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**Any contemplated change in the tax treatment of pensions warrants careful analysis of the potential effects on the availability and extent of pension benefits, the financial markets, and the U.S. economy.**

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# Pension Fund Taxation: Examining the Issues

- The Bush administration is actively studying a proposal to tax the purchase or sale of securities as a means of raising federal revenue. Some observers believe the proposal has a strong chance of being included in the 1991 budget agreement.

- An excise tax on capital gains from short-term investments by pension funds, such as that proposed by Sens. Robert Dole (R-KS) and Nancy Kassebaum (R-KS), would likely have far-reaching implications beyond its primary aims of limiting pension fund "churning" (frequent turnover of investments) and promoting long-term investment horizons.

- A short-term turnover tax could decrease market liquidity to some extent and affect patterns of rates of return and national savings. There is no consensus on the effect such a tax would have on volatility.

- Under a turnover tax, pension fund investment managers would probably have to decide what is prudent based on after-tax, rather than before-tax, considerations; plan sponsors could tend toward passive rather than active investment management.

- A short-term turnover tax's long-term effect on pension asset allocation would not be apparent for perhaps a decade.

- Since 1983, Australia has made major changes in its taxation of pension, or superannuation, fund contributions and benefits. This nation's experience may hold valuable lessons for the United States as policymakers address the issue of pension fund taxation.

## ◆ Introduction

The tax treatment of U.S. pension funds is receiving close attention from public policymakers. Concerned with the bulging federal budget deficit, policymakers are assessing whether pension funds are meeting public policy objectives. A central concern is that pension funds may not be taking a sufficiently long-term view regarding investments. As a result, some in Congress have proposed either transaction taxes or taxation of capital gains from short-term pension investments. In particular, the current debate over whether U.S. pension funds should be subject to a tax on short-term capital gains has centered on the roles pension funds play in stock market volatility[1] and the role of institutional investors in financial markets.

This *Issue Brief* explores issues related to proposals for taxing pension funds. It assesses the effects that a short-term capital gains tax, such as as that proposed by Senators Robert Dole (R-KS) and Nancy Kassebaum (R-KS), might have on markets, investment managers, sponsors, asset allocation, and national savings. Finally, to see what can be learned from another nation's experience, this *Issue Brief* details recent taxation changes in the Australian pension system.

## ◆ Taxation Proposals

In the United States, retirement plans must meet qualification rules to receive tax preferences. These rules specify that benefits be nondiscriminatory (that is, they cannot favor highly compensated employees) and meet minimum eligibility and design rules.

An employer's contribution to a qualified plan is tax deductible within specified limits. The pension plan does not pay any taxes on investment income. Employee contributions may be on either a pretax or an after-tax basis, depending on the plan type. Benefits generally are taxed when received by the employee, with excise taxes imposed on early withdrawals.

Within this structure, several proposals have been made for taxing U.S. pensions, by taxing either the plan sponsor or the beneficiary.

- Eliminate the double taxation of equity to equate debt and equity financing.
- Place a transaction tax on all purchases and sales of securities.
- Tax net capital gains.
- Tax capital gains in instances where the investments were not held for a certain period (a short-term turnover tax).
- Tax all investment income.
- Impose excise taxes in addition to the current 10 percent penalty for premature distributions.
- Tax all pension benefits as ordinary income.[2]
- Tax employer contributions to pension funds as current income to employees.
- Impose an indirect tax by prohibiting companies from deducting their pension contributions.

The first four proposals, which are currently under consideration by public policymakers, are discussed below.

The revenue effects of these changes would differ. For example, according to estimates from the Employee Benefit Research Institute (EBRI) Employee Benefit Revenue Estimating Model, the inclusion of employer pension contributions as taxable income to employees would generate an additional $31 billion in annual federal revenue, while inclusion of pension earnings in employees' taxable income would increase revenue by $42 billion a year (Salisbury and Davis, 1990).

### Eliminate Double Taxation of Equity

The U.S. Department of the Treasury is considering a proposal aimed at establishing tax neutrality between debt and equity financing. Currently, dividends are taxed at the company level before distribution and at the shareholder level as income after distribution. Interest paid on bonds, however, is tax deductible to the company and taxed only at the bondholder level as income.

