Tax Incentive Policy on U.S. Pension System and Reform Proposals

Zhuan DU

Gies College of Business, University of Illinois at Urbana-Champaign, Urbana IL 61820, United States
furudoshie@gmail.com

Keywords: Pension system; Tax incentive; Policy; Reform proposal.

Abstract. This article mainly introduces the tax incentives of the U.S. pension system and proposes suggestions on its further reform. In terms of corporate pension tax incentive, we introduce the general course of development and the main role of tax incentives. We then analyze two operating modes of corporate annuity. Finally, we provide proposals on the reform of pension system utilizing the tax incentives.

Introduction

Tax incentives refer to taxation rules designed to incentivize production, consumption, investment and other economic activities and behaviors. Categories of tax incentives include general tax incentives for domestic production, special incentives for domestic production, external trade incentives, etc. Tax incentives for domestic production generally refers to tax exemption, tax relief, accelerated depreciation to domestic industries; special incentives refer to specific tax treatment to certain industries/regions such as emerging industries, farming and mining; foreign trade incentives refer to encouraging the export of goods and foreign investment.

From a governmental point of view, tax incentives are tools created by altering the tax code and regulation, used to achieve the social and economic objectives of the government through exempting part or all of the burden of the taxpayer. It is the provisions that give preferential treatment to certain activities, assets, forms of organization and financing methods, and an important part of tax policy.

From an economic point of view, if a transaction could result in a reduction of the amount of expected tax liabilities, then it is considered that the transaction brings tax benefits. In the pension plan system, the collection of fees, fund management and investment operations, treatment and payment of the annuity combined together to create reduction of tax liabilities, thus is considered as a form of tax incentive.

There are some noteworthy aspects regarding tax incentives that need to be addressed. First, tax incentives are defined by expected tax liability rather than actual tax. Therefore, the importance of tax incentives must be evaluated at the time of making financial decision rather than after the occurrence of transaction. Second, the tax benefit is defined by the present value, which means that tax incentives may take form of tax deferral. Third, a party being nominally taxed may not change the fact that the tax reduction is already realized. This paper takes the tax incentives on the pension system of the United States as an example, introducing its main contents and specific operational modes and proposing possible direction for reform.

The U.S. Pension Plan

The Development of the U.S. Pension Plan

The United States was the first country in the world to formally establish a pension plan which dated back to 1875, when the railroad carrier American Express established a formal pension plan for its employees. Unlike today's pension system, American Express's initial pension plan only provided compensation to permanently disabled workers.
At the end of the nineteenth century, the rapid industrialization of the US economy, the transformation of the family pension approach and the establishment of the retirement system contributed to the development of the system. While the problem of employee pension was not prioritized as compared to issues regarding working conditions, working hours, wages and union organization, employers gradually began to realize the importance of meeting the economic needs of employees after their retirement.

With the advent of the Great Depression in the 1930s, a large number of such plans faced the problem of insufficient savings, and employers had to take urgent measures to mitigate economic losses. They either reduced the level of commitment to the pension fund, or slowed down the rate of employee retirement, and some companies even canceled the mandatory retirement provisions. The US federal government took over the rail transport pension plan and injected part of the public funds into the plan, as well as developing an annuity plan for the joint payment of the employer and the employee.

After the start of the Second World War, the US federal income tax began to increase substantially, the proportion of the population earning the income tax and the income tax rate increased from 4.1% and 4% in 1935 to 65.3% and 23% in 1945. But incentives that allow pension plans to pay a certain percentage of the tax included in the pre-tax and pension trust investment income before the calculation of federal income tax exemption greatly stimulated the enthusiasm of employers, combined with the wartime measures like price control both led to the American workers asked for the wage-based and other welfare requirements, so that the pension plan in the post-war America surged rapidly. According to the American Employee Welfare Institute's Pensions Investment Report, by the end of 2003, the total defined benefit plan totaled $1893 billion, of which $900 billion of contribution is in stocks, $423 billion in bonds, $187 billion in cash or equivalents, and the rest $383 billion in other assets. The defined contribution plan has $ 219.8 billion in retirement assets, of which $739 billion in stock, $225 billion in bonds, $131 billion in cash or equivalents and $1,010 billion in other assets. The total size of the corporate pension in the United States reached $9.057 trillion.

