



New Pension Tax Policy for 2014 and its Implications

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From 2014, personal pensions eligible for tax deductions will receive different treatment. The old tax deduction system will be replaced by a tax credit system. Although the goal of the new system is to enhance fairness in taxation, it is expected to increase the tax burden of personal pension buyers and therefore have a direct impact on personal pension participation. In order to support retirement income security, it is necessary to consider restoring and even expanding the tax deduction system.

1. Introduction

Starting from 2014, pension savings widely known as “qualified personal pensions” (personal pensions eligible for tax deduction, hereinafter referred to as personal pensions) will be subject to a new tax credit system. Until last year, contributions of up to KRW 4 million to these personal pensions were tax deductible, and only the withdrawals from the pensions were to be taxed in the future. But the 2013 tax regime reform introduced the tax credit system. Proponents for the new system argue that the previous tax deduction system was problematic because it provided higher tax savings for high income earners under the progressive income tax regime. Together with this change, tax deductions for other personal expenses (e.g., medical expenses, education expenses, etc.) are replaced by tax credits as well.

This reform, however, is expected to impose a negative impact on personal pension participation and cut the contributions to personal pension plans. If personal pension assets decrease, retirement income security of those in tax brackets higher than the middle class will

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be weakened. Therefore, it would be better to differentiate personal pension contributions from other tax deduction items and keep them subject to tax deductions. On another front, financial firms that often use personal pensions' tax benefits as a marketing point should try to enhance the pension products' performance.

2. Income deduction on private plans

Since 2011, personal pension participants were eligible for tax deductions up to KRW 4 million.¹⁾ For example, a taxpayer with the marginal income tax rate of 26.4% can save up to KRW 1.05 million; the amount is deducted from his taxable income if he contributes KRW 4 million to a personal pension. Because the deduction has the KRW 4 million ceiling, the maximum tax saving is KRW 1.05 million even if he contributes, say, KRW 6 million. But all other things being equal, another taxpayer whose marginal tax rate is 16.5% can get an income tax saving up to KRW 0.66 million. Because the tax deduction system reduces taxable income and the income tax is progressive, the amount of tax saving decreases for lower income earners. In this regard, some view the tax benefits for personal pensions as regressive. Considering that the latter case, with low taxable income, is unlikely to spend KRW 4 million on a personal pension, the actual tax saving for low income earners will be even smaller.

To address this issue, the government changed the tax deduction system to the tax credit system, which will apply a flat 12% tax credit ratio up to KRW 4 million of personal pension contributions.²⁾ Under the new system, the tax savings for all taxpayers, regardless of income level, will be the lesser of 12% of personal pension contributions or KRW 0.48 million (12% of KRW 4 million). Under the new system, the two taxpayers from the above example will have to pay extra taxes (KRW 0.57 million for the former and KRW 0.18 million for the latter). This translates into a tax hike of 1.2% ~ 1.5% for personal pension members whose taxable income is between KRW 12 million and KRW 88 million (refer to (8) in Table 1). The new system provides higher tax benefits for those in the 6.6% tax rate bracket, but it is hard to expect them to contribute as much as KRW 4 million to personal pensions.³⁾

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- 1) The KRW 4 million ceiling is for the sum of contributions to personal pensions and voluntary additional contributions to employer-provided retirement plans. Therefore, the tax regime change will affect both types of pension.
 - 2) If the tax credit limit is fixed on rates rather than on amounts (for example, 10% of income) or the tax credit rates are increasing at income level, the tax saving effect will be greater for high income earners as was the case in the previous tax deduction system.
 - 3) It is worth considering placing a lifetime limit for the income deductions, which allows individuals to contribute more when their annual income increases.

**Table 1. Comparison between tax deductions and tax credits**

(Unit: KRW 10,000, %)

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Taxable income	%	Tax deduction	%	Tax credit	%	Difference	%
400	6.6	26.4	6.6	48.0	12.0	-21.6	-5.4
1,200	16.5	66.0	5.5	48.0	4.0	18.0	1.5
4,600	26.4	105.6	2.3	48.0	1.0	57.6	1.3
8,800	38.5	154.0	1.8	48.0	0.5	106.0	1.2
30,000	41.8	167.2	0.6	48.0	0.2	119.2	0.4

Notes: (2) The tax rate includes the income tax rate as well as local tax rate.