The proposal under consideration would require companies to pay one tax rate on all pretax earnings,

[1]Volatility refers to the frequency and magnitude of rises or declines in prices within a period of time.

[2]Currently, five-year averaging of lump sums may be used on a one-time basis to minimize a beneficiary's income tax liability.

regardless of whether it would then be distributed as dividends or interest. A tax credit would be given to those receiving the income (either as dividends or interest), to be used during the tax period in which the income was received.

This proposal may have unintended consequences for tax-exempt entities such as pension plans. Investors would look at returns from various asset classes on a net basis (that is, factoring in the impact of the tax credit received from stocks and bonds) and, after a transition period, asset prices would reflect these net rates of return. The rates of return before making this adjustment would undoubtedly decrease, especially for bonds that previously provided tax deductions for the interest payments made by the corporations. Unfortunately, pension plan assets would only be affected by the before-adjustment rate of return since the proposal apparently provides no market for tax-exempt organizations to sell these unusable credits.

Thus it appears that pension funds would lose the competitive advantage they currently hold over investments in non-tax-sheltered vehicles. Given that plan sponsors under this scenario could obtain the same net rate of return by investing outside of the pension fund, it is logical to expect a decrease in pension contributions. Sponsors of defined benefit plans would find it difficult to justify anything more than the minimum required contributions, given the inherent cash flow inflexibility of pension assets.[3] At the same time, sponsors of defined contribution plans would not be able to provide tax advantages to participants that they (participants) could not achieve themselves in the financial markets. Since retirement savings outside of a qualified retirement plan setting would allow individuals to reflect their exact propensity to save (rather than some average rate for the group to comply with nondiscrimination requirements), it is logical to assume that even existing defined contribution plans would be scaled back in the future.

The most far-reaching effect of this proposal for pensions would be to reduce the attraction for companies and individuals to place money in pension funds.

[3]In other words, once the funds are contributed to a pension fund, the sponsor could not use them in the event of cash flow problems unless the plan was overfunded and the employer was willing to terminate it.

### Tax Securities Transactions

The Bush administration is also actively studying a proposal that would impose a transactions tax on the purchase or sale of securities as a means of raising revenue to help reduce the federal budget deficit. Treasury Secretary Brady has expressed support for such a proposal and several observers believe it has a strong chance of being included in the 1991 budget agreement. The Congressional Budget Office (CBO) also included such a tax among the revenue raising alternatives in its annual compilation of deficit reduction options.

A levy of as much as 0.5 percent would be imposed on the sale of stocks, bonds (except Treasury securities), futures contracts, and other instruments. CBO estimates that such a tax would raise about $12 billion per year initially. The tax could apply to all investors, individuals, corporations, and tax-exempt institutions such as pension funds.

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**Supporters of a transaction tax point to the fact that the markets of nations that have enacted such a tax have not suffered.**

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The potential effects of the proposal are unclear. Securities industry representatives believe that such a tax would reduce liquidity[4] in the markets and, by increasing the cost of transactions, depress stock prices. In the extended wake of the stock market decline of October 1987, many observers believe that any action that reduces market liquidity will have an adverse impact on the economy. A Congressional Research Service analysis predicts that a transaction tax would reduce short-term trading due to the fact that transaction costs would claim a very high percentage of the gross profit on short-term trades (Kiefer, 1990). Some observers believe that sharp changes in the prices of

[4]Liquidity refers to the ability to easily convert assets into cash or cash equivalents.

stocks (increased volatility) could result. Supporters argue, however, that a reduction in short-term trading would allow corporate managers to focus on long-term objectives.

Supporters of a transaction tax also maintain that its tax impact would be, for the most part, highly progressive. They also point to the fact that the markets of nations that have enacted such a tax have not suffered. These countries include Belgium, Denmark, France, Portugal, Spain, Italy, Japan, West Germany, Great Britain, and Canada. However, opponents note that the latter five countries are taking steps to reduce or eliminate the taxes (Power, 1990).