**Functions of U.S. Pension System**

When the government uses tax policies to regulate economic and social activities, the regulation follows certain operating procedures. In the process of implementing the pension plan, tax adjustments will cause changes in the taxpayers' income. Under the precondition that the economic benefits being reasonable, the taxpayer will adjust his behavior according to his own interests: when the tax rate is low and the preferential treatment is favorable, the taxpayers will increase the capital investment in the pension plan, reflected in the amount of tax revenue. If the treatment is unfavorable, the taxpayers will prefer to hold on cash more. Other benefits or savings instead of investment mainly manifest as the substitution effect of tax policy. In the market, the general transmission mechanism of tax regulation becomes a common regular process, and the taxpayer's behavior adjustment has its inevitability. The adjustment range depends on the intensity of tax regulation and market reaction. The establishment of a pension plan, for a successful business development, has the following positive effects:

First, it can benefit the recruitment of talents. The establishment of a well-funded pension plan is an important factor of an enterprise's investment in human capital. Without proper human capital investment, a corporation will likely experience difficulty attracting suitable talents for furthering its development.

Second, it can establish an effective incentivization mechanism. The pension plan may not cover all the workers in the corporation, and this will prompt the workers to work actively and in order to meet the standards required by the enterprise to ensure the annuity payment.

Third, pension plans receive favorable tax treatment. To encourage enterprises to establish supplementary insurance programs, the U.S. government often grants preferential tax treatment. For example, the government has promulgated the relevant policies and regulations, allowing
investment income of the fund to be exempted from taxation. These tax incentives and policies help the universal implementation of the benefit plan.

Fourth, pension plans represent a large amount of funds actively seeking for investment. It could be viewed that the entire economy has played a role in gathering capital. Especially in times of economic depression, the role of pension funds as an accumulation of capital becomes even more prominent, as the capital could assist in stimulating or stabilizing the troubling economy. At present, the capital accumulated in the pension funds of some large US companies is roughly equal to the size of the enterprises themselves.

**Tax Incentives on US Pension Plan**

The pension plan, receiving deferred tax recognition treatment, usually goes through three transaction stages as designed by the system, namely contribution, investment and operation, and annuity payment. Accordingly, annuity policy is also similar to this system. The difference is that the annuity policy is under different tax categories in different aspects: whether the employer is allowed to include the planned contribution expense into the cost before paying out annuity to the employees; whether to allow self-insured pension plan contributions deducted from taxable income to avoid abuse; for the pension plan to accumulate fund investment income is exempt from income tax; whether personal income tax will be levied on participants when they receive their annuity amount from the pension plan; if plan participant's death or other event causes non-participants becoming beneficiaries, whether to impose inheritance tax, gift tax on the pension income.

The level of preferential tax policy not only takes account of the incentive to maintain a certain size of the annuity plan, but also took account of the state's fiscal revenue and budget balance. The balance between the two had been through the entire historical process involved in the US pension scheme tax system, so that the two systems were mutually restricted and common development. Under the guideline of encouragement and limitation, the US Federal Revenue Service limited the tax policy by two means to maintain fiscal budget balance: 1) set a series of test conditions (which will be discussed below); 2) The amount of annual contribution to the plan. Prior to the enactment of the Employee Retirement Income Security Act of 1974, U.S. regulations did not impose any restriction on annual contribution to the pension plan, so that in certain scenarios, employees were offered generous pensions. Therefore, controlling the amount of tax incentives of the annuity plan not only prevented the annuity plan, especially the fixed benefit plan to raise funds too much, but also to curb the unreasonable losses for US Treasury income.

Annual remuneration. The limit imposed by Section 415 of the Tax Act is determined by the employee's annual salary. The US Department of Inland Revenue provides detailed provisions on the remuneration that should be included and excluded in the Annual Remuneration. It includes wages, salaries and any remuneration for the provision of personal services, but does not include duty-free employee benefits. Among them, the amount of payment of the deferred payment remuneration plan, whether it is tax or non-tax benefits, is generally not included in the annual income of the employee. In addition, Section 415 of the Tax Act stipulates that the annual remuneration of an employee must include the amount of the pre-tax payment paid to the 401 (k) and 403 (b) plan financed by the government. The IRS also provides a number of safe harbors annual remuneration-defined pension plans that are automatically identified as qualified under the tax codes relating to annual remuneration provisions.

Multiple annuity plans. In accordance with the Tax Act 415, all fixed contribution plans funded shall be treated as a plan by the same employer; likewise, all fixed benefit schemes supported by the same employer are the same. Companies that are owned by the same controlled group, or controlled by the same parent company, and affiliated companies are considered as the same employer and the plan must be considered together.

