Pensions, tax treatment

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To encourage (or at least not discourage) saving for retirement, tax policy generally accords favorable treatment toward contributions, investment income, and/or benefits related to income accumulated for retirement.

Private pensions receive favorable tax treatment in the United States and in most other countries. In the United States, an employer's pension contribution is deductible in computing corporate income taxes, and the investment earnings on plan assets are not taxed. The employee is taxed once—personal income tax liability is deferred until the employee receives a distribution from the plan. In comparison, for savings through wage payments, the employee is taxed twice—when wages are received and when investment earnings are received on the subsequent savings.

Policy aspects of the tax treatment of pension plans

The U.S. tax code requirements to qualify for favorable tax treatment are used to regulate pension plans. To be tax-qualified, a plan must meet minimum standards regarding participation, vesting, and nondiscrimination against lower-paid workers (McGill and Grubbs 1989). For plans not meeting these standards, the employer's contribution must be included in the employee's taxable income if it is to be tax-deductible to the employer.

Favorable tax treatment is justified by the argument that, without a tax subsidy, families would save too little for retirement. A key issue concerning the taxation of pensions is: Do the tax exemptions increase coverage and individual savings or do they simply substitute pensions for other forms of saving? As well as the possible effect on workers' savings, the tax treatment of pensions may affect other microeconomic decisions of workers and employers: (1) wages versus pensions, (2) deferred wages versus pensions, (3) other fringe benefits (such as employer-provided health insurance) versus pensions, (4) Social Security versus pensions, (5) defined benefit versus defined contribution plans, (6) individual plans versus employer-provided plans, (7) self-employment versus corporate employment, (8) lump-sum benefits versus annuities, and (9) pension investments in some types of assets versus others.

Calculating the tax liability

Private pension plans involve three transactions, which are possible occasions for taxation—contributions, investment income, and benefits payments.

Contributions

Employer pension contributions and wages are deductible business expenses under the corporate income tax. From a tax perspective, employers are indifferent between paying wages and contributing to pension plans. However, employers are not indifferent between making pension contributions and paying deferred wages. Because there is no way to shelter from the corporate income tax money set aside to pay deferred wages, pensions are preferred by employers to deferred wages when compensation is deferred.

To protect the Treasury against excessive tax deductions, limits are placed on pension contributions. Maximum contributions to a pension plan depend on plan type (e.g., defined benefit, profit-sharing), whether the employee is covered by more than one plan, and whether the plan is top-heavy, which refers to plans (mainly for small firms) where a disproportionate amount of the benefits accrue to the owners of the firm and key employees. Limits are placed on the maximum employee earnings that can be used to determine benefits or contributions. There are also contribution limits based on the extent to which pension assets exceed or fall short of liabilities (Hubbard 1994).

Employer and employee contributions are treated differently by the U.S. tax code. Employer contributions are not taxed as income to the employee, avoiding personal income and Social Security payroll taxation when the contributions are made.

Employee contributions are generally taxable under the personal income tax and the Social Security payroll tax. Employee contributions to salary reduction plans are an exception.

The most common type of salary reduction plan is the 401(k) plan, named after the Internal Revenue Code section that established it. In salary reduction plans, employee contributions are deductible from before-tax earnings, a feature that may explain much of their popularity. While salary reduction plans generally require employee contributions, other pension plans rarely do.

Investment earnings and assets

Once an employer or employee has contributed to a pension plan, the investment earnings on those funds are not taxed. This aspect of the tax treatment

of pension plans is called the "inside buildup." Pension assets maintained in the pension plan are also not taxable. However, when an employer terminates an overfunded defined benefit plan and surplus plan assets revert to the employer, those assets are taxed at the corporate income tax rate plus an excise tax of 20 percent. The excise tax rate is increased to 50 percent unless the employer transfers part of the excess assets to a replacement plan or provides a benefit increase under the terminating plan. This tax treatment discourages firms from terminating overfunded defined benefit plans.