**Tax Net Investment Income**

The possibility of a tax on the net investment income of all currently tax-exempt organizations—including pensions—was recently raised by staff of the Joint Committee on Taxation.[5] Some observers have argued that pensions are *tax-deferred*, rather than *tax-exempt*, entities and so would not be subject to such a tax. Congressional staff, however, cite precedent in the Internal Revenue Code for taxing such entities as pension plans to help pay for enforcement costs.[6] Depending on the rates at which employees and pensions are taxed, this proposal could drastically decrease the tax advantages of sponsoring a plan.

**Tax Short-Term Investment Income**

In September 1989, Sens. Kassebaum and Dole introduced the Excessive Churning and Speculation Act of 1989 (S. 1654), which would place an excise tax of 10 percent on capital gains from assets held 30 days or less and 5 percent on gains from assets held more than 30 days but less than 180 days. Any plan with less than $1 million in assets at its most recent valuation would be exempt from these taxes as well as transactions entered into as a hedge (that is, transactions to reduce risk). The aim of the bill, according to its sponsors, is not to raise revenue but to limit pension fund "churning"—frequent turnover of investments—and promote long-term investment horizons.

Proponents maintain that the large majority of pension beneficiaries are in defined benefit plans and therefore would be unaffected by this tax because their employers would pay it. Other observers, however, predict that both defined benefit plan participants and beneficiaries would share the cost of a tax on short-term investment income through reduced benefit increases.

A turnover tax, as drafted, would also apply to defined contribution plans. By lowering the investment return credited to each plan member, such a tax most likely would decrease the amount available for retirement income.

Those opposed to a turnover tax state that pension funds already invest in the best interests of participants and beneficiaries and that such a tax would limit the return achievable through short-term investments, thereby limiting the return and perhaps the participants' benefits (McGrath, 1990; Scholes, 1990). It has also been argued that pension plans could increase their use of options[7] and futures[8] as hedges to obtain the same investment position as the taxed transactions, thereby incurring additional transaction costs but avoiding the tax.

Proponents maintain that a tax on short-term capital gains would discourage destabilizing speculation, excessive financial engineering,[9] and excessive shareholder impatience (Summers, 1990).[10]

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[5]Based on remarks by Carolyn E. Smith, legislative counsel to the Joint Committee on Taxation, at an employee benefits conference sponsored by the Hartford Institute on Insurance Taxation, June 26–27, 1990 (Bureau of National Affairs, Inc., 1990).

[6]The tax code "imposes a 2 percent excise tax on private foundations for audit and enforcement costs; arguably, the same justification could be transferred to the pension plan area in light of the cost of enforcement of the Employee Retirement Income Security Act, according to [Joint Tax Committee legislative counsel Carolyn E.] Smith" (Bureau of National Affairs, Inc., 1990).

[7]In general, an option is the right to buy or sell a security for an agreed-upon price. If the right is not exercised after a specified period, the option expires and the buyer forfeits the money paid for the option.

[8]A futures contract is an agreement to buy or sell a specific amount of a commodity or financial instrument at a certain price on an established future date.

[9]That is, engaging in transactions purely for financial gain.

[10]Summers has stated, however, that he would prefer a transaction tax over a short-term capital gains tax.

## ◆ Assessing the Impact of a Turnover Tax

While it is difficult to accurately predict the full impact of a new pension tax—particularly its magnitude—it is possible to gain a sense of how a proposal might affect financial markets, plan sponsorship, and investment strategy. For illustrative purposes, the effects of a short-term capital gains tax can be investigated.

The tax's potential effects can be grouped into five primary areas:

- the impact on financial markets;
- the impact on managers' investment behavior;
- the impact on plan sponsors' decisions and the data on which those decisions are based;
- the impact on asset allocation; and
- the impact on national savings.

An analysis might also include such aspects as plan design and operating expenses, level of benefits, funding policy, federal revenues, and other macroeconomic factors, but the above-listed are the most evident and the most relevant.

While the following discussion most readily applies to defined benefit plans, the same arguments could also be used for defined contribution plans. Participants in defined contribution plans often have the option to direct their funds toward one or more investment alternatives and would be faced with the same potential changes in market conditions as the defined benefit plan sponsor.

