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Retirement Savings: The Tax Issue

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Abstract

Providing for retirement is a prominent motivation for saving. Saving for retirement raises several issues: how much to save, which asset allocation to choose and which degree of risk to afford, how to annuitize efficiently. In addition, there is an important, though sometimes neglected, issue: tax.

Basically, saving means postponing consumption, transferring purchasing power into the future. The efficiency of this transfer may be measured by the net real rate of return (NRRR). This paper addresses the issue of analysing and quantifying the impact of tax systems on the NRRR.

That impact may be huge, and strongly interact with the "how much to save" issue.

We illustrate our analysis with the cases of the United States, France, the United Kingdom and Canada.

Keywords: Savings, retirement, tax planning, pension funds

JEL classification: E21, G11, G18, G22, H24

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His main fields are portfolio optimization, asset management, wealth management and tax incidence (in particular on investment return).

1. Introduction

How to get a sufficient purchasing power during the retirement period is a major concern today, as life expectancy increases and public pension systems tend to recede. This refers to finding efficient means of dealing with lifetime risk (Sharpe, 2012),

Other major issues are the choices of how much to save for retirement (saving is costly in terms of lost immediate consumption), and how annuitize efficiently, how to deal with longevity risk, and how to tackle the tax aspects. There is also the issue asset allocation, and especially the degree of risk which is tolerable.

This paper focuses on the tax issue of retirement savings. Efficiency in this respect means improving the outcome of purchasing power at retirement compared to the savings effort.

2. Savings for retirement: Why the Net Real Rate of Return (NRRR) matters

Retirement can be defined as a period in life in which an individual no longer receives income from his or her profession or labour. This individual's consumption needs will therefore have to be met by other funds: either transfers or labour income earned prior to retirement that was not consumed immediately and was therefore saved. Saving is therefore a key factor in having funds available for consuming during retirement.

Conversely, retirement is a motivation to amass savings during a person's working life. It is not the sole motivation – people also save as a precaution, to meet temporary interruptions in labour income, and to satisfy the desire to transmit purchasing power to their heirs – but it is an important motivation.

One characteristic of saving for retirement is the length of the time horizon (delayed purchasing power). Usually retirement lasts in average around twenty years and follows forty years of work. On average, a period lasting approximately thirty years elapses between the time when savings are amassed and the time when they are used for consumption.

This length varies depending on the age of the working individual under consideration: for a young person entering the workforce, this period is almost fifty years – a half-century. For an individual about to enter retirement, it would be ten years or so.

There are two principal schemes for saving for retirement: an individual format and an institutional format, which we will refer to generically as pension funds.

All methods combined, savings for retirement must be substantial. The targeted goal is often defined as a ratio –50% to 70%– of the benefit received to the labour income in the last years of employment or sometimes the benefit received to the average of labour income over the working life.

In fact, it is achievable consumption that is the aim, so that a certain lifestyle can be maintained after retirement, at least partially. Arguments are made that the needs of consumption are lower after retirement due to, among other reasons, children having left the household. But there are also arguments in favour of aiming at higher level of resources to cover care and medical bills.

With an actual rate of return (after tax) on investment near zero, which is optimistic today for risk-free savings, approximately one-third of all labour income must be set aside for savings, with a desirable replacement rate of two-thirds[1].

Table 1

The savings effort required based on real return

T = 30 years, replacement rate = 2/3

Real return	Required Saving Rate	
	(a)	(b)
-2%	0.611	0.379
0%	0.333	0.250
2%	0.184	0.155
4%	0.103	0.093
6%	0.058	0.055

(a) : Replacement rate as a proportion of working life income

(b) : Replacement rate as a proportion of working life income net of retirement savings

This assessment is made using a two-period model, assuming that savings is amassed mid-career and its fruits are spent midway through the retirement period. In practice, the model should be fine-tuned to take account of the characteristics of the labour income time profile and mortality tables. It is worth bearing in mind that the orders of magnitude obtained are nonetheless significant.

