Taxation of Retirement Savings

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Taxation of Retirement Savings

- Common for developed countries to use the tax system to encourage citizens to self-provide for their retirement
  - Limit burden of the old age pension on the budget
    - However, tax concessions can have a significant revenue cost
  - Compulsory and voluntary schemes
  - National, employer provided, and self-employed schemes
- Less common in developing countries
  - Compulsory contributions to national pension fund
  - Possibly also employer provided schemes
    - Subordinate to national pension fund
- Cross-border issues
- Treatment of other forms of long-term savings – such as life insurance

Models for Taxation of Retirement Savings

- TTE
  - Contributions taxed; pension fund income taxed; and pay-outs exempt
  - This is the taxation model that applies to savings generally (such as on bank deposits)
  - No concessional treatment for retirement savings
- EET
  - Contributions exempt; pension fund income exempt; and pay-outs taxed
  - Deferral system - tax on retirement savings is deferred until pay-out
  - This allows savings to grow at a greater rate than normal savings under TTE
- EEE
  - Contributions exempt; pension fund income exempt; and pay-outs exempt
  - Complete exemption of retirement savings
  - May apply to compulsory retirement savings through the national pension fund

Variations on the Standard Models

- Common variation on the EET model is a TET model
  - This may arise because –
    - Concessional tax treatment limited to employer contributions
      - Employee contributions paid out of after tax earnings
    - Ceiling on deductible contributions by employer and/or employee
      - Contributions made in excess of the ceiling are taxed
  - The tax on pay-outs needs to be adjusted to reflect the fact that contributions may have been partially taxed
    - Necessary to avoid double taxation

OECD and EU Countries

- 2015 OECD Report - Stocktaking of the Tax Treatment of Funded Private Pension Plans in OECD and EU Countries
- Findings
  - EET is the most commonly used model in OECD and EU countries
    - 17 OECD Countries (34) and 13 EU countries (28) use EET
  - Six different regimes are found in the other OECD and EU countries with TET the next most commonly used model
  - Other models – TEE; ETE; ETT; TTE; and EEE

Cost of Retirement Savings Concessions

- TTE is the normal tax treatment of savings
- Any departure from TTE involves a tax concession
  - Tax concessions referred to as "tax expenditures"
  - Tax expenditure is a spending program done indirectly through the tax system
- Tax expenditure for retirement savings can be very expensive for the budget
- Important that tax concessions for retirement savings are properly modelled to understand the cost to the budget

Cost of Retirement Savings Concession

- Australia has adjusted the tax treatment of retirement savings several times over the last 30 years to limit the impact of the concession on the budget
- In effect, Australia partially taxes at each stage (contribution, fund income, and pay-outs
    - Note, though, that pensions paid to over 60s are exempt regardless of taxation of contributions and fund income
- However, adjustments to the tax treatment have added significant complexity to the tax law so as to avoid double taxation resulting from legislative change
- Despite the changes, there is still concessional treatment and the estimated cost to the 2016/17 budget is AUD$40billion

Employer-provided Retirement Schemes

- EET system recommended
- Ceiling on tax-deductible contributions
- Pension fund
  - Approved to obtain tax benefits
  - Fund must satisfy conditions to ensure that it is genuinely established for the benefit of all employees and not just executives, and to limit abuse
  - Non-approved funds treated the same as normal savings
    - TTE
- Pay-outs
  - Pensions and lump sums
  - Adjust to extent that some part of the pay-out represents previously taxed contributions

Tax Deductible Contributions

- Contributions may be made by employer, employee, or both
- Employer contributions are part of the cost of remunerating employees so should be deductible under general principles
- Tax-free fringe benefit to employees
- Ceiling on tax-deductible contributions
  - Limit on the balances that can be accumulated in a tax concessional environment
  - Based on what is considered adequate for a comfortable retirement
  - Coordinate with reasonable benefit limits on pay-outs

Ceiling on Tax Deductible Contributions

- Ceiling set as a percentage of employee's employment income
- Options for taxing excessive component
  - Taxed directly to employee as a fringe benefit (contribution deductible to employer)
  - Taxed indirectly through a non-deductible rule for employer (contribution exempt to employee)
    - However, this does not tax excessive contributions made by tax exempts

Deductibility of Employee Contributions

- Deductibility of employee contributions
  - Complication is trend to make wage withholding a final tax on employment income
  - No deductions (employment related or personal) may be allowed against employment income
  - However, deductions may be possible if employer is making the contribution on behalf of employees out of employment income
    - It can be factored into wage withholding amounts
  - If employee contributions are deductible and a ceiling applies, then ceiling needs to take account of both employer and employee contributions