### Impact on Financial Markets

*Liquidity*—Commentators appear unanimous that market liquidity would decrease to some extent if a tax were placed on gains from short-term trading, simply because short-term trading increases market liquidity. Reduced liquidity can be costly, however. Investors demand a higher rate of return as compensation for the reduction in liquidity. For example, closed-end funds (those with a fixed number of shares) sell at a discount from their liquidation value. This reduced liquidity may make it more costly for firms to raise money through the markets. That is, if liquidity is reduced, lower prices and higher demanded returns in the stock and bond markets increase the cost of capital to firms.

*Return Patterns*—Patterns of rates of return may also be affected by a short-term tax. The returns may depart from historical patterns, but the extent of that departure is impossible to predict. Changes may be so small as to be indistinguishable from normal volatility. Alternatively, instant changes may be very large, such as those that followed the widely leaked plans of the Australian government's 1988 pension and general fiscal proposals (discussed later in this *Issue Brief*)—which included a capital gains tax. So much investment capital flowed into Australia that its dollar quickly rose by 10 percent relative to U.S. currency and prices for Australian stocks boomed to post-crash highs (Ezra, 1990).

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**Market volatility has not increased by most measures since World War II, while trading volumes have increased.**

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*Volatility*—The debate on a turnover tax in particular, and on some of the other proposals as well, centers on the idea of reducing short-term investments in the stock market as a means of reducing short-term volatility. The term "short-term investors" is sometimes thought to include only those who speculate in the market, deriving profits from short-term mispricing or from a short-term misalignment between markets (that is, the stock market and the futures market). However, a turnover tax would also be levied on those who purchase a security based on fundamental values[11] and then sell it as fundamentals change within a short time period.

According to Ezra (1990), market volatility has not increased by most measures since World War II, while trading volumes have increased. However, patterns of

[11] A security's fundamental value is determined through analysis of the issuing company's balance sheet and income statement as a means of forecasting the security's future price movements.

volatility have changed in that there have been more precipitous drops recently. Although large fluctuations have been less frequent, they have been much larger. Of late, these fluctuations have been occurring on the down side more than on the up side, and this can be unsettling to the confidence of market participants.

Opinion is mixed on the question of whether the imposition of a short-term tax would lead to a change in volatility. Some commentators point out that short-term trading helps to quickly return market prices to fundamental values; by comparison, a capital gains tax would introduce trading friction, possibly leading to more abrupt price changes. Others claim that a short-term trading tax would cause investors to trade less frequently in response to small changes in fundamental values, thereby attracting long-term investors.

Proponents of the tax argue that high stock turnover prevents corporate managements from undertaking long-term projects. They cite corporate management's claim that short-term investors make it difficult for the firm to invest in long-term research and development projects. In contrast, Scholes (1990) compares turnover in the U.S. and Japanese stock markets, since the Japanese are typically identified as the epitome of long-term planners (table 1). Although Japan does impose a transaction tax, which presumably would dampen turnover rates, its stock market turnover rates are high relative to those of the U.S. markets.

Furthermore, recent testimony by the Committee on Investment of Employee Benefit Assets of the Financial Executives Institute shows that U.S. pension fund stock turnover has been roughly 10 percentage points lower than that of the New York Stock Exchange (NYSE) for actively managed portions of pension fund portfolios and roughly 20 percentage points lower than the NYSE when the passive portions of pensions are also included (Shultz, 1990). Thus, it remains unclear whether pension fund stock turnover discourages long-term business planning.

EBRI is currently conducting a study to analyze the investment turnover of U.S. pension assets. Turnover data are being collected by type of asset, the most relevant to this debate being U.S. equities, although turnover rates are also being collected on international equities, short-term bonds, and long-term bonds, among others. In addition, a second survey will ask for the criteria used in hiring and firing investment managers and about investment manager tenure. A third survey will ask investment managers how they determine investment strategy and whether these strategies inherently represent a short-term perspective. Results of the study are expected in the fall of 1990.

Table 1
**Turnover in the New York and Tokyo Stock Exchanges, 1986–1988**

| Year | 1986 | 1987 | 1988 |
|---|---|---|---|
| New York Stock Exchange | 64% | 73% | 56% |
| Tokyo Stock Exchange | 75 | 96 | 98 |

Source: 1989 fact books of the Tokyo and New York Stock Exchanges. As printed in testimony by Myron Scholes of Stanford University before the Senate Finance Committee on March 21, 1990.