Savings here should be understood in a sense widened to include contributions to mandatory plans, in particular through pay-as-you-go regimes. Naturally, the savings effort is very

[1] Apart from tax, the real rate of return is influenced by the magnitude of fees levied on the purchase of financial products, their management, and the cost of insuring mortality risk. Along this line, William Sharpe stresses the interest of low-cost solutions for the management of retirement assets (a global indexed fund for the risky part) and mortality insurance (tontines).

dependent on expected real return. This is obviously very important for risk-free investing, where expected real return is very low and sometimes even negative. The effort can be substantially reduced for higher real returns but they can only be achieved through risk-taking.

In case of low real returns, the saving effort is so huge that it is certainly fair to compute the ratio on a net-of-saving basis, to express the target in terms of old-age potential consumption as a fraction of working age potential consumption, or working age income net of retirement savings (column (b) in Table 1). That reduces somewhat the savings ratio target but it remains important for low returns.

Two main factors influence the NRRR: the first one is the gross real rate of return (GRRR) on the investments; the second one is the wedge between the gross and the net real rate of return introduced by the tax system. The first factor is related to the quality of the asset management and it includes a risk management dimension (Maillard, 2011). The second factor is tied to the tax rules and the way tax choices are made under those rules.

To sum up the importance of the NRRR, one should consider that the loss of 1 percent in the real rate of return, due to tax or other factors, leads to an increase by 35% in the saving effort to preserve the same level of purchasing power at a 30 year horizon.

Whether a decrease in the rate of return due to tax encourages savings or discourages savings, and under which conditions, is not the purpose of this paper. It has been addressed since a long time (Feldstein, 1984). Tax however creates distortions in a major decision in people's life.

3. The impact of various tax schemes

There are two main categories of tax schemes applied to retirement savings.

1) In tax-deferred schemes, savings are deductible from the taxable income the year they are built. Withdrawals, whether ad-hoc or organized as annuities, are added to taxable income of the year they are made. That is for the principle.

Tax-deferred schemes include most pension funds. For tax purposes, pay-as-you-go pension schemes work under the same pattern.

There are in many countries specific tax-differed schemes. For the countries we have chosen to illustrate our analysis, we have identified (see Annex 2):

- The Individual Retirement Account (IRA) and the 401-k plans in the case of the United States
- The Retirement Saving Plan (French acronym: PER) in the case of France, which has been recently reformed and encompasses in fact several schemes.
- The Registered Retirement Savings Plan (RRSP) in the case of Canada

We have not identified specific tax-differed plans in the UK case.

2) In other schemes, savings are built from the after-tax labour income. The return on such savings is usually taxed. At retirement time, the savings pot has to be transformed into annuities, which will generally be subject to income taxes. This category includes tax-favoured schemes as well as the general taxation of savings.

We have identified quite a lot of tax-favoured schemes in the countries under review. Their effect is to lower the effective taxation rate of the return, sometimes to zero.

In the next sections, we will assess how the tax system transforms the gross real rate of return in the net real rate of return.

Using notations defined in Maillard (2012), we call:

- r the gross nominal rate of return (GNRR)
- r' the net nominal rate of return (NNRR)
- $\hat{r}'$ the net (after tax) real rate of return (NRRR)
- $\hat{r}$ the gross real rate of return (GRRR)
- p the average inflation rate during the period under review

By definition, we have:

$$1+\hat{r}=\frac{1+r}{1+p} \quad 1+\hat{r}'=\frac{1+r'}{1+p}$$

We will also use when relevant the continuous definition of the rates of return (underscoring the symbol)

$$\underline{x}=\ln(1+x)$$
$$\underline{\hat{r}}=\underline{r}-\underline{p} \quad \underline{\hat{r}}'=\underline{r}'-\underline{p}$$

4 Tax-differed plans

In this sort of plan, retirement savings are deductible from the income tax the year they are built. An investment W_0 will cost the saver $(1-\tau_a)\ W_0$ where τ_a is the marginal income tax rate when active. At time of withdrawal T, the value of the investment will be:

$$W_T = W_0(1+r)^T$$

The withdrawal will be taxed at rate τ_r , which is the marginal income tax rate when retired.