Annual payment tax cuts. In calculating the deduction limit for the employer's contribution in Section 404, the annual income for each program participant should not exceed $170,000. Section 404 provides guidance for the annual tax contribution to the profit-sharing pension, the money purchase pension plan and the 401K plan.
The amount of payment exceeding the tax reduction limit. Any excess payment can be transferred to the next year or after the planned year to cut taxes. In order to prevent the employer from obtaining tax exemption by continuing to remain in the tax benefit annuity plan, the tax law provides for a penalty tax of 10% for any extra tax deduction in accordance with the Tax Act. The penalty tax itself could not be deducted from the current taxable income of the employer; and the employer of the subsidy is allowed to exempt the excess from the plan when it is drawn.

Modes of Pension Operation

The U.S. pension plan operates in two modes: defined benefit and defined contribution, so its operating mechanism is also different. The modes of operation of the two annuities are highlighted below.

(1) Determine the beneficiary of the pension plan. Determining the type of benefit refers to the fixed monthly pension available to employees after retirement. The formula for receiving pensions is as follow:

\[ \text{Pensions} = 1.75\% \times \text{working period} \times \text{final pension salary} \]

Here, 1.75\% is the substitution coefficient. The work period refers to the time from the employee joining the plan to the retirement or separation of employees, and the employee service period can be up to 40 years. Endowment salaries can have multiple selection criteria, such as the wage on the last working day, the average wage over the past 10 years, or the average of the best 3-year salary over the last 10 years.

In the defined benefit programs, as employers ensuring that their employees receive a fixed monthly pension, they have to establish a trust fund to protect the interests of investors and employees. This requires that the employer provide the trust fund with a monthly or annual payment. If the fund's investment rate of return is relatively high, for employers, you can reduce the payment, reduce the cost of the pension system; For employees, the pension is more secure. Conversely, if the fund's assets are not sufficient to cover the payment of the pension, in this case, if the employer has solvency, the deficit should be repaid in time. If the employer is insolvent, even if the operation fails or goes bankrupt, the employees of the company, both retired and unincorporated employees, are at risk of losing their pension income. In order to solve the fund deficit, the U.S. government made two provisions: First, the separation of trust funds from corporate assets. Provisions of pension funds are not allowed to invest in the corporation, or the provisions of the fund to invest in the highest proportion of the corporation; the same time, the custodian of the fund and investors are required to separate. The U.S. government has provided legal provisions for the establishment of an endowment insurance fund system and the code of conduct for fund managers, restricted the selection of investment products with high risk levels and examined and supervised the management and performance of the endowment insurance funds. The second is to establish a guarantee mechanism. Ensuring the smooth implementation of the beneficiary pension plan, the U.S. government provides for the establishment of a pension benefit guarantor company. In 1974, the U.S. government passed the Private Endowment Insurance Revenue Guarantee Act, which mandated that all companies that are defined benefit pension plans pay insurance premiums to pension insurance benefit insurers. When the pension fund meets financial difficulties or bankruptcy, the pension insurance company pays the retirees a defined pension. By guaranteeing the pension company through endowment insurance, the government stipulated that the fund should provide the lowest income guarantee to the definite benefit plan in the private insurance system and protect the rights and interests that workers should get. In order to check that the assets of the trust fund will not affect the interests of the beneficiaries due to losses, some governments have taken the form of stipulating the trust fund to purchase reinsurance.

(2) Defined contribution annuity plan. The determination of contribution annuity scheme means that the contribution rate is fixed in advance, and employers generally assume most of the contribution, and employees can voluntarily choose to pay an additional contribution of up to 25\% of their salary. Employee contributions mainly for two purposes: First, the purchase of commercial insurance to protect against accidental personal risk; the second is to establish a personal investment.
account for employees. In general, workers pay funds into an investment agency, the investment agency to provide employees with investment tools. How to carry out the investment in the employee's account the investment portfolio is mainly decided by the staff and workers themselves and the investment agency is authorized to operate. The investment method can be stocks, bonds, special fixed deposits and insurance. In the implementation of investment programs, the accumulation of funds on the employee employment period and the amount of return on investment is closely related to the rate of return. The amount of personal funds accumulated by individual accounts depends mainly on the effect of the employee investment program.