Planning horizons may be shorter in the United States than in other countries, perhaps because of the relatively high cost of capital due to U.S. tax policies and higher U.S. interest rates. Capital investments that have a long time horizon seem more attractive to investors when interest rates are lower; thus, foreign investors can afford to take a longer investment horizon than U.S. investors.

Foreign investors have invested more heavily in the United States since 1986 for a number of reasons:

- the U.S. tax rate is lower than those of many countries;
- foreign investors do not pay U.S. capital gains tax and may have no such tax in their own countries; and
- the elimination of some corporate tax shelters by the Tax Reform Act of 1986 led some companies to require higher before-tax rates of return, making them more attractive to foreign investors whose countries allow these tax shelters (Scholes, 1990).

*Asset Classes*—A short-term turnover tax would have the most dramatic effect on types of assets in which short-term gains are likeliest to arise—in other words, stocks, followed by long-term bonds.

*Derivative Securities*—The impact that a short-term pension turnover tax might have on derivative securities (that is, options and futures) has not received widespread publicity. The general observation has been that investors may be able to use derivatives to achieve the investment position they want without technically triggering the tax because hedging transactions apparently would not be subject to a turnover tax (as proposed in the Dole/Kassebaum bill). In fact, when writing covered call options[12] or using futures as a hedging instrument, there are securities behind the derivatives until the net position becomes a short position.[13] Therefore, it might appear that the use of derivatives should not trigger the tax at all; however, the hedging exceptions could be difficult to administer.

### Impact on the Investment Behavior of Managers

A short-term investment gains tax would affect the investment behavior of pension fund investment managers in a number of ways. These effects fall into two general areas: the "prudent man" standard and the value of "investor insight."

First, regardless of what else would be changed with the adoption of a turnover tax, the prudent man standard in the Employee Retirement Income Security Act of 1974 (ERISA) is unlikely to be disturbed. Under this standard, fiduciaries must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[14] Because the performance standard is so high, the prudent man rule can be translated to require the actions that a prudent expert would take.

Under the turnover tax proposal, managers would have just one more factor to include in their investment and trading considerations: most likely they would have to decide what is prudent based on after-tax, rather than before-tax, considerations.

Second, the value of superior analytical or research insights (investor insight) could be dramatically reduced. Summers (1990) provides a description of such when considering the effect of a short-term capital gains tax. He shows that insight would need to be effective enough to compensate for the tax. In other words, when evaluating an insight by comparing possible upside gains with downside potential, an investor would need to lower the magnitude of upside gains due to the tax. Summers (1990) shows an example in which the value of the insight would be decreased by one-half with a 10 percent tax on short-term gains. Therefore, fewer trades would be executed based on investor insight, which again relates to market liquidity.

### Impact on the Decisions of Plan Sponsors

In addition to the way managers view the financial markets, the way plan sponsors make investment policy decisions would also be affected by a short-term turnover tax. In practice, sponsors generally first look to the past for help in predicting the future; this is the basis for such decisions as hiring an investment manager. For example, a sponsor would look at the manager's investment style, the riskiness of the manager's investments, and the manager's success. But many of the historical yardsticks used to evaluate this information would no longer be relevant because of the change created by the tax, making such decisions more difficult.

For example, Australians were faced with the question of whether investment results should be monitored on an after-tax basis or a before-tax basis, as before that nation's recent reforms. While an after-tax comparison would make sense, it would make comparisons with the past difficult because there is often little data on after-tax results. Therefore, the Australian pension industry, as an ad hoc step, generally examines total fund data on an after-tax basis and returns by asset class on a pretax basis due to the lack of after-tax data at that level; there is some question whether this is a long-term solution.

[12]Writing a call option involves selling the right (or option) to buy a security at a specified price during a specified period of time. With a covered call option, the seller owns the security that the purchaser of the option may buy.

[13]A short position occurs when the underlying security is no longer owned.

[14]ERISA section 404(a)(1)(B).

