

# Tax Treatment of Pensions

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\* Views presented are those of the authors and do not necessarily represent the views of the Investment Company Institute or its members.

# Organizing Principles

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- Progressivity
  - Tax benefit of a deferral is different than the tax benefit of a deduction
  - Progressivity of tax provision versus progressivity system-wide
- Deferral & the Incentive to Save
  - Savings decision related to after-tax rate of return

# Tax Benefit of Deferral

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- Rough equivalence of tax deferral and Roth treatment
- When equivalence does not hold
- Tax benefit of tax deferral related to
  - tax rate on ordinary income
  - tax on capital income
    - capital gains, dividends, and interest tax rates
    - frequency of realizations/taxation
  - length of deferral
  - tax rate on contributions relative to tax rate on distributions

# PDV Estimates of Tax Benefit of One-Time Deductible Contribution

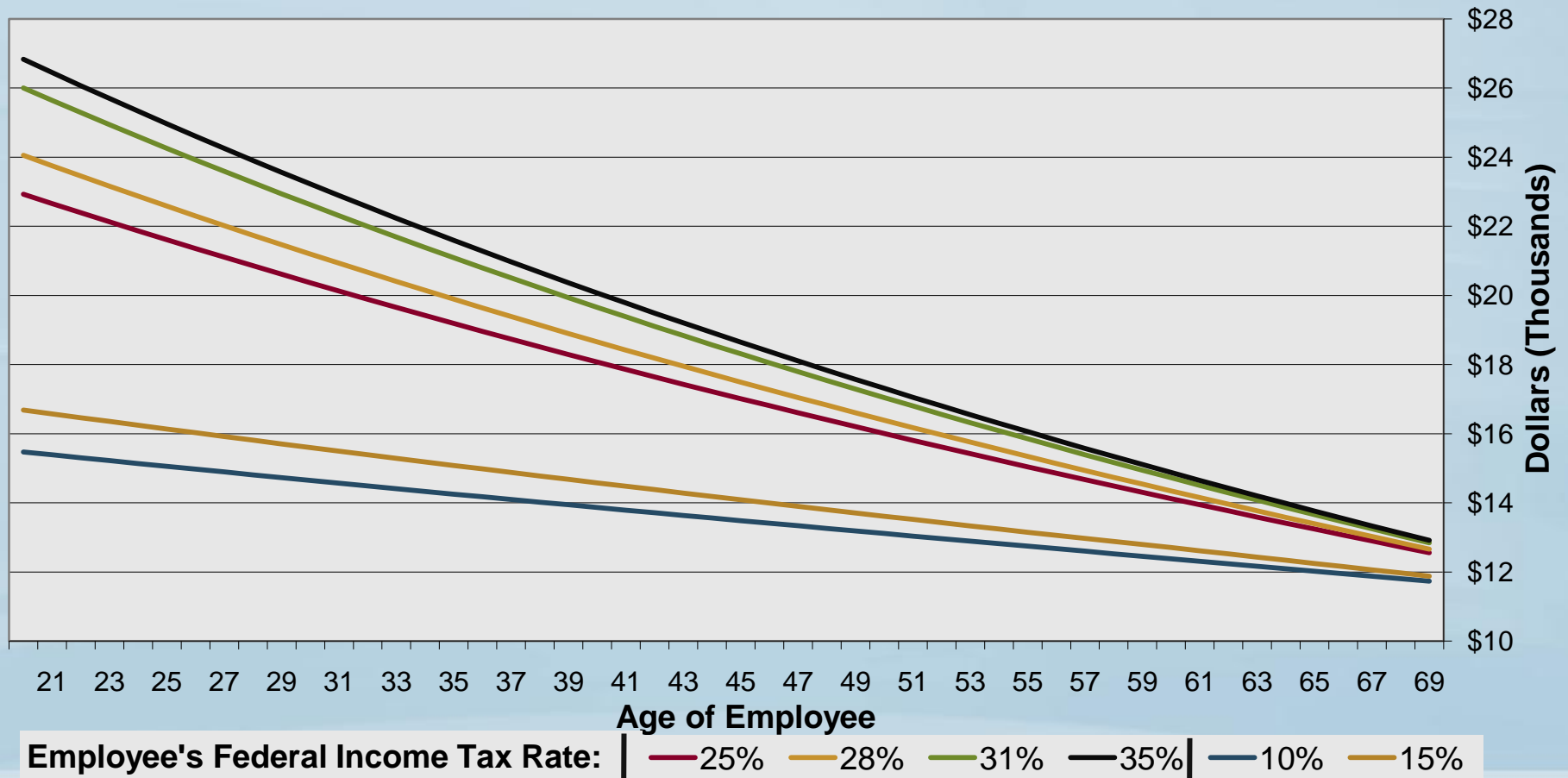
**Assumptions:** Risk free rate of return is 5%  
 Expected investment return is 5%  
 One-time \$1,000 deductible contribution  
 Hold until 70-1/2  
 Distribute using RMD rules  
 Live to age 100  
 Effective tax rate on capital income 15%