(3) Tax saving from tax deductions (= KRW 4 million × (2), assuming that personal pension contribution is KRW 4 million).

(4) The percentage of tax saving from tax deductions in the total taxable income (= (3) ÷ (1)).

(5) Tax saving from tax credits (= KRW 4 million × 12%).

(6) The percentage of tax saving from tax credits in the total taxable income (= (5) ÷ (1)).

(7) The difference between the two systems (= (3) – (5)).

(8) The percentage of the difference in the total taxable income (= (7) ÷ (1)).

3. Issues around the tax regime change

This round of tax regime reform could significantly affect personal pension participation. With the tax credit rate fixed at 12%, those subject to the marginal income tax rates over 12% will see their tax burden increase. Accordingly, existing personal pension members are likely to cut their contributions, and the number of new subscribers to personal pensions will decrease. This will reduce overall personal pension assets and debilitate retirement income security.

A more serious effect, however, is the degradation of public confidence over the government policy. It was only three years ago when the Korean government raised the tax deduction ceiling on personal pension contributions from KRW 3 million to KRW 4 million in order to help the middle and upper class accumulate retirement assets. The question here is if Korea has made any progress in this area significant enough to change its persistently-pursued policy tone.

Another concern is the lack of coherence between public, retirement, and personal pension schemes.⁴⁾ In 2018, the self-employed will be allowed to join the individual retirement pension (IRP). Since they do not have the separate employer-provided retirement plans, the IRP available to them takes the form of both employer-provided retirement plans and personal pension plans, and desirably, the two pension schemes should receive the same tax treatment.⁵⁾ It seems fair to

4) Under the new tax system, the contributions to public pensions (e.g., national pension) are still subject to tax deductions.

5) The retirement pension contributions by pension sponsors (not pension participants) are part of salary, but subject to tax deferral until they are withdrawn after retirement.



allow the self-employed to make extra contributions corresponding to the retirement pension scheme. In this case, giving tax deductions for one part and tax credits for the other part would be unreasonable.

In addition, the extent to which the tax deferrals on personal pension contributions are truly regressive should be evaluated. The criticism that tax deductions under the progressive tax regime are regressive is based on the fact that tax savings from tax deductions increase with income levels. But because the tax deduction system places a ceiling, the ratio of tax savings to income actually falls as income levels increase. We cannot describe a tax system as progressive just because the absolute amount of tax paid by high income earners is larger than that of low income earners. Likewise, a tax system should not be labeled as regressive just because high income earners get larger refunds in absolute value. Those in higher tax brackets receive more in refunds because they pay more tax, while those in lower tax brackets pay less tax because they earn less.

Also noteworthy is that a single taxpayer who is now in the KRW 12 million income bracket may be able to earn KRW 46 million or KRW 88 million at some point in life. For example, an employee may make KRW 12 million of taxable income in his early twenties, KRW 46 million in his thirties, and KRW 88 million in his forties. The complete life cycle should be considered because income generally increases with age. Some countries offer extra tax deductions for those in their forties and fifties, and give them chances to better prepare for their retirement. For instance, the US usually places a \$5,000 ceiling on IRA contributions, but permits catch-up contributions of up to \$1,000 for those over 50 years old.⁶⁾

There may be questions about why the government should provide support for personal pensions that are part of personal savings or investments. Those who oppose government intervention may not like this idea, and even those who are for government-backed social security may feel that financial preparation and retirement planning for the middle and upper class should be left to the private sector.

In fact, for the affluent, personal pensions can be a wealth management tool. Even under the new system, personal pension contributions provide at least a 12% return⁷⁾ and terminating

6) The general contribution ceiling is increased by \$500 according to inflation, and accordingly, the ceiling was raised to \$5,500 in 2013. However, the catch-up contribution limit is not subject to indexation.