Second, a short-term turnover tax could cause plan sponsors to tend toward passive rather than active investment management. As Summers (1990) points out, if investment judgments or insights are taxed at a punitive rate, then those judgments will be acted upon less frequently. Therefore, sponsors may want or feel the need to have a larger share of the fund placed with managers who invest passively.

**Impact on Asset Allocation**

Asset allocation is a plan sponsor's ultimate expression of investment policy. Very few plan sponsors adopt extreme positions, particularly in defined benefit plans. They are neither totally risk averse, seeking solely to avoid risk even at the cost of forsaking all but risk-free returns, nor are they totally reward seeking, ignoring risk as they seek the highest possible returns. The consequence is that virtually all sponsors adopt a diversified mix of asset classes as the expression of their investment policy. It would take an extreme change in the risk/reward characteristics of investments to shift sponsors away from this stance.

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**At the end of the first quarter of 1990, private trusteed pension funds invested 40 percent of their assets directly in stocks, 17 percent directly in bonds, and 7 percent in cash.**

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The *EBRI Quarterly Pension Investment Report* shows that at the end of the first quarter of 1990, private trusteed pension funds invested 40 percent of their assets directly in stocks, 17 percent directly in bonds, and 7 percent in cash. Nineteen percent of their assets were invested in bank pooled funds. If the asset allocation of the bank pooled funds is included in the distribution (thereby including direct and indirect investments of equity, bonds, and cash), then these pension funds invest 49 percent of their money in equity, 21 percent in bonds, 11 percent in cash, and 20 percent in other investments. This investment distribution has been fairly stable during the past seven years (table 2).

Within this general diversified asset allocation, some shifts might take place given a turnover tax. Specifically in the patterns of potential rewards, there might be some reduction in exposure to stocks and some smaller reduction in exposure to long-term bonds. But it is difficult to tell whether changes in volatility and covariance[15] characteristics would augment or offset these effects.

In Australia, there has been little dramatic change in asset allocation (Lucas and Bransford, 1990). There was, however, a shift away from cash—from 20 percent in cash before the reforms to 12 percent in cash afterward. Of the 8 percent that moved to stocks, 5 percent shifted to foreign stocks and 3 percent to Australian stocks (Lucas and Bransford, 1990). The significance of the shift is not entirely clear, but to the extent that investments were taken out of cash and placed into something akin to long-term assets, it was in the direction of stocks.

It is never clear whether an investment shift is a long-term strategic reassessment of the market following a tax change or a short-term tactical move based on current market conditions. Since pension investment managers are not prone to making major shifts quickly, the long-term impact of a tax change would not be apparent for perhaps a decade.

**Impact on National Savings**

The impact of a short-term turnover tax on savings would depend on the type of pension plan being considered.

*Defined Contribution Plans*—Under a defined contribution plan, any short-term trading would decrease the net return to the participant vis-à-vis his or her potential return without a tax. As the net return decreases, the amount of current consumption the participant chooses to forgo in lieu of savings would be expected to decrease.

[15]Covariance refers to whether the returns of two or more asset classes move together. A well-diversified portfolio would include asset classes that are not highly correlated (that is, they have dissimilar patterns of return).

*Defined Benefit Plans*—Under a defined benefit plan, a lower net return would likely result in increased employer contributions to offset the loss in the short term. In the long run, employers may take the increased costs of providing a specific level of retirement benefits into account and establish a less generous benefit formula than otherwise would have been established.

## ◆ Australia's Experience

Since 1983, the Australian government has phased in several major changes in its taxation of superannuation[16] fund contributions and benefits. These changes are intended to expand pension coverage, increase equity and efficiency, and ensure that superannuation becomes the principal retirement savings vehicle in Australia (Larum, 1990).

[16]The term "superannuation" rather than "pension" is used in Australia because the majority of Australians take their benefit in the form of a lump sum.

Recent key changes in the Australian taxation system include the introduction of a tax on capital gains and benefits, reform of business taxation, significant reductions in both personal and corporate rates of income tax, introduction of a full imputation system for share dividends, and the reform of superannuation taxation (Larum, 1990).

