Recommendations to Facilitate the Smooth Transition of Tax-Qualified Pension Plans

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1. Phase-Out of the Tax-Qualified Pension Plan

In recent years, large companies have been reforming their severance payment and pension plans. In fact, 84% of companies with at least 1,000 employees have revised their severance payment plans in the past three years, or plan to do so in the next three years. By comparison, little progress has occurred among small and medium enterprises (SMEs)—for companies with under 100 employees, the ratio is only 27.6% (Table 1).

Table 1 Status of Company Severance Payment Plans

	Reformed in last 3 years	Will reform in next 3 years	Total
All firms	14.3 %	20.5 %	34.8 %
1,000+ employees	35.2 %	48.8 %	84.0 %
300〜999 employees	23.2 %	40.2 %	63.4 %
100〜299 employees	16.3 %	28.2 %	44.5 %
30〜99 employees	12.1 %	15.5 %	27.6 %

Source: Ministry of Health, Labor and Welfare, *General Survey on Labor Conditions (2003)*.

However, SMEs also face pressures to revise plans. The primary reason is the Defined Benefit Corporate Pension Law that went into effect in 2002, which stipulates that tax-qualified pension plans (TQPP) be phased out completely within a decade. As of March 2003, the number of TQPPs stood at 59,000. Since they require only 15 members, most are found in small and medium enterprises.

Other factors are also involved. For one, the burden of these plans on companies has grown. At companies with pension plans, poor investment returns after the collapse of the bubble economy have required additional contributions to prop up pension finances. And at companies with lump-sum severance payments, longer service careers and the upcoming mass retirement of baby boomers are adding an extra burden. In many cases, managers are overwhelmed by the massive size of lump-sum severance payments that will have to be paid out.

Nonetheless, SMEs have made little progress because managers are preoccupied by more

pressing daily business and cash flow concerns, leaving little time to address severance payment and pension issues. Changing these plans requires knowledge of finance, taxes, and labor regulations. SMEs simply have too little time and manpower to address each of these concerns.

Even though the law only stipulates that companies determine the future of their TQPPs by 2012, delaying reforms will increase the burden on companies as low interest rates induce additional contributions, and as baby boomers start to retire.

2. Advantages and Drawbacks of Alternatives

Existing TQPPs need to be converted into other plan types. From the enforcement of the DB law in April 2002 until March 2004, the number of TQPPs declined from 78,000 to 59,000, a drop of approximately 19,000. By the end of 2004, the decrease is estimated to have reached almost 25,000.

In 2002, it was assumed that most TQPPs would be converted into company-type defined contribution plans or corporate defined benefit plans. Yet as of November 2004, only 3,134 companies had implemented company-type DC plans, and only 2,565 of these companies have less than 300 employees.

Defined contribution plans are difficult to implement for several reasons: (1) withdrawals are restricted until age 60, (2) investment management fees and investment education of employees are costly, and (3) conversion is not possible until funding shortfalls are eliminated. At present, the adoption rate of Japanese 401(k) plans increases with company size, and is less than 1% at companies with under 100 employees. This stands in sharp contrast with the 40% enrollment rate in the U.S., where the 401 (k) plan originated (Table 2).

Table 2 Adoption Rate of Defined Contribution Plans, by Company Size

Japan DB plan

Company size	Firms with DB plan	No. of firms nationwide	Adoption rate
Up to 99 employees	1,922	1,195,109*	0.16 %
100～299 employees	643	28,260	2.28 %
Total	2,565	1,223,369	0.21 %
300～999 employees	420	8,301	5.06 %
1,000+ employees	326	2,161	15.09 %
Total	746	11,291	6.61 %

U.S. 401(k)

Company size	Participation rate
Up to 99 employees	40.0 %
100+ employees	68.0 %

Note: * Of this, 618,000 companies have less than 5 employees and are thus ineligible for Employees' Pension Insurance.
Sources: For number of Japanese companies introducing DC plans, Ministry of Health, Labor and Welfare; for Japan's nationwide company totals, Teikoku Databank (www.tdb.co.jp); for U.S data, Dept. of Labor, *National Compensation Survey: Employee Benefits in Private Industry in the United States*, March 2004.

