The Tax Treatment of the Defined Contribution Plan
– From Company and Individual Perspectives –

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A December 1999 policy paper by the Liberal Democratic Party on tax reform presented a detailed outline of the defined contribution pension plan and package of related tax measures. With the government working toward introducing the scheme during fiscal 2000, further details are expected to follow.

Table 1 shows the general outline of the new system. Company employees and the self-employed will be eligible to participate; full-time housewives and public employees will not. The scheme is separated into corporate plans (allowing company contributions only) and individual plans (allowing individual contributions only). Corporate plans will be implemented by the companies adopting the scheme, while the individual pensions will be implemented by the Pension Fund Association. Both the corporate and individual pension assets will be managed in individual accounts, and investment instructions will be issued by the participant. If, at age 60, the participant satisfies certain requirements, a lump sum or an annuity will be allocated. Withdrawal of pension assets before that time will be subject to severe restrictions. When the participant changes jobs or quits, the plan will be transferred to the new employer or to a transitional account at the Pension Fund Association (PFA). The new scheme thus seeks to eliminate tax disadvantages caused by transfers.

Figure 1. Outline of the Defined Contribution Plan

	Corporate plan	Individual plan
Implementation	• Company (optional)	• Pension Fund Association
Eligibility	• Company employees	• Self-employed and others • Company employees (but only if no DB or DC company plan exists)
Participation	• Based on labor agreement, other provisions	• At request of individual
Investment instructions	• From participant	
Portability	• Tax treatment is not affected by transfer of pension assets upon job change	
Benefits	• Lump sum or pension benefits are distributed when conditions are satisfied (withdrawal is limited to certain conditions)	
Tax treatment		
Contribution limit	• If no corporate DB plan exists: ¥432,000 / year (¥36,000 / month) • If corporate DB plan exists: ¥216,000 / year (¥18,000 / month)	• Self-employed, etc: ¥816,000 / year (¥68,000 / month; less NPF premium) • Company employees: ¥180,000 / year (¥15,000 / month)
Contributions	• Tax deductible as expense	• Tax deductible
Investment earnings	• Taxable (Special Corporation Tax on Pension Funds -- suspended until March 2001)	
Benefits	• Taxable (pension is eligible for public pension deduction / lump sum is taxed as retirement income)	

Source: Compiled from LDP, "Fiscal 2000 Tax Reform Policy Paper."

The impact of the defined contribution plan will depend largely on its tax treatment, which has thus been followed with great interest. Now that most of the tax issues have been addressed, the implications of the new pension scheme are becoming clearer for corporations and individuals. This paper examines the content of the defined contribution plan from the perspective of the company and individual, focusing particularly on the treatment of the scheme under the taxation system.

1. The Company Perspective

(1) Shifting to a Defined Contribution Plan

1. Progress on the tax front

Debate originally began on the introduction of the defined contribution plan as a viable solution to the deficiency of reserve funds for retirement benefits. The rush to introduce the plan can be explained by the new corporate accounting rules that take effect in fiscal 2000, which will require companies to disclose future reserve shortfalls for retirement benefits.

The LDP's policy paper on tax reform clearly specifies the following in relation to the shift from defined benefit plans and retirement allowance reserves to a defined contribution plan:

- In line with labor agreements, corporations operating company plans will be able within specified limits to transfer the accumulated retirement allowance reserves and pension assets of the Employees' Pension Fund and tax qualified plans to corporate defined contribution plans.

- Taxation measures needed to accompany the shift from defined benefit to defined contribution plans will be put in place.

Thus at least on the taxation front, the door leading to defined contribution pensions has been opened, although somewhat conditionally.

In the LDP tax reform paper, the contribution limit of companies with defined benefit plans (Employees' Pension Fund, tax qualified plans, etc.) is set at ¥216,000 per year. On the other hand, no number has been specified for the transferable limit mentioned in the policy paper. In any case, once a fixed limit is set, companies are expected to transfer a part of their defined benefit plans into defined contribution plans.

2. Defined contribution plans will not solve funding problems

The introduction of the new plan is not, of course, a magic solution to the deficiency in reserve funds for retirement benefits. The shift to a defined contribution plan will be instrumental in preventing further reserve fund shortfalls but will not solve existing shortages. Also, prior to the shift from a defined benefit plan to a defined contribution plan, several hurdles must be cleared, including that of labor negotiations.

It is, however, difficult to imagine that all employees will welcome the defined contribution plan because of several features of the plan. For example, even if company contributions to the new plan are calculated to produce benefits equivalent to the existing defined benefit plan, actual benefits will not be determined until benefits are paid because the investment risk is borne by the participant. Another point of contention will be the interest rate to apply when calculating the defined contribution plan's benefit equivalent of the defined benefit plan. Since adoption of the defined contribution plan is a separate issue from the cost of retirement benefits, negotiations could falter if companies try to also reduce retirement benefit costs in the process. And even if agreement is reached on defined contribution plans, the shift is likely to take several decades until completion.

In dealing with the shortage of reserve funds for retirement benefits, companies need to consider their short-term and long-term responses to the new accounting rules separately.