7) Tax deductions under the previous system and the 12% return from tax credits under the new system are returned to pension members every year, so there is no compounding effect. On the contrary, investment returns have a compounding effect, and thus



pensions would incur losses, which may minimize the adverse impact of the new system. But still, the new system is more likely to adversely affect personal pension membership. It is not easy to cut spending on other tax deduction items. Households usually do not adjust medical and educational expenses in order to increase tax deductions. On the contrary, personal pensions have no visible and instant benefits other than tax savings. Post-retirement income security is of course important, but this is a long-term, distant goal whose effect will materialize at least 20 to 30 years after. Most taxpayers participate in personal pensions for tax benefits, and put up with inconveniences of personal pensions (e.g., the decrease in current spending, and the restrictions on withdrawal). Under the current circumstances, it is hard to ensure that taxpayers will continue to prepare for their retirement through personal pensions or other means despite less tax benefits. Even baby boomers, who experienced high growth and increasing incomes, are unprepared for their retirement, and previous generations are in even worse situations. This is one of the reasons behind the efforts to introduce the basic pension system and encourage more investments in pension plans. To prevent the problem from lingering for the next 20 to 30 years, multi-faceted policy efforts are necessary to improve the national, retirement, and personal pensions. And the tax reform on personal pensions should be reconsidered here.

4. Retirement in the aging society and the government's role

Basically, tax deductions for personal pension participants are provided because public pension alone is not sufficient for a financially secure post-retirement life. For the retirement income security, individuals make their own arrangements and are backed by public support. For example, Korea's National Pension guarantees certain levels of pension benefits (30% of the average pre-retirement income for those with an average income and over 30-year membership period). But some members whose income is above the average will be given less pension benefits and a lower income replacement rate. Hence, the middle and upper class should make more personal contributions to maintain their pre-retirement incomes level after retirement.

Many countries use tax deductions to support private pensions (retirement and personal pensions) in order to help citizens prepare for retirement. Since 2001, Korea also offered tax deductions on 100% of the contributions to personal pensions.⁸⁾ Personal contributions to

are more important. For personal pensions to better function as a tool for retirement asset accumulation, it is worth considering either optional or mandatory wire transfers of tax savings to individual pension accounts.

8) Personal pensions were first introduced in Korea in 1994. Until 2000, 40% of contributions up to KRW 0.72 million were included



pensions are deducted from taxable income, and the withdrawal from the pensions will be taxed in the future. In other words, pension contributions are subject to tax deductions in the contribution phase, but will be taxed in the payout phase. Pension contributions are deferred income, and the difference in tax rates between the two phases will be tax benefits for pension participants.⁹⁾ Because income in the contribution phase tends to be higher than that in the payout phase, taxes in the latter period will be lower and the government concedes the differences. In exchange for tax deductions on pension contributions, pension members are restricted from withdrawing pension assets or using them for purposes other than retirement income. Korea also imposes “other income tax” (22%) and “early-withdrawal penalty” (2.2%) for withdrawals within the first five years of pension participation. Lump-sum withdrawals even after the age of 55 are subject to other income tax. It is common to place a numerical or percentage limit on tax deductions (e.g., KRW 4 million) to limit tax concessions. The upper limit is often set each year, but sometimes a lifetime limit is placed per taxpayer, e.g., the UK places a £1.25 million ceiling starting this year.¹⁰⁾

Retirees’ income security can reduce state spending on social welfare, and this can offset the decline in tax revenues from tax deductions. Admittedly, this statement may not have sound convincing in the past. But it is gaining ground as many of the social programs develop and exclude those in upper income brackets.

In the aging society, a nation should give serious policy considerations to tax smoothing. The older generations usually pay less tax compared to the working age generation. A rapidly aging society like Korea is highly likely to see its tax revenues decline as the population ages. In that sense, tax deductions on personal pensions can be critical for tax smoothing. Individual taxpayers participate in pensions for consumption smoothing: reduce current spending to increase future spending. At the same time, the government uses pensions for tax smoothing: cut current tax revenues to increase future tax revenues. In the aging era, it should be a national policy priority to keep the pension tax base for future needs.

in tax deductions. In 2001, the amount of tax deductions went to 100% (up to KRW 2.4 million), and again the ceiling was raised to KRW 3 million (including voluntary contributions on employer-provided retirement plans). In 2011, the ceiling was raised to KRW 4 million.

9) Because personal pension contributions will be taxed in the payout phase, tax deductions for them are different from deductions for other items, whose tax saving effect ends each year.

10) The ceiling was at £1.80 million for the 2011/12 fiscal year, £1.50 million for 2014/15, and will be at £1.25 million after 2014/15.



5. Conclusion

At the end of 2013, many policies were introduced to stabilize retirement income in an era where life expectancy is almost 100 years. But tax policy, perhaps the government's most important communication tool, seems slightly out of harmony with other policy initiatives. At least for pension matters, the government should reconsider bringing the tax deduction system back or even expanding it.