

OPINION

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Characteristics of Korea's Taxation System on Pensions and Policy Directions for Promoting Pension Asset Accumulation

In Korea's tax treatment of pension schemes, the most basic principle is the "Exempt-Exempt-Taxed" (EET) regime under which contributions and investment returns on pension assets are exempted from tax and pension benefits are taxed upon withdrawal. Korea's most representative public pension plan, National Pension Service (NPS), is subject to the EET regime that is similarly applied to retirement pensions. As for the IRP and Pension Savings, contributions are eligible for tax deduction and investment returns are exempted from tax. If a beneficiary chooses a lump-sum payment, retirement income tax is imposed while if an annuity is selected, pension benefits are subject to pension income tax.

Pension tax systems adopted by other countries offer a wider range of tax incentives to private pension plans than to public pensions. The salient features of such systems include a significantly high tax exemption limit on pension contribution, a wide range of options for tax planning, and subsidy and/or tax credit for pension contribution by low income earners.

Compared with other countries' taxation approach on pension, the overall framework of the taxation system on pensions for the NPS and retirement plans needs to be maintained, while the tax treatment of IRPs and personal plans should be geared toward providing larger incentives for pension contribution. It is also necessary to raise the exemption limit on pension contribution and adjust upward the limit on a periodic basis by indexing on inflation rate or other macro-economic indicators. Both contribution with tax deferral and one with after-tax income need to be available. In addition, we need to allow tax credits and/or matching contributions by the government for the pension contribution to ensure retirement income for the low income earners.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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Currently, Korea is faced with growing concerns that rapid aging and severely low fertility rates would slow down economic growth and intensify economic instability for the elderly. According to a report published by the OECD, Korea is projected to become the most aged society among OECD countries by 2060, with its total fertility rate for the second quarter of 2023 hitting a record low of 0.7. It is impossible for the country to avoid economic shocks caused by the demographic cliff and the resultant financial insecurity of the elderly.

Establishing a robust pension system is the most crucial policy measure to mitigate old-age poverty. Korea's pension system has evolved into a multi-pillar structure comprised of public pension, retirement pension and private pension schemes. Public pension schemes have been designed as a mandatory participation system and under the current pension allowance structure, public pension funds are expected to deplete after 2055. This explains why the pension reform geared toward paying more contributions and receiving benefits at a later time is currently discussed as a way to prop up the public pension function. Given the need for bolstering the function of retirement pension and personal pension schemes, it is necessary to seek ways to promote contribution accumulation and boost returns on pension assets.

Another factor to be considered is the tax treatment of pension schemes. How a pension tax system is structured has a huge impact on the composition of personal pension assets, thereby making a significant difference in the development of the capital market. Major advanced economies have introduced and implemented a wide range of tax regimes to provide subsidy and/or tax credit for savings for retirement, including tax deferral on pension contributions, tax deferral on investment returns, and grant provision. The salient feature of Korea's tax treatment of pensions is tax deferral on contribution payment and investment returns. However, Korea's tax treatment of pension schemes has been continually criticized for failure to provide various tax incentives and to fully protect low income earners. Against this backdrop, this article examines features of the existing tax treatment by pension type and seeks how to improve Korea's pension tax system by comparing it with pension tax regimes adopted by other countries. It will also explore what tax policy alternatives are needed to promote pension saving and efficiently improve national welfare.

Characteristics of Korea's taxation system on pensions

Korea's pension system is largely divided into public pension and private pension schemes.

In addition to the National Pension Service (NPS), the most representative public pension, the government employees pension, military personnel pension, private school teachers pension and special post office employees pension are also included in the public pension category. Private pension schemes include the retirement pension and personal pension plans. The most basic principle for Korea's taxation on pensions is the "Exempt-Exempt-Taxed" (EET) regime under which contributions and investment returns are exempted from tax and pension benefits are taxed upon withdrawal. Under the tax system of the NPS, contributions to the NPS are exempted from tax. Employer contributions to NPS accounts are not considered taxable income of employees and thus, employers can treat them as deductible expenses. Employee contributions are fully deducted from income when the aggregate income is calculated, thereby being considered completely tax-free. Investment returns on pension assets are exempted from tax at the time of occurrence but pension benefits are taxed upon withdrawal. In principle, global taxation is applied to pension benefits provided by the NPS. A beneficiary can choose a more advantageous regime between separate taxation that applies the tax rate of 3% to 5% to the NPS pension income depending on age and global taxation that applies a progressive tax rate depending on income level. If annual pension income from private plans exceeds KRW 12 million, benefits provided by the NPS and private plans are combined with other income, which is subject to global taxation.