Turning next to corporate defined benefit plans, as of November 2004, 586 of the 911 DB plans in existence are Employees' Pension Funds (EPF) that have returned the contracted-out portion. SMEs comprise a very small portion of this total due to two major impediments: (1) companies must still assume all investment risk, and (2) rigorous funding rules prevent the kind of flexibility enjoyed by TQPPs, such as making annuity payments only to mandatory retirees.

A third alternative is conversion to the small and medium enterprise retirement allowance mutual aid plan. As of November 2004, a total of 4,674 establishments had converted TQPPs to this plan, which has several advantages for SMEs: (1) the scheduled investment return is guaranteed and there is no risk of having to make additional payments, (2) paperwork is minimal, requiring only the payment of contributions to receive a severance payment, and (3) contributions are tax exempt. However, a major drawback is that the plan is restricted to small companies with under 300 employees or under 300 million yen in capitalization. In addition, participating companies who also have a TQPP cannot convert the TQPP into the plan. The advantages and drawbacks of the three alternatives are summarized in Table 3.

Table 3 Advantages and Drawbacks of Conversion Alternatives

	Company-type DC plan	Corporate DB plan	SME retirement allowance mutual aid
Advantages to company	・Employee bears investment risk ・Each employee's individual standing is clear	・Employees' investment education ・Benefit can be cut or withheld for voluntary or punitive separation	・No investment risk ・No extra cost or work ・Subsidy provided
Drawbacks to company	・No withdrawal to age 60 ・Low contribution limit ・Cost of providing information, educating employees ・Payable for voluntary or punitive separation	・Company bears investment risk ・Stricter rules apply than for TQPP (cannot limit annuity payment to only mandatory retirees) ・Strict funding rules and fiduciary responsibility apply	・Max limit on contribution ・Cannot cut benefit in case of voluntary retirement ・Only SMEs are eligible

3. Recommendations to Facilitate Conversion

Due to the various drawbacks, only about 8,000 TQPPs have converted into the three alternative plans.

This means that over 10,000 TQPPs still need to be either converted or terminated. If terminated, the accumulated funds will be distributed to employees and taxed as one-time taxable income, not as retirement income. Compared to the same amount of severance payment or pension income, employees receive less net income after deducting taxes and social insurance premiums. For companies, supplementing the lost amount would impose an extra burden. Moreover, unless management and labor agree that the distribution to employees is part of the severance payment

in the labor agreement (retirement benefit rules), this matter could lead to disputes in the future.

To avoid such problems, the only viable solution is to consider possible combinations with life insurance products, while moving as much TQPP assets as possible into the alternatives mentioned above. Meanwhile, the government must take measures to address the drawbacks of each alternative.

First, the early withdrawal restriction of DC plans must be eased, particularly for withdrawals to meet objectives such as a home purchase or educational expenses. In addition, the SME retirement allowance mutual aid plan needs looser requirements regarding number of employees and capitalization so that companies can continue to participate as they grow.

If a TQPP must be terminated, we recommend allowing the lump-sum payment to be converted into a defined contribution plan. Under the recent public pension reform, the Pension Fund Association will be reorganized and restarted as a new entity in October 2005. The new entity's scheme to annuitize one-time benefits and severance payments disbursed from pension funds should be applied to TQPPs as well.

Finally, company managers should not respond passively to the TQPP phase-out. They need to aggressively overhaul severance payment and pension plans not only to reduce severance payments, but to enhance the original aim of recruiting and retaining employees.

Toward this end, we recommend companies to: (1) revise severance payment rules so that they are easy to understand and reflect each employee's contribution to company performance, such as point-based benefits, and (2) engage in retirement planning with individual employees.