Age of Taxpayer	Tax Rate of Contribution/Tax Rate of Distribution			
	35%/35% MTR	35%/25% MTR	25%/25% MTR	25%/15% MTR
30	\$199	\$299	\$230	\$330
40	\$165	\$265	\$191	\$291
50	\$129	\$229	\$149	\$249
60	\$91	\$191	\$105	\$205

# Tax Benefit by Age & Marginal Tax Rate

Assumptions: tax rate same at contribution & distribution; federal plus state (average) tax; cap gains & dividends rate 15% or 5%; 50 percent bonds & 50 percent stocks; bonds 5% return distributed annually; stocks 9.25% returns with 0.75% short term gains; 1.5% qualified dividends, 3.0% realized long-term gains, 4.0% unrealized gains; paid out using RMD starting at age 70-1/2

**Taxable Compensation Equivalent to \$10,000 401(k) Contribution**



# Tax Benefits & Progressivity

- U.S. retirement policy
  - Social Security plus supplements (employer plans and private savings).
  - Social Security replaces a higher percentage of earnings for workers with low lifetime earnings
  - Those with higher lifetime earnings are most likely to want to supplement Social Security in retirement.
- ➔ • Higher earners likely to benefit more from tax incentives for savings regardless of how structured

## System-wide #1

- “Retirement system” more progressive than suggested by examining income tax treatment alone.

## System-wide #2

- “Microprogressivity” versus a progressive income tax

# Unequal Incentive to Save?

- After-tax rate of return – not the tax benefit – is the incentive to save
- Roth example:
  - Invest \$1 (post-tax labor income) for 20 years earning 5% interest

Tax rate	After-tax Distribution		Tax benefit
	Taxable Account	Roth Contribution	
	$(1 + r(1-t))^{20}$	$(1+r)^{20}$	
15%	\$2.30	\$2.65	\$0.35
35%	\$1.90	\$2.65	\$0.76

# Unequal Incentive to Save? (Con't.)

- Deductible contribution example:
  - Invest \$1 (pre-tax labor income) for 20 years earning 5% interest

Tax rate	After-tax Distribution		Tax benefit
	Taxable Account	Deductible Contribution	
	$(1-t)(1+r(1-t))^{20}$	$(1+r)^{20}(1-t)$	
15%	\$1.95	\$2.26	\$0.30
35%	\$1.23	\$1.74	\$0.49

# Brief History of Deferral

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- Revenue Act of 1921 allowed deferral of employer profit-sharing contributions
- Revenue Act of 1926 allowed deferral of employer contributions to pensions
- Social Security Act of 1935
- Revenue Act of 1942: nondiscrimination rules
- Employers introduce CODAs in 1950s
- ERISA (1974) introduces IRAs
- 1974, 1978, 1981: 401(k)s