### Benefits and Contributions

Prior to 1988, the tax applied to amounts accumulated in superannuation funds was not payable until benefits were paid out, rather than when benefits were accrued; this carried a significant revenue cost. In 1988, the government announced reforms that brought the

Table 2
**Asset Allocation of Private Trusteed Pension Funds, 1982–First Quarter 1990**

| | Directly Held Assets | | | | | | Directly Held Assets | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| End of | Equity | Bonds | Cash items | Other assets | Bank Pooled Funds | Total Assets | Equity | Bonds | Cash items | Other assets | Bank Pooled Funds | Total Assets |
| | | | (billions) | | | | | | (percentage) | | | |
| 1982 | $234 | $131 | $ 70 | $134 | $ 86 | $ 655 | 35.8% | 20.1% | 10.7% | 20.4% | 13.1% | 100.0% |
| 1983 | 276 | 140 | 88 | 155 | 102 | 760 | 36.3 | 18.4 | 11.6 | 20.3 | 13.4 | 100.0 |
| 1984 | 278 | 152 | 89 | 164 | 112 | 795 | 35.0 | 19.1 | 11.2 | 20.6 | 14.0 | 100.0 |
| 1985 | 351 | 177 | 95 | 196 | 148 | 967 | 36.3 | 18.3 | 9.8 | 20.3 | 15.3 | 100.0 |
| 1986 | 404 | 198 | 91 | 211 | 157 | 1,061 | 38.1 | 18.6 | 8.6 | 19.9 | 14.8 | 100.0 |
| 1987 | 410 | 191 | 104 | 211 | 186 | 1,102 | 37.2 | 17.4 | 9.4 | 19.1 | 16.9 | 100.0 |
| 1988 | 450 | 195 | 125 | 227 | 215 | 1,212 | 37.2 | 16.1 | 10.3 | 18.8 | 17.7 | 100.0 |
| 1989 | 551 | 224 | 102 | 254 | 248 | 1,379 | 40.0 | 16.2 | 7.4 | 18.4 | 18.0 | 100.0 |
| 90Q1 | 530 | 219 | 92 | 242 | 246 | 1,330 | 39.9 | 16.5 | 7.0 | 18.2 | 18.5 | 100.0 |

| | Asset Allocation of All Assets with Bank Pooled Funds Allocated | | | | | Distribution of All Assets with Bank Pooled Funds Allocated | | | |
|---|---|---|---|---|---|---|---|---|---|
| End of | Equity | Bonds | Cash items | Other assets | Total assets | Equity | Bonds | Cash items | Other assets |
| | | | (billions) | | | | (percentage) | | |
| 1982 | $262 | $146 | $109 | $138 | $ 655 | 40.0% | 22.2% | 16.7% | 21.1% |
| 1983 | 314 | 155 | 132 | 160 | 760 | 41.3 | 20.3 | 17.4 | 21.0 |
| 1984 | 309 | 171 | 147 | 169 | 795 | 38.8 | 21.5 | 18.5 | 21.3 |
| 1985 | 394 | 197 | 173 | 204 | 967 | 40.7 | 20.4 | 17.9 | 21.0 |
| 1986 | 460 | 224 | 156 | 221 | 1,061 | 43.4 | 21.1 | 14.7 | 20.8 |
| 1987 | 484 | 224 | 172 | 222 | 1,102 | 43.9 | 20.4 | 15.6 | 20.1 |
| 1988 | 538 | 233 | 201 | 241 | 1,212 | 44.4 | 19.2 | 16.6 | 19.8 |
| 1989 | 667 | 276 | 166 | 270 | 1,379 | 48.4 | 20.0 | 12.1 | 19.6 |
| 90Q1 | 647 | 272 | 151 | 260 | 1,330 | 48.7 | 20.5 | 11.3 | 19.5 |

Source: *EBRI Quarterly Pension Investment Report*, first quarter 1990.