The net rate of return will thus verify:

$$(1+r')^T = \frac{W_T(1-\tau_r)}{W_0(1-\tau_a)} = \frac{W_0(1+r)^T(1-\tau_r)}{W_0(1-\tau_a)}$$

$$(1+r')^T = (1+r)^T \frac{1-\tau_r}{1-\tau_a}$$

Note that this result also holds for real rates of return.

$$(1+\hat{r}')^T = (1+\hat{r})^T \frac{1-\tau_r}{1-\tau_a}$$

We are able at this stage to remark that:

(i) Tax-differed schemes are inflation-neutral

More often than not, tax systems are “nominalist”. They tax nominal rather than real interest rates, nominal rather real capital gains (and depreciation allowances for corporate tax are not inflation-indexed). Tax-differed schemes are thus a safe harbour for the case of an inflation comeback. Even for the currently low rates of inflation (1%-2%), nominalism hurts as we will see in the next subsection.

(ii) If the marginal income tax rate is the same when active and when retired, the net and gross real tax rates coincide

In such case, the tax system is neutral towards the decision of saving, of postponing consumption.

(iii) If the marginal income tax rate is lower at retirement, the scheme provides an add-on to the rate of return.

To assess the potential magnitude of this add-on, it is convenient to use the continuous definition of the rate of return.

$$\underline{\hat{r}}' = \underline{\hat{r}} + \frac{1}{T}\ln\left(\frac{1-\tau_r}{1-\tau_a}\right) = \underline{\hat{r}} + \underline{s}$$

$$\underline{s} = \frac{1}{T}\ln\left(\frac{1-\tau_r}{1-\tau_a}\right)$$

Table 2 below gives the magnitude of the add-on for various marginal tax rates in the period of activity and the period of retirement, for a thirty-year time horizon which corresponds to the average time length between retirement and activity.

Table 2

Impact of the tax system of the net real rate of return

	Marginal income tax rate - Activity						
Retirement	0%	10%	20%	30%	40%	50%	60%
0%	0.00%	0.35%	0.74%	1.19%	1.70%	2.31%	3.05%
10%	-0.35%	0.00%	0.39%	0.84%	1.35%	1.96%	2.70%
20%	-0.74%	-0.39%	0.00%	0.45%	0.96%	1.57%	2.31%
30%	-1.19%	-0.84%	-0.45%	0.00%	0.51%	1.12%	1.87%
40%	-1.70%	-1.35%	-0.96%	-0.51%	0.00%	0.61%	1.35%
50%	-2.31%	-1.96%	-1.57%	-1.12%	-0.61%	0.00%	0.74%
60%	-3.05%	-2.70%	-2.31%	-1.87%	-1.35%	-0.74%	0.00%

More generally, the advantage:

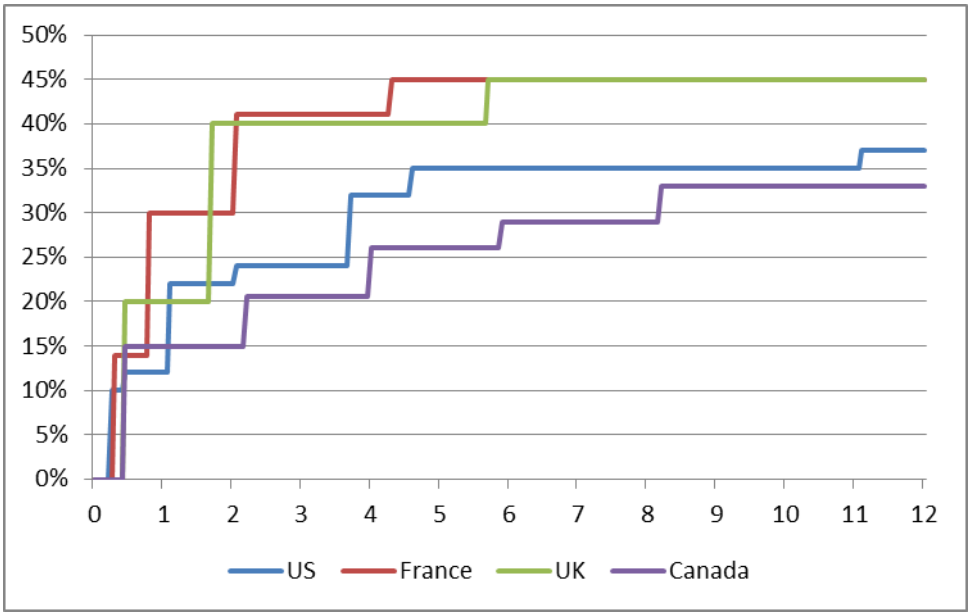
- Increases with the difference between marginal tax rates in retirement and in activity
- Increases with the proximity of retirement.

