991 tax reform.
Sweden	ETT	Lower tax rates are applied to benefits.
France	E－T	Maximum nontaxable limit exists for contributions. Due to tax method, fund is taxable.
Australia	TTT	Contributions, investment gains, and benefits are all taxable. But deductions and reduced tax rates apply to all.
Japan	E--	Maximum nontaxable limit for employee's contributions is very small (for tax qualified retirement pension). Investment gains are taxable (maximum nontaxable limit exists for gains on EPF). Benefits are taxable except for tax deductions on lump sum.

Note: In Germany, taxation of pension funds outside of companies and the direct insurance system is close to TET. However, taxation of book reserve pension funds is not necessarily TET.
Sources: E.P. Davis (1995), *Pension Funds*, Clareton Press, as partially reprinted in Employees' Pension Fund Association (1999), *Foreign Pension Systems*, Toyo Keizai Shinposha.

Specifically, we propose establishing a uniform annual limit on nontaxable contributions to retirement savings plans until age 65. Income and expense deductions would be allowed up to this limit regardless of the source (severance payment, wage income, or contributions), regardless of whether the employer or individual makes contributions, and regardless of the type of plan to which they contribute. The National Pension Fund (NPF), individual annuities, and individual DC pension plans would also be covered. However, all employer contributions to corporate DB and DC pension plans are to be subtracted from this limit. For example, if the annual contribution limit is 500,000 yen and the employer contributes 300,000 yen to a DB plan, the individual can contribute up to the remaining 200,000 yen.

A key point here is to allow the unused portion of the limit to be carried over to following years. Thus a person who has used none of the contribution limit over the years can contribute an amount equivalent to 30 to 40 years of service upon retirement. Alternatively, a lump-sum withdrawal from a DB pension plan or severance payment for early retirement can also be contributed. And if contributions stop temporarily due to unemployment or time off from work, extra contributions can be made later to compensate once work is resumed. Temporary financial needs for a home purchase or educational expenses can also be flexibly accommodated. With the carryover, elimination of the retirement income deduction would not pose a major difficulty for people nearing retirement age.

Still, elimination of the pension deduction will face stiff opposition. This deduction was originally introduced in 1973 to enhance elderly welfare (initially the deduction was 600,000 yen). Even after the tax classification of pension income was changed from wage income to miscellaneous income in 1987, the deduction was retained supposedly because pension recipients are elderly persons of limited financial means, and because they have no control over benefit amounts.

However, the financial strength of elderly persons is not determined by pensions alone. In addition, it is common knowledge that the wealthiest segments actually benefit most from this deduction.

The declining financial strength of the elderly can be adequately addressed with the old-age deduction (500,000 yen maximum at present). The time has come to revise the pension deduction, and if there is strong political resistance, we propose setting a new contribution limit specifically for persons up to a certain age in exchange for abolishing the pension deduction.

3. Learning from the RRSP in Canada

The model that most resembles our approach is the Registered Retirement Saving Plan (RRSP) in Canada. Individuals preparing for retirement can make a nontaxable contribution of up to 18% of the previous year's taxable income or a maximum of 13,500 Canadian dollars, and investment gains are tax deferred. In addition, unused portions of the contribution limit can be carried forward. However, a pension adjustment (PA) is made by subtracting contributions to corporate DB and DC plans from the limit. Contributions to the RRSP can be made up to age 69, after which withdrawals, which are taxable, must be made either in lump sum or installments (Figure 4).

With the well-known Individual Retirement Account (IRA) in the U.S., lump sums from other tax qualified plans can be contributed to an IRA. And since different tax rules apply to other plans, employees with corporate plans can enjoy tax deductions for both corporate pension plans and IRAs. To address the problem of people who do not prepare adequately for retirement until late in life, the U.S. tax reform of 2001 has allowed persons age 50 and over to make additional small contributions. This has the same beneficial effect as carrying over unused contribution limits.

Figure 4 The Registered Retirement Saving Plan (RRSP) in Canada

Eligible persons	・Persons under age 69 with income
Nontaxable contribution limit	・Lesser of $13,5000 or 18% of previous year's taxable income (unused portion can be carried forward) ・Over-contributing is taxable and penalized if over $2,000 ・Pension adjustments (PA) are subtracted from the limit as follows:
Withdrawal in old age	・Start withdrawal either as pension or lump sum before age 69
Early withdrawal	・Can borrow up to $20,000 for home purchase (must repay within 15 years)
Spousal RRSP	・Can contribute to spouse's account (within same contribution limit)

Plan	Pension adjustment
Deferred Profit Sharing Plan	Actual contribution of employer
Money Purchase Provision	Actual contributions of employer and employee, plus distributed surplus
Defined Benefit Provision	Change in yearend monthly pension amount from previous year × 9 — $600

4. Nontaxable Contribution Limit Should Start at ¥440,000

The realization of our uniform tax treatment proposal is obstructed by several technical problems. First, there is difficulty keeping records of the nontaxable contribution limits of individual taxpayers. This can be solved by using a national pension number identification system as used in DC plans. Of course, a taxpayer number identification system would also suffice.

The second problem is how to allocate contributions to corporate DB plans among participants' accounts. Ideally, each year's corporate contribution should be allocated in proportion to the present value of pension benefits generated by each individual's service in that year. However, such actuarial calculations are impossible. In Canada, the amount is approximated by taking nine times that year's increase in the accrued monthly pension amount, and then subtracting 600 dollars. In any case, a key consideration in the method selected will be its simplicity and ease of use.