Comparing the two plans, it is determined that the beneficiary annuity adopts the insurance and guarantee operation mechanism, and the determination of contribution is made through the operation mechanism of the investment fund. In determining the benefits of the program, companies can wage growth rates based on employee wages, death rates, pre-determined interest rates and other companies calculate the contribution rate. Since the contribution rate of the corporation is affected by the investment income of the trust fund, continuous actuarial calculations are required. If the fund's investment rate of return is relatively high, corporate contribution rates will decline, even without payment. The Kodak Company has made no contribution for a long time to its pension fund due to the relatively high return on investment obtained in the past 13 years. Relying on investment income can only guarantee the retiree's payment. The advantage of such a program is that, apart from the impact of employee wage increases, employer contributions are also affected by the return on investment of trust funds. In contrast, to determine the contribution of the program, employers have limited liability, the employer is only responsible for full payment on schedule, do not bear the risk of investment; fund investment risk borne by the employee, the employee is the ultimate responsibility for the investment program. The bankruptcy of Enron in the United States posed a great challenge to the defined contribution annuity plan. As 58% of Enron employee pension funds were used to buy shares in the company, employees were caught in the piles of old-age savings and lost jobs as the company went bankrupt. In the United States, many large companies such as Coca-Cola, General Electric, McDonald's and other employees invest much of the annuity in the company's stock. Enron's bankruptcy, the annuity investment had a warning significance.

The Reform of US Tax Incentives

1. Enhance the development momentum through introducing other tax incentives. Tax incentives are a powerful engine driving the development of the corporation. The 401K plan has the payment and investment income exempted from taxation, and the taxation only happens in the collection of funds when the annuity is paid out, so the beneficiary receives tax deferral treatment. For employees, the employer can pay the cash directly, or allow the employer to deposit this part of the money into the 401K plan, and this part does not need to pay personal income tax. In the progressive personal income tax, high-paying employees can reduce the income tax in this way, which can greatly mobilize the enthusiasm of employees. Employees by giving up part of the immediate consumption, access to the future of old-age security. According to Friedman's "long-term income hypothesis", rational consumers are not based on the current income level, but based on long-term "long-term income level" to make consumer decision-making, in order to maximize the effectiveness of personal income. In fact, this is an intertemporal equilibrium decision process. Thus, deferred income taxes allow employees to smooth the entire life cycle through rational planning, which is quite beneficial to those who participate in the program. For employers, the funds invested by the enterprise in the program can be used as a cost of production before taxation, but also greatly motivated the employer's enthusiasm.

2. Respect individual's choice and promote flexibility. US 401K plan fund investment management is very stressed that the individual's autonomy, employee participants dominate, by their own discretion to pay the proportion of investment assets and the number of portfolio investment risk by the participants at their own risk. Funds are very broad, including stocks and
funds, bonds, bank deposits and so on. This allows the program to better fit the needs of the individual.

3. Simplify the restrictions and increase coverage. Simplifying the restrictions is an important driver of the development of the annuity. At present, the United States has a high requirement the pension system, and only part of the prominent businesses could meet the regulation requirements. This could exclude corporations of smaller size. On this issue, the United States has specifically tailored for small and medium enterprises Simple 401K and Solo 401K, promoting the well-being of more citizens by ease the requirements for the small and medium enterprises and their employees.

4. Improve the legal support and security system. Robust legal system is the fundamental for the development of a standardized pension system. The 401K program itself is the product of Article 401K, supplemented by the US Internal Revenue Code of 1978, and its subsequent rapid development is also closely related to the continuous establishment of the corporate annuity legal system in the United States.

5. Continue to improve the supervision system. The legal system is the first line, yet the regulation must follow up, and effective external supervision ensures effective operation and successful payment without interruption or termination.

**Conclusion**

This article mainly introduces the related contents of tax incentive in U.S. pension system and the related suggestions of its further reform. In the aspect of tax incentives for the pension system, the general course of development and main functions are introduced. Then, the main contents of the tax incentive plan of U.S. pension plan are introduced, including incentives and control, qualification examination and tax management. The two modes of operation of the system, including the determination of the benefit annuity plan and the determination of the contribution plan is analyzed. We then put forward reform proposals on the reform of tax incentives on the pension system. In the aspect of corporate tax incentives, we argue that tax incentives should be further improved to enhance the development momentum: respecting the autonomy and flexibility of individual choices, simplifying restrictions and increasing coverage, improving legal support and security system, and continue to improve the regulatory system of enterprise annuity.

**References**


