SOCIETY OF ACTUARIES

Article From:

The Actuary

January 1987 – Volume No. 21, Issue No. 1

THE PENSION TAX SHELTER

By C. L. Trowbridge

That the qualified retirement plan has important income tax advantages, especially to the benefited worker, has long been well known. Employer contributions to such plans, as well as the investment earnings on the contributions, are not taxable to the individual until the benefits are actually paid. The tax on pension contributions is long deferred, the employee enjoying the interest on the lower taxes in the meantime. Employee contributions to these same plans, however, are not treated so favorably, only the interest, and not the contribution itself, being tax-deferred.

It has been public policy that retirement plans are to be encouraged, and that the tax laws are the vehicle for such encouragement; but it is also public policy that pensions cannot discriminate in favor of the highly paid. The myriad of rules surrounding "qualified" pension and profit-sharing plans is largely intended to prevent such discrimination.

Given the favorable treatment that the tax law has long given employees under qualified retirement plans, it is not surprising that the pressure to extend this favorable treatment has been great. This pressure has been exerted in at least two directions — the extension of favorable treatment to additional groups, and the substitution of the full tax deferral (on the employee contribution and interest) for the more limited deferral of interest only.

This article is an outline of these two kinds of extensions of the qualified retirement plan tax-shelter, how they have occurred, and how they are now affected by the most recent changes in income tax law. The expansion of the pension tax shelter is one of the factors in a deteriorating tax base, a trend that the new tax law attempts to reverse.

Extensions outside the qualified area

The very first of the several extensions of the retirement plan tax shelter to other than employees under qualified plans came very early. State, local and federal goverments pay no income taxes, but they offer retirement plans, some of which are qualified, but some of which are not. As a practical matter, governmental retirement plans get the same favorable tax treatment, regardless of whether the plans are technically qualified. Whether a decision as to this matter was ever made via some rational process, or whether the extension of the qualified plan tax treatment to employees under non-qualified government plans was simply assumed, this author has no knowledge. Nonetheless it is clear that this was the result and that the same is true as to plans of other non-profit employers. Today, employees of entities that pay no tax usually enjoy the tax advantages of qualified plans, even when these plans are not qualified and even though the non-discrimination rules may not be met.

The tax deferral for business, government and non-profit employees having been well established soon after WWII, agitation soon began for giving the small businessman, the farmer, and other self-employed a similar opportunity. Eventually the laws were changed to give the self-employed a route to the tax deferral objective through what is known as the Keogh or HR10 plan.

With the extension of the idea to nearly any form of paid endeavor, and to owners as well as the employees, there remained only the employee of an employer without a retirement plan who could not somehow enjoy the tax advantages of pension deferrals. Even this hole was filled with the coming of IRAs in the 1970s. Although originally only for those who did not enjoy the tax deferral in some other form, IRAs later became available to most employed individuals, though subject to certain maximums, and to some penalties on early withdrawal.

Full deferral in lieu of partial deferral

Although the quite different treatment of employer and employee contributions has been generally sustained over the years, there has been substantial shifting out of the traditional employee contributions (with limited tax appeal) and into forms that are more fully tax deferrred. We will here look at some of the ways in which this shifting has taken place.

That non-contributory plans are more "tax effective" has been a part of the general wisdom for quite some time. The great majority of negotiated retirement arrangements are employer-pay-all, and contributory plans are less common, even among salaried employees, than they once were. As employers find it desirable to "improve" their plans, at least one of the ways they have of doing so is to absorb some or all of what otherwise would be an employee contribution. There has been, then, a drift toward fully tax deferred plans, entirely apart from any changes in the IRC.

More important, however, is another development. Employee and employer contributions are only marginally separable. Both arise from the compensation that the employer pays the employee for the services that the employee renders. Does it make any real difference whether an employee's salary is stated as 100, of which he contributes 6 to a retirement plan, while the employer contributes another 6; or, alternatively, the salary is stated as 94, while the employer contributes 12 to a non-contributory plan? The take home pay in both cases is 94, and in both cases the flow to the pension arrangement is 12. Only the tax is different. This simple illustration shows that employee contributions change to the better treated employer variety without too much difficulty, unless the IRS, in an effort to protect its tax base, takes heroic steps to prevent it.

The foregoing occurred to pension experts long ago, and gave rise to what this paper will call the VPC (voluntary pay-cut) approach. For some reason the VPC approach first developed for employees of 501c(3) organizations and was later extended to public school employees. Under certain conditions the law permits these employees to take voluntary reductions in pay, and to invest the difference in TSAs (tax-sheltered annuities). Why these groups were singled out for this especially favorable tax treatment, or why annuities were favored over other ways of investing retirement monies, may be a subject for debate, but the TSA has long been with us and still survives. Not only can the required employee contributions change their spots, but the employee can elect to make additional tax-deferred contributions as well. TSAs have been especially popular among the teaching profession.