Most income tax systems are progressive, meaning that the marginal tax rates increases with income. The basis of the computation of income tax is the application of a rate schedule (see Annex 1). For the countries under review, the rate schedules are plotted in Table 1[2].

[2] Those schedules apply to a single person. To render them comparable, the income brackets are normalized by the average wage in the country.

Table 1

Marginal income tax rates as a function of income



Generally, income at retirement is lower than income when active. One should therefore expect a lower marginal income tax rate when retired. That is not always true. Firstly, retirees may well be remain in the same tax bracket as they were in their working time. To illustrate that, chart 2 plots the difference between marginal tax rates assuming that retirement income is two thirds of income when active, and chart 3 the add-on the real rate of return provided over a 30 year period

Chart 2

Difference in marginal tax rates in retirement and in activity

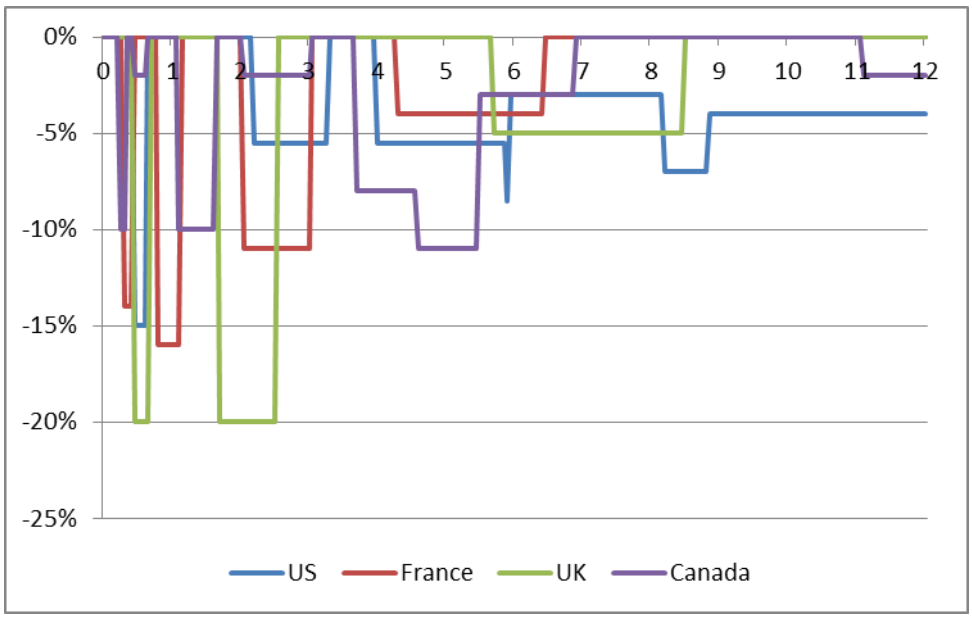
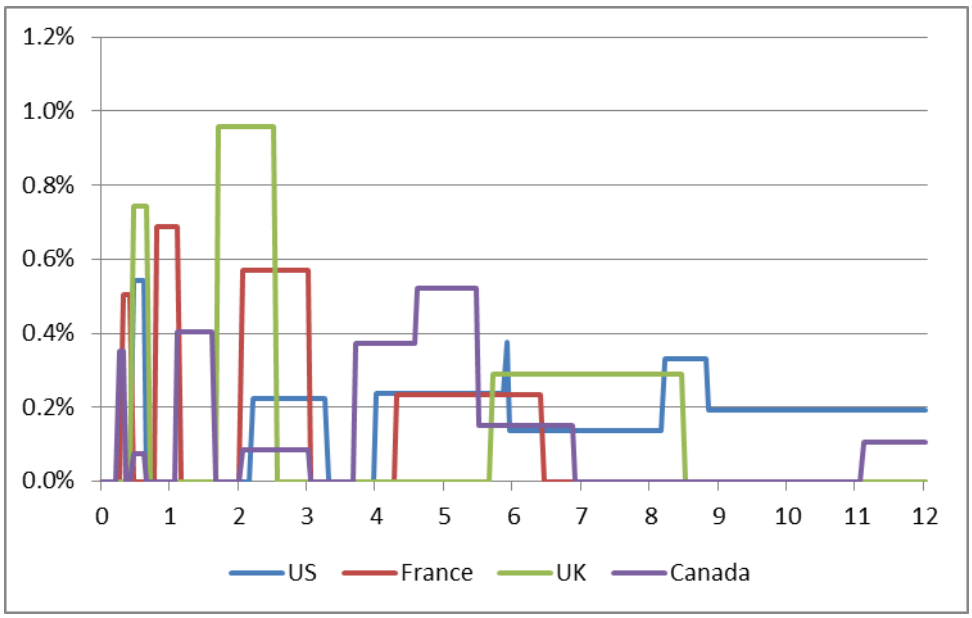