The last problem is that of determining the criteria for nontaxable contributions and investment gains. DB plans in Japan are at risk of failing to preserve benefits due to funding shortfalls. Preferential tax measures should not be applied in that situation. Thus as long as funding shortfalls exist, investment gains should be made taxable.

However, the severance payment and pension plan have traditionally had the characteristic of being a bonus for performance. Thus the strict funding requirements stipulated in the Defined Benefit Corporate Pension Law of June 2001 are inappropriate. During the transition period of five to ten years, the law should allow funding shortfalls to be alleviated with benefit cuts, as already allowed under the same law.

Moreover, as a complement to public pensions, annuities are ideal because they can hedge against the risk of longevity. However, under the Defined Contribution Pension Law, preferential tax measures are applicable not only to annuities but to fixed-term annuities and lump sum payments. Making annuities mandatory would impede their use because people could not freely make withdrawals after retirement. Furthermore, it would raise the reverse selection problem and make premiums more expensive.

At the present level of income-related benefits for the Employees' Pension Insurance (EPI), corporate and individual pensions do not need to be paid out as annuities. In the future, if EPI benefits are reduced to improve pension finances, it will suffice to make participation in private pensions mandatory, and to require the purchase of annuities. If public pension benefit cuts reduce the income tax deduction for social insurance premiums, raising the contribution limits will not decrease tax revenue.

Another problem is how to set the contribution limit. The 13,500-dollar limit in Canada is equivalent to over one million yen. However, if the unused portion of contribution limits is allowed to be carried over, an appropriate level would be 440,000 yen per year, which is the current contribution limit for DC plans. If this limit is fully used for 40 working years, and if the average annual investment return is 2%, plan assets will reach 25 million yen at age 60—the equivalent of the average severance payment.

Finally, we calculate the decrease in tax revenue resulting from the proposed system. Let P be the initial tax deductible contribution, t be the marginal tax rate during the contribution and investment phase, t' be the marginal tax rate in the benefit (dissaving) phase, r be the interest rate, and n be the deferment period in years. With tax-deferred contributions and investment gains, plan assets after n years can be expressed as

$$P(1+r)^n \times (1-t') \quad \cdots \quad (A)$$

On the other hand, if contributions and investment gains are taxable, the initial taxable contribution $P(1-t)$ increases at a rate of $r(1-t)$. Thus plan assets after n years is expressed as

$$P(1+r(1-t))^n \times (1-t) \quad \cdots \quad (B)$$

The difference (A)$-$(B) represents the increase in plan assets due to the difference in marginal tax rate and the deferred taxation of investment gains, or stated differently, the decrease in tax revenue. We can convert this to its present value at the beginning by dividing (A)$-$(B) by $((1+r)^n$.

Assuming six million employed persons each uses the full contribution limit of 440,000 yen, total contributions in one year will amount to 25 trillion yen (P). Let the average tax deferral period n be 15 years, marginal tax rate t be 20% during the contribution and investment phase and marginal tax rate t' be 10% during the dissaving phase, and interest rate r be 2%.

By straightforward calculation, the decrease in tax revenue (A) – (B) amounts to 4.9 trillion yen, with a present value at the start of 3.6 trillion yen. Changing r to 3% and the contribution and investment phase to 20 years, the decrease in tax revenue is 8.5 trillion yen, with a present value at the start of 4.7 trillion yen. These are estimates of the decrease in income tax revenue under the proposed system.

However, two existing tax breaks would disappear under the proposed system—the pension deduction and deductions for corporate pension contributions—which reduce tax revenue by two trillion yen (Figure 5). Furthermore, the retirement income deduction would disappear under the proposed system.

At present, 33 million regular private and public employees participate in the severance payment system. Assuming that one million persons leave their jobs every year and receive ten million yen in benefits, total benefits would amount to ten trillion yen per year. If the retirement income deduction allows 80% of that payment to be deducted from taxable income, nontaxable income would total eight trillion yen, for which the lost tax revenue would amount to 800 billion yen at a marginal tax rate of 10%, and 1.6 trillion yen at a 20% rate.

Taken together, the total tax recovery—the *increase* in tax revenue brought about by abolishment of current tax breaks under the proposed system—would amount to between 2.8 trillion to 3.6 trillion yen. Thus even if all employed persons were to fully use the 440,000 yen contribution limit, 60% (2.8 trillion yen / 4.7 trillion yen) to 100% (3.6 trillion yen / 3.6 trillion yen) of the lost tax revenue (at present value) would be recovered.

Figure 5　Decrease in Tax Revenue Due to Current Tax Deductions

(¥ trillion)

	Employer's share	Employee's share	Total
Deductions for pension benefits, etc.			1 (approx.)
Tax deductible corporate contributions			1.0
			2.0
Breakdown of tax deduction corporate contributions			
Defined benefit plans	0.8	0.1	0.9
Employees' Pension Fund	0.4	0.1	0.5
Tax qualified pensions	0.4	0	0.4
Defined contribution plans	0.1	–	0.1
Total	0.9	0.1	1.0

Note: Numbers for defined benefit plans are estimated from 1997 statistics.
Source: Government Tax Commission