Table 3
**Tax Treatment of Pensions, United States and Australia**

| Country | Employee Contributions[a] | Employer Contributions[a] | Earnings | End Benefits |
|---|---|---|---|---|
| United States | Nondeductible[b]<br>Exempt | Deductible<br>Exempt | Exempt | Marginal rate |
| Australia | | | | |
| Previous | Nondeductible[c]<br>Exempt | Deductible<br>Exempt | Exempt | Lump sums: 15/30%[d]<br>Pensions: marginal rate |
| Current | Nondeductible[c]<br>Exempt | Deductible<br>15% tax | 15% tax | Lum sums: 0/15% tax[e]<br>Pensions: marginal rate less 15% |

Source: Adapted from a table provided by John Larum of the Australian Consulate-General.
[a]The first entry refers to the tax treatment for the contributor. The second entry refers to the tax treatment for the pension/superannuation fund. (For example, in the United States, employer contributions are deductible from the employer's income. That contribution is then exempt from tax in the hands of the pension fund.)
[b]May be deductible in certain circumstances, such as under section 401(k) arrangements.
[c]May be deductible in certain circumstances, such as when an employee is self-employed or the employer contribution is limited, as for part-time employees.
[d]Under the former system, the tax is 15 percent on the first $55,000 and 30 percent thereafter. If a lump sum is taken before age 55, the full amount is taxable at 30 percent.
[e]Under the new system being phased in, the tax is zero on the first $64,500 (indexed) and 15 percent thereafter. If a lump sum is taken before age 55, the full amount is taxable at 20 percent.

taxation of superannuation into line with the general taxation of savings and transferred a portion of the tax from the time of benefit receipt to the point at which contributions are made. The contributions tax was set at a uniform rate of 15 percent and the benefits tax reduced by the same amount (table 3).

By 1992, the tax on lump-sum benefits (the most prevalent form of superannuation benefit receipt) for those aged 55 and over will be reduced to zero on the first $68,628 (indexed from $64,500) and 15 percent on additional amounts—down from the current 15 percent on the first $55,000 and 30 percent on the remainder. The tax on lump sums received prior to age 55 will be reduced from a flat 30 percent to no more than 20 percent (Larum, 1990).

Most retirement plans in Australia are defined contribution plans. The application of a tax on deductible contributions, when combined with the reduction in tax on end benefits, means that the level of net benefits provided by defined contribution funds is not reduced, but government revenue is received earlier. For defined benefit funds, there is a gain for participants if the level of pretax benefits received is not reduced to account for the changes in tax structure.

## Investment Income

Changes also were made in the treatment of investment income. Before 1988, when superannuation funds were exempt from tax, the funds were denied the benefit of dividend imputation credits. In Australia, dividends are taxed only once, with dividend imputation tax credits available to dividend recipients for application against their total tax.

Under the previous tax system, however, the credits remained unusable by superannuation funds, resulting in their dividend income being effectively taxed at the full company rate. This produced a substantial bias in investment decisions away from shares in Australian companies and toward investments that yielded untaxed income, such as debt instruments, rental properties, and offshore investments (Larum, 1990).

The 1988 reforms included a 15 percent tax on investment income, including capital gains, thus giving funds access to dividend imputation credits. As imputation is at the full company rate of 39 percent, it is possible for most funds to significantly reduce or eliminate their investment income tax through the use of the dividend imputation credits. To date there is no evidence of a resulting shift in funds' asset allocation toward Australian equities (Larum, 1990), but an accurate evaluation may require more time.

Finally, there was a significant cost to plan sponsors associated with converting their accounting systems to accommodate the new tax system. A similar type of cost would be incurred by U.S. plans with the adoption of a turnover tax.

## ◆ Conclusion

Given their current tax-favored status, pensions represent a potential source of new revenue to the U.S. government that may be particularly tempting in light of persistent pressure to reduce the federal budget deficit. In addition, some public policymakers believe that tax changes are needed to ensure that pension fund managers take a long-term view in their investment decisions.

A wide range of proposals have been set forth for taxing pension funds. Each would have numerous and complex implications, however, affecting not only the pension system but also the financial markets and, therefore, other investors. The effects of a turnover tax, for example, would be far reaching, as described above.

The current system of U.S. pension taxation is grounded in a public and private partnership to provide a measure of income security to retired workers and their families. Any contemplated shift in that partnership warrants careful consideration of the potential effects on the availability and extent of pension benefits, the financial markets, and the U.S. economy.

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