The tax treatment of retirement pensions is similar to the tax system for the NPS. An employer is required to save one-twelfth of an employee's total annual income to a retirement pension account. The employer can treat the reserves as deductibles, and the employee is eligible for tax exemption on the reserves. The retirement pension scheme is similar to the NPS in that investment returns generated from asset management are exempted from tax. Retirement income tax is levied on retirement pension benefits that are subject to schedular taxation rather than global taxation. The same retirement income tax is imposed on pension benefits, regardless of whether a beneficiary chooses a lump-sum payment or an annuity. But if an annuity is selected, 30% of the finalized retirement income tax amount is reduced.

Unlike the NPS or retirement pension, the individual retirement pension (IRP) is a voluntary participation pension scheme and thus, contributions to the IRP are not subject to tax exemption and only eligible for tax deductions that involve relatively small tax incentives. Under the IRP scheme, 12% or 15% of the contributions paid by a participant is deducted from

the settled tax amount, depending on income level. Investment returns generated during the IRP management period are exempted from tax. If a beneficiary decides to receive a lump-sum payment, retirement income tax is levied, while if the beneficiary opts for an annuity,¹⁾ pension income tax of 3% to 5% is applied, depending on age.

Personal pension plans, which are a voluntary participation type, can be divided into personal pension savings that are eligible for tax incentives when pension savings are deposited (“pension savings”) and pension insurance that qualifies for tax benefits when contributions are saved and is exempt from tax upon withdrawal (“pension insurance”). The tax treatment of pension savings is regarded as the EET regime as tax incentives are provided for contributions in the tax deduction form. On the other hand, the Taxed-Exempt-Exempt (TEE) regime applies to pension insurance in that there are no tax incentives for contributions but if certain conditions are met, pension benefits are not taxed. The tax system for the IRP is found practically equal to the tax treatment of pension savings. Contributions to pension saving accounts are only eligible for tax deductions, and investment returns generated from the management process are not taxed. In the case of a lump-sum payment, retirement income tax is levied, while if an annuity is selected, the pension saving scheme imposes pension income tax in the same way as the IRP does. As for pension insurance, contributions are paid with after-tax income because there are no tax incentives for contributions. If certain conditions are met,²⁾ taxation on investment returns is also exempted. If tax exemption requirements are satisfied, benefits from pension insurance are not taxed.

Comparison with taxation approaches on pensions adopted by other countries

The tax treatment of pensions varies from country to country. Not all pension tax systems of other countries determine taxation based on the distinction between stages of contribution payment, investment and receipt of pension benefits. In many cases, public pension schemes use the pay-as-you-go system where benefits payable to pension recipients for the current year are covered by the contributions paid by all participants in that year, rather than collecting contributions and saving them as reserves. Hence, it is impossible for such countries, unlike

1) To qualify for tax deduction, the beneficiary should pay contributions for at least five years and have received pension benefits as an annuity for 10 years or more at the age of 55 or older.

2) To qualify for tax incentives, insurance premiums should be paid within the amount of KRW 1.5 million per month for at least five years and the insurance contract should be retained for at least 10 years.

Korea, to distinguish between contribution payment, investment and pension receipt stages. A case in point is the US pension tax system. The US has implemented Social Security on a pay-as-you-go basis as an important public pension scheme. Japan has operated a public pension scheme that is similar to Korea's, but its financing method is the pay-as-you-go system. When it comes to paying pension benefits based on the pay-as-you-go system, the taxation issue boils down to whether income tax should be imposed on the pension income received by the beneficiary. In the US, if the total amount of other taxable income excluding pension income exceeds a certain amount, income tax is levied on 50% to 85% of the pension amount. If the combined amount of pension and other taxable income ranges from \$25,000 to \$34,000, income tax is levied on 50% of the pension amount, and if the combined income exceeds \$34,000, up to 85% of the pension amount will be subject to income tax.³⁾ In other words, the US tax system levies income tax on public pension recipients according to certain requirements, which is considered similar to Korea's tax system of levying income tax in the pension receipt stage.

Pension tax systems adopted by other countries offer a wider range of tax incentives to private plans than to public pensions. This is because as for private plans, contribution amount is highly likely to change at the employee's own will. The tax treatment of private pensions takes various forms such as the EET, TEE, TTE, TET, ETT, and EEE. Among these regimes, the EET is the most widely used type, followed by the TEE. Major economies such as the US, the UK, Germany and Japan basically apply the EET-type tax system to private pensions. Although the EET is the underlying taxation regime, however, they have introduced other pension plans eligible for various tax incentives such as the TEE-type products, allowing pension participants to optimize asset portfolios suitable for their own financial needs.