Another form of essentially the same phenomenon has been the so-called

(Continued on page 5)

The Pension Tax Shelter

(Continued from page 4)

non-qualified unfunded deferred compensation plan. In some cases these plans cover broad employee groups and in some key employees negotiate with their employers that part of their compensation currently earned be deferred. Under certain conditions these deferred compensation plans are permitted, though in this situation the employer gets no immediate tax deduction. ERISA limits these programs to a select group of management and highly compensated employees.

Government and other tax exempt employers may adopt deferred compensation plans under Section 457. Such plans are theoretically unfunded, but as a practical matter are very similar to TSAs.

Another development along VPC lines is the currently popular 401(k) plan, little different in principle from the TSA, except that the conditions imposed are somewhat different, and one that can be adopted by most employers. The Internal Revenue Code imposes some rules preventing 401(k) plans from being primarily for the highly paid.

Finally, the IRA, mentioned earlier as the ultimate extension of the "tax-shelter for pensions" idea beyond the corporate employee group, is also the ultimate extension of the concept of getting employer contribution tax treatment for what *surely* are contributions from the benefited individual himself. To take advantage of an IRA no employer financing is required, though if there should be some, that is fine too.

Where we stand today

By now the tax code has become very complicated. As each of these new approaches is developed, special rules and regulations are written, and these tend to be inconsistent. These special provisions accumulate, since none of these various approaches is ever completely abandoned.

The very newest approach to tax-reform, the TRA of 1986, does relatively little to the retirement plan tax-shelter, which remains very much alive and well. Because certain other kinds of tax-shelter were badly hurt by the recent efforts to preserve the tax base, the importance of the retirement plan in the tax planning of the American people may well be increased, even though, as many have noted, the tax rates themselves will be lower.

We must not leave the impression that the new tax law left retirement plans unscathed, because it is clear that there is a certain amount of tightening with respect to some of the forms mentioned. Especially were some of the limits on the maximum amounts of VPC tax deferral reduced (eg 401k and 403b); and the conditions under which a person might defer income via an IRA were made more stringent. For the very messy details, consult your favorite Employee Benefit Plan Newsletter. ☐

A Half-Century of Membership

(Continued from page 1)

in which they attained age 25.

4. The geographical distribution of present addresses, by state or province, is:

Ontario	26
Florida	22
New York	16
Connecticut	12
New Jersey	11
California	7
Other states	41
Other provinces	11
Foreign	2
Total	148

Note that the Canadian proportion is 25%.

5. There are only three women in this select group, all born before 1900. The most senior in terms of membership is Esther Johnson, FSA 1926.

6. Among the 105 half-century FSAs are 10 past-presidents of the Society, and two past-presidents of the American Institute of Actuaries, one of the predecessor actuarial organizations.

7. Dan Lyons, FSA 1930, was recently recognized by the *Actuarial Review* as a 50-year FCAS. There may be others who are 50-year Fellows in both Societies, but if so we are unaware. ☐

Recent Social Security And Medicare Enactments

(Continued from page 1)

This legislation also makes clear that the cost of the provision that no beneficiary will receive a decrease in the benefit check, after taking into account the counterbalancing effects of the COLA and SMI premium increase, will be borne by SMI, not OASDI.

In the past there have been times when interest-bearing government obligations have been converted to non-interest bearing book entries, an action of the Treasury to avoid the public debt limit. This "disinvestment" or "delayed investment" issue created quite a stir in 1985. The Budget Reconciliation legislation restores any interest lost to the OASDI funds as a result of not being able to invest all net income at the beginning of October. The basis for depositing the OASDI-HI contributions by state and local governments was also changed, so that these will be transmitted by each entity separately rather than through centralized state agencies. The effect should be to speed up the transfer.

The Budget Reconcilation legislation made a number of changes in the Medicare program, although many of those related to the reimbursement of hospitals and other suppliers which will not be dealt with here. The change that will be most widely felt by beneficiaries is that the initial deductible for HI for 1987 will be less than would have occurred under prior law. This deductible would have been $572, but was lowered to $520. It is interesting to note than an arbitrary increase occurred for 1982; if this had not been made, and there were no decrease in the recent legislation, the result would have been $508. In the future, the deductible amount is to be indexed by changes in the hospital-cost "market basket" index, with adjustment to reflect changes in the case mix. The indexing was formerly done on the basis of the average per-diem cost for inpatient hospital services for the HI insured, but this has produced faulty results for the last two years, because the average duration of hospitalization has decreased significantly, thus causing an artificial rise in the average *daily*

(Continued on page 7)