(2) Diversification of Employee Welfare and Retirement Benefit Plans

While the defined contribution plan tends to be seen primarily as a solution to the shortfall in pension reserve funds, its real merit may lie in promoting the diversification of retirement plans.

Recently, several companies including Matsushita Electric have introduced a plan that allows employees to receive some of their retirement benefits in salary form. Introduction of the defined contribution plan would expand the range of choices further.

For example, one format is to provide a defined contribution plan rather than a defined benefit plan to new employees who wish to invest their pension assets themselves. Or, assuming that employees consent, their salary could be reduced and the difference paid into a defined contribution plan.

Not only retirement benefits and salary, but employee welfare plans may become incorporated into plan designs. Some companies are adopting a scheme known as a "cafeteria plan" in

which employees can choose from a menu of welfare options presented by the company. A defined contribution pension plan, for example, could be placed on this cafeteria plan menu of options.

How should limited resources be optimally allocated between retirement benefits, salary, welfare, and the new defined contribution plan? Debate between companies and employees is expected to heat up further in the future.

(3) Special Corporate Tax will not Change

1. The meaning of the special corporate tax

The LDP policy paper describes the application of the special corporate tax to the defined contribution pension scheme.

What exactly is the Special Corporation Tax on Pension Funds? Let us consider the case of qualified retirement pensions: the company's contribution is deducted as an expense when made, while the tax on the employee is deferred until the benefit is paid. (This tax deferment reflects the fact that the employee is not in a position to use the company's contribution at the point it was deducted as an expense.)

That is, a time lag arises between the tax deduction for the company's contribution, and the income tax levied on the individual when benefits are received. The special corporate tax is an attempt to collect interest in arrears during this deferment period.

The special corporate tax rate is 1% (approximately 1.2% with the addition of inhabitant tax). This figure is determined based on the amount of tax that would be levied if the company's contribution were paid as salary to the employee. In concrete terms, the special corporate tax is calculated by multiplying the salary earner's average tax rate by 7%, which amounts to an interest rate far in excess of current market interest rates.

2. Special corporate tax should be reformed

Table 2 compares the tax treatment of the defined contribution plan with that of closely related plans. As the table shows, with regard to defined benefit plans, the special corporate tax is levied on pension assets exceeding 2.7 times the substitutional part (assets that substitute for part of the basic pension) of the Employees' Pension Fund. In the case of qualified retirement pensions, the special corporate tax is levied on all pension assets.

The LDP's policy paper advocates levying the special corporate tax on the defined contribution plan in line with the way it is levied on qualified retirement pensions.

However, the interest rate of 7% in the calculation base is too high. If employees are allowed a tax deferment and companies a tax deduction, it makes little sense that only the interest is being collected.

Also, the defined contribution plan has a unique difficulty in relation to the special corporate tax. Since pension fund management companies (such as life insurers and trust companies) are required to pay the special corporate tax, they collect the tax on behalf of their customers. In reality, because it is technically impossible to collect the tax from individual employees, the companies actually shoulder the tax burden. But with the defined contribution plan, individual accounts make it technically possible for employees to actually bear the burden. Deciding whether the company or employees must bear the special corporate tax may become a contentious issue between labor and management.

The business community has repeatedly called for the abolition of the special corporate tax, and its application is currently suspended for the duration of fiscal 2000. Should such a tax be reapplied to the new defined contribution pensions? When tax reform is examined in fiscal 2001, this point must be debated again.

Figure 2. Comparison of the Defined Contribution Plan and Related Plans

	For company		For individual		Tax on distribution
	Contributions	Special corporate tax	Contributions	Investment earnings	
Employees' Pension Fund	Tax deductible for company; tax exempt for employee	Tax exemption for equivalent of 2.7 times substitutional part of basic pension assets	Tax deductible as social insurance premium	Not taxable	Taxable as retirement or miscellaneous income (less public pension deduction)
Qualified retirement plan	Tax deductible for company; tax exempt for employee	Taxable	Subject to ¥50,000 deduction limit for life insurance premiums; remainder is taxable	Not taxable	Taxable as retirement or miscellaneous income (less public pension deduction); individual contrib. are not taxable
Defined contribution plan	Tax deductible for company; tax exempt for employee	Taxable	Tax deductible contrib. subject to max. of ¥816,000 per year (including NPF premiums) for self-employed; ¥180,000 for workers w/o company plan	Subject to special corporate tax	Taxable as retirement or miscellaneous income (less public pension deduction)
National Pension Fund	–	–	Tax deductible as social insurance premium up to max. contrib. of ¥816,000/year	Not taxable	Taxable as miscellaneous income (less public pension deduction)

Source: NLI Research Institute

2. Review from Individual Perspective

(1) More Debate Needed on Supporting Individual Provisions for Retirement

With the rapidly falling birth rate and rising average age, the social security system is no longer able to withstand the strains placed on it, and the need for people to provide for their own old age is growing. In fact, the public pension law passed in March includes a 5% reduction in earnings-related benefits and an increase in the plan eligibility age.