As for other countries' tax treatment of private pensions, one of the key features is the significantly high tax exemption limit on pension contribution. In this respect, it is worth examining the tax exemption limit imposed by the US private pension tax system. Private pensions in the US primarily take the form of retirement plans, including qualified retirement plans (401(k)), the IRA and quasi-qualified pension plans. Under qualified retirement plans and the IRA, participants are allowed to select from two types: (1) the basic plan where contributions are tax-deferred and (2) the Roth plan where contributions are taxed and

3) See www.ssa.gov.

withdrawals are tax-free. In the case of 401(k), the annual contribution limit for 2022 is \$61,000 for combined employee and employer contributions, which increases to \$67,500 if the employee is aged 50 or older. In the case of the IRA, the annual contribution limit for 2022 is \$6,000, or \$7,000 for those 50 or older. When comparing the contribution limit of 401(k) and the IRA with Korea's retirement plans and IRP, there is a significant divergence in tax incentives. The upper tax exemption limit in the US can be considered relatively high, even allowing for the average income level of the US being twice that of Korea. It is also noteworthy that the US regularly adjusts the limit upward.

Globally, countries seem to gradually expand tax support packages to help low income earners accumulate pension assets. The US applies a different set of tax credit rates depending on income level to promote contribution payment by low income earners, allowing individuals of different income levels to claim a tax credit for 10%, 20% and 50% of contributions. A growing number of countries are giving a matching contribution or a fixed amount of pension grant. This means that the government pays a certain share of a participant's contributions or disburses a certain amount if the participant meets specific qualifications. Australia and New Zealand give a 50% matching contribution to eligible plan holders, while the German government puts in place a flat grant system.

Suggestions for tax policy improvement

A comparison between pension tax systems of Korea and other countries provides an important implication that how the pension tax system is designed has a greater impact on the role of private pensions rather than on public pensions. In Korea, participation in the public pension and retirement pension is mandatory. As for mandatory participation, the structure of tax benefit payment hardly affects pension participation and accumulation of pension assets. Understandably, tax benefits are needed for mandatory participation. The goal of making public and retirement pensions compulsory is financial security for the elderly. This requires increasing the amount of pension benefits through tax benefits, given that the replacement rate is not sufficiently high.

In the case of voluntary type pension plans including IRPs and personal pensions (pension savings and pension insurance), how tax incentives are provided can make a huge difference in pension participation and accumulation of pension assets. Considering that public pension

schemes alone hardly ensure financial stability after retirement, tax incentives for IRPs and personal pensions should be generously provided. Accordingly, the overall framework of the pension tax system for the NPS and retirement plans needs to be maintained as a whole, while the tax treatment of IRPs and personal plans should be geared toward providing larger incentives for pension contribution.

To enhance the function of private pensions, the tax exemption limit on pension contribution should be raised. Compared to Korea, several countries including the US have higher tax exemption limits on contributions. The key to financial stability after retirement is to save more income as pension contributions during the employment period. As the replacement rate of public pensions is not high, it is hard to deny the fact that tax incentives are the most important factor in expanding the role of private pensions. Korea needs to raise the tax exemption limit on pension contributions, considering that quite a few countries grant higher levels of tax incentives to enhance the pension function through voluntary participation. Also necessary is adjusting upward the tax exemption limit on contributions on a periodic basis. Korea's pension tax system has been continually criticized for being too rigid in adjusting the tax exemption limit. Accordingly, an institutional framework should be established to periodically adjust tax exemption limits by indexing on inflation rate or other macro-economic indicators.

There is also a need to diversify how tax incentives are provided. Korea's tax treatment of pensions is basically underpinned by the EET regime. Although the TEE regime is applied to pension insurance as an exception, it is worth considering adopting tax incentives of various forms. Pension participants should be eligible for both contribution with tax deferral and one with after-tax income. If pension participants are allowed to select from those two means depending on their current income and post-retirement income, it would increase the likelihood of accumulating optimal pension assets. In a narrower range of options, it is likely for pension participants to fail to reach the optimal asset level. Given that foreign countries have adopted EET and TEE regimes in various forms, Korea should offer a wider range of choices to pension participants.

When tax incentives are provided to promote participation in private pensions and boost contribution payment, it is commonly observed that the effect of tax incentives is more prominent among higher-income classes. Low income earners cannot afford to keep paying contributions to fully benefit from tax incentives due to their limited resources for saving. A

more aggressive tax support scheme is required to mitigate the problem of vulnerable groups being excluded from pension-related tax incentives. Regarding pension contribution by low income earners, it is worth considering providing grants in the form of refundable tax credits or matching contributions, going beyond offering tax incentives eligible for contributions and investment returns. Notably, the so-called Youth Leap Account characterized by high levels of preferential interest rates and subsidies was launched in June 2023. Against this backdrop, tax incentive packages in the form of refundable tax credits or matching contributions can improve significantly the retirement income security for low income earners.