Approved Pension Funds

- Fund (trust) established for the benefit of employees on retirement or permanent disability, or for the benefit of relatives of a deceased employee
- Standard conditions
  - Membership confined to employees
  - Contributions can be made only by the employer and/or employee
  - Benefits are fully secured and members are informed of benefits
  - Preservation and portability
  - Reasonable benefit limit
  - Limitation on investment in "in-house assets"
  - Fund not permitted to make loans to members
  - Assets of the fund are not excessive having regard to expected benefits to be provided to members

Preservation

- Tax concessions intended to encourage private saving for retirement
- Benefits payable when the member retires permanently from the workforce
  - Preservation of benefits until retirement
  - Retirement age under fund rules should not be less than the public sector retirement age
    - Preservation age
- Exceptions - benefits may be paid before member reaches preservation age
  - Permanent disability
  - Death of the member
  - Permanent departure from the country
  - Some countries may allow partial access to benefits in case of severe personal hardship

Portability

- Benefits are transferable to another employer-provided fund on change in employment
  - Avoids employees being members of multiple pension funds during working life
  - Portability allows employees to maximise benefits through a single private pension plan
  - Often difficult in developing countries
  - Developed countries
    - Industry-based private pension schemes
    - Employees set up own private pension scheme

Reasonable Benefit Limits

- Limit what can be accumulated and accessed in a tax concessional environment
- Based on what is considered adequate for a comfortable retirement
- Design options
  - A legislated monetary amount as benefit limit
  - Formula based on: (i) annual salary at retirement (or average over last 2 or 3 years); and (ii) period of service
- Need to coordinate with ceiling on tax deductible contributions as both are broadly aimed at the same thing

Limitation on In-house Assets

- In-house asset
  - Loan made to the employer or an associate of the employer
  - Shares or other interest in the employer or an associate of the employer
- Example limitation = total cost of in-house assets of the fund is not to exceed, at any time, 10% of the cost of all assets of the fund

Taxation of Pay-outs

- Pensions, lump sums, annuities purchased with lump sums
  - Consistent treatment
- Taxation of lump sums depends on the taxation of contributions and pension fund income
- Pay-out should not be taxed to the extent that it represents taxed contributions and fund income – otherwise there is double taxation
- Concessional treatment of lump sum pay-outs
  - Problem of double dipping – recipient consuming the lump sum pay-out and then going on the old age pension

Cross-border Issues

- Taxation of retirement savings involves multi-steps
- Tax concessions often assume that the member stays in the jurisdiction for the whole of their working life
- Employees may lose private pension scheme tax benefits when accept an assignment in another country
- Article 18 of OECD Model provides for residence country only taxation of pensions and other similar remuneration in respect of past employment
  - Rule applies regardless of tax treatment of contributions and pension fund income

Expatriate Labour and Pension Fund Contributions

- Expatriate labour will prefer to retain existing private pension arrangements when posted abroad
  - Limits loss of pension rights/benefits
  - Practical difficulties of having pension arrangements in different countries
- Expatriate posted abroad may change of residence
  - Potential loss of deductions in home country for employee contributions as now made by a non-resident
  - Potential loss of deduction in host country for employer contributions as now made to a non-resident fund

Expatriate Labour and Pension Fund Contributions

- Discussed in Commentary to Article 18 of the OECD Model DTA
- Treaty partners may choose to cover pension fund contributions in DTA
- As employee likely to have little or no taxable income in home state, OECD Commentary recommends source state recognition of contributions to pension fund in home state
- Conditions
    - Employee not a resident of the source state prior to posting
    - Pension scheme in the home state corresponds with pension scheme in source state

DTAs and Pension Fund Income

- The CS may each provide an exemption for the income of pension funds under domestic law
- Exemption applies only to resident pension funds
  - Means that, for example, dividends and interest paid to a non-resident pension fund are subject to withholding tax
- Commentary to Article 18 of OECD Model provides that the CS may extend the pension fund exemption to funds resident in the other CS
  - Reciprocal exemptions
- Exemption may also be provided in Article 11 as a general incentive to encourage investment in CS by pension funds

DTAs and Pension Fund Pay-outs

- Multistage nature of taxation of retirement savings means that taxation of pay-outs depends on the taxation of contributions and fund income
- If an individual resident in a TTE country changes residence to an EET country, then pay-out likely to be subject to double taxation
    - Commentary to Article 18 of OECD Model provides a CS may agree to exempt pension/lump sum if the recipient would have been exempt if remained resident in the other CS
- Opposite can also occur when an individual resident in an EET country changes residence to a TTE country, then pay-out may benefit from double non-taxation