However, the government's stated aims for the defined contribution plan do not mention changing the social security system. The bill announced in July 1997 expressly limited defined contribution plans to employees of companies without defined benefit plans and to the self-employed, and advocated the need to support people in making their own provisions for retirement.

As a result, individual contributions to the defined contribution plan are limited to employees of companies without either defined benefit or defined contribution company-type plans, and to self-employed persons among others.

For the self-employed, a maximum contribution (¥816,000 a year) is set inclusive of the National Pension Fund contribution. That is, total tax breaks for the self-employed have not been raised further in the present bill.

As a result, the only expansion in tax breaks aimed at supporting individuals to provide for their retirement is the ¥180,000 per year tax break for employees of companies without company plans.

(2) Relationship to Tax Incentives for Saving

Another reason the bill limits the scope of individual contributions and contribution amounts is to achieve consistency with savings-related taxation.

Savings incentives in Japan's taxation system have a long history. After the war, tax incentives for saving were increased to finance industrial investment for rebuilding the economy. But by the time the rapid growth era was over, Japan had one of the world's highest savings rates, and no longer needed savings incentives as much. In fact, as trade friction between Japan and the U.S. grew into an international issue, Japan looked for ways to expand domestic demand, and in 1988 restricted the *maruyu* tax exemption on small savings accounts to the elderly. In the same year, full tax exemptions for the workers' asset-formation savings plans were abolished

with the exception of plans with specific policy objectives — the pension savings plan and housing savings plan.

Thus the general decline in savings incentives over the past few decades may account for the scarcity of tax breaks for individual contributions in the defined contribution plan.

In the defined contribution plan, strict rules are stipulated on early withdrawal before the age of 60. This appears to be intentionally done to distinguish contributions clearly from savings. By identifying a specific policy objective of encouraging people to provide for their own retirement, the plan reduces the chance that contributions will be confused with general savings.

(3) Special Corporate Tax on Individual Contributions Impedes Acceptance of System

Although at first glance it appears strange, the policy paper advocates levying a special corporate tax on the individual contributions made under the defined contribution plan. As described in section 1 (3), the rationale for the special corporate tax is explained as being deferred interest on pension assets. In the case of existing defined benefit plans, the company actually carries the tax burden. Under the defined contribution plan — an individual pension scheme — it would be inconceivable for the company or Pension Fund Association to bear the cost of this tax. Therefore, it can only be supposed that this tax will be collected from individual pension accounts.

While this treatment may be consistent with conventional thinking on taxation, it makes little since from the perspective of individuals. Rather than deducting 1% as a special corporate tax from pension assets, it would surely be better to apply a 20% separate withholding tax to the pension income as in the case of normal financial assets (even if we suppose a quite high interest rate of 3%, the 20% withholding tax would be equivalent to a special corporate tax rate of only 0.6%).

When the defined contribution plan is introduced, the ¥816,000 contribution limit will cause self-employed persons to closely compare the National Pension Fund with the defined contribution plan. Because the National Pension Fund serves as an additional benefit to the basic pension, the fund enjoys the same tax break as social insurance contributions, as shown in Figure 2. (That is, the fund is not taxed at contribution or investment but when benefits are received.) If the defined contribution plan, however, is taxed at investment, its appeal would decline relative to the National Pension Fund. Unless one savors the prospect of making investment decisions oneself (which is not a tax characteristic), the National Pension Fund presents a more attractive choice than the defined contribution plan.

Collecting deferred interest on individual contributions will seriously inhibit the acceptance of the new system. As mentioned earlier, the drafters of the new system should reconsider applying the special corporate tax to the defined contribution plan.

3. Toward Future Debate

The taxation system fulfills an extremely important role as a tool of government policy. Policy intentions conveyed by the tax system have the power to change the behavior of companies and individuals. What, then, is the policy intention being sent by the tax treatment of the defined contribution plan?

The debate on the introduction of the defined contribution plan has had several objectives: to solve the shortage of reserve funds for retirement benefits; to meet the growing need to help people provide for their own retirement needs; and to support labor mobility by providing portability of pension assets.

The LDP policy paper on tax reform seems clearly inspired by the need to find answers to all of these imperatives. But in some ways, the many issues being addressed make the policy message hard to discern.

Furthermore, if we introduce the new system before debating such issues as how to help people provide for themselves in the face of a changing social welfare system, or how the existing retirement benefit plan framework and tax system should be reorganized, then the tax treatment for the new plan must be basically decided within the scope of the existing framework.

In the future, while working on reform of the public pension system and establishing company pension legislation that comprehensively regulates retirement benefit plans, we must thoroughly debate important issues, including how to support people in providing for themselves after retirement, and which direction the reorganization of retirement benefit plans should take. In returning to this kind of basic debate, we should think again about the role of the defined contribution plan. We will surely discover room for reconsidering, in particular, who the individual contribution scheme should be targeted at (perhaps not only at employees with no company pension and the self-employed), what the limits of the contributions should be, and whether the special corporate tax should be levied on contributions.

References

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