Distributions of benefits

Pension benefits received at retirement or earlier are taxed under the federal and state personal income tax rates, but are not subject to the Social Security payroll tax. A participant generally recovers tax-free the amounts that have been included previously in his or her taxable income. These tax-free amounts are called "basis," and generally consist of the employee's after-tax contributions. Because of the progressivity of the income tax system, frequently workers have lower marginal income tax rates in retirement than while working. Lump-sum distributions received before retirement are subject to an excise tax as well as the personal income tax. The excise tax is designed to discourage those distributions, under the theory that pension plan assets should be used exclusively for financing retirement consumption.

Implications of the tax treatment of pensions

The tax treatment of pensions moves the United States towards a consumption tax system. Earnings saved through a pension are not taxed until received in retirement. A consumption tax avoids the double taxation of savings that occurs under the current income tax system.

The two aspects of the tax advantage of pensions are income-smoothing and the tax-exempt status of pension plan earnings. When income is taxed according to a progressive tax scale, workers can avoid paying high marginal tax rates on pension contributions during their working lives and instead can pay lower inframarginal tax rates when they receive their pension during retirement.

Even if the marginal tax rates the worker paid were the same in retirement as when working, with a progressive tax scale the worker can gain because the first pension dollars are taxed at lower inframarginal rates. The first dollar received in retirement is taxed at the lowest tax rate, and subsequent dollars are taxed at progressively higher marginal rates. Because of the tax advantages of income-smoothing, workers will want larger pensions under a progressive tax system than a flat tax system (Ippolito 1990).

The tax system has reduced the desirability of defined benefit plans relative to defined contribution plans. First, employees can make tax-deductible contributions to defined contribution plans but not to defined benefit plans. Second, the Omnibus Budget Reconciliation Act of 1987 reduced the amount of funding that could be put into a pension plan that was overfunded. This reduced the amount that could accumulate in a defined benefit plan earning the tax-free rate of return, reducing the tax advantage of defined benefit plans relative to defined contribution plans.

Pension tax expenditures

Tax expenditures for pensions are measured relative to a comprehensive income tax under which the increase in the present value of expected retirement benefits (roughly equal to the employer contribution plus investment earnings) is included in the employee's taxable income. Pension benefits are not taxed. Thus, the Treasury Department's estimate of tax expenditures consists of (1) the revenue loss from exempting employer contributions and investment earnings, offset by (2) the revenue gain from currently taxing private pension benefits. Most of the tax benefits of pensions accrue to middle-income families, those with incomes between $30,000 and $50,000 in the early 1990s. The tax expenditure for pensions is the largest tax expenditure for individuals, representing 18 percent of total tax expenditures for individuals and a revenue loss of $51 billion in 1992 (Dorsey 1992). (This amount includes the tax expenditure for pension plans provided by federal, state, and local governments and other nonbusiness employers.)

The tax expenditure figures indicate the amount of federal income tax revenue lost in a tax year as a result of private pensions. The tax expenditure figures overstate, however, the long-term loss of revenue. A worker's lifetime loss measure would calculate the amount of revenue lost this year as a result of pension accruals for workers and subtract the expected present value of taxes paid on those currently accruing benefits. Unlike health insurance premiums, which are never subject to federal taxation, retirement fund contributions and investment earnings eventually face the individual income tax when paid out to retired workers.

Additional readings

Dorsey, Stuart. "Taxation of Pensions." In *Trends in Pensions 1992*, edited by John A. Turner and Daniel J. Beller. Washington, D.C.: U.S. Government Printing Office, 1992.

Hubbard, Richard L. "The Tax Treatment of Pensions." In *Pension Funding and Taxation: Implications for Tomorrow*, edited by Dallas L. Salisbury and Nora Super Jones. Employee Benefit Research Institute, 1994.

Ippolito, Richard A. *An Economic Appraisal of Pension Tax Policy in the United States*. Homewood, Ill.: Irwin, 1990.

McGill, Dan M., and Donald S. Grubbs, Jr. *Fundamentals of Private Pensions.* 6th ed. Philadelphia: University of Pennsylvania Press, 1989.

Cross references: fringe benefits; individual retirement accounts; saving, taxes and.