Chart 3

Return add-on



Secondly, the computation of income tax is more complicated than the submission of income to the tax brackets. There may be rebates, extra charges, and additional levies. In the case of France, social levies apply to pensions (above a certain level) but retirement savings is not deductible from such levies. For example, in France, people ending their career in the 30 % or 41 % bracket have a high probability of staying in the same bracket at retirement. Their

marginal tax rate at retirement will be increased by an 8.9 % social levy, and will thus substantially exceed their marginal tax rate in activity.

In some countries (Canada and the US), there exists provincial or state income taxes, which combine with the federal income tax. Those income taxes are generally progressive, and their top rates vary in a wide range: from 10% in Alberta province to 25.75% in Quebec; from 0% in several American states to 12.3% in California. This may complicate the assessment of the tax system on retirement savings, especially if workers move from one locality to another.

Thirdly, it should be noticed that the tax system is not stable throughout time: marginal rate applying to a certain level of income may go up, and down. This variability in the tax system introduces a degree of uncertainty on the expected NRRR.

Fourthly, for people with irregular labour income, tax-differed scheme offer the opportunity to make big contributions in the years of high income, and high marginal income tax rates, and relatively small contributions in the years of low income (under the limits of possible floors and ceilings in the scheme). This is a way to mitigate the huge disadvantage at which irregular income-earners are in the face of progressive yearly income taxation.

All in all, tax-differed schemes are relatively efficient to meet the target of postponing consumption over a long period of time. They are also efficient at annuitizing.

The main reservations are that that not all assets are available in those schemes (residential real estate is generally not a possibility) and that the saver may not have a complete mastering of the way assets are managed, and the degree of risk she is submitted to.

5 Other schemes and general taxation of savings

In such schemes, savings are built from after-income tax income. They are invested in assets which produce a gross return. The return itself is taxed and the NRRR is obtained by (Maillard, 2011):

$$\hat{r}' = \frac{r' - p}{1+p} = \frac{r(1-\theta) - p}{1+p} = \frac{(r-p)(1-\theta) - \theta p}{1+p}$$

$$\underline{\hat{r}}' = \underline{r}' - \underline{p} = \underline{r}(1-\underline{\theta}) - \underline{p} = (\underline{r} - \underline{p})(1-\underline{\theta}) - \underline{\theta}\,\underline{p} = \underline{\hat{r}}(1-\underline{\theta}) - \underline{\theta}\,\underline{p}$$

The tax rate on the real return is such that:

$$\hat{r}' = (1-\hat{\theta})\hat{r} = \frac{r(1-\theta) - p}{1+p} \qquad \hat{\theta} = 1 - \frac{r(1-\theta) - p}{r-p}$$

$$\underline{\hat{r}}' = (1-\underline{\hat{\theta}})\underline{\hat{r}} = \underline{\hat{r}}(1-\underline{\theta}) - \underline{\theta}\,\underline{p} \qquad \underline{\hat{\theta}} = 1 - (1-\underline{\theta}) + \underline{\theta}\frac{\underline{p}}{\underline{\hat{r}}} = \underline{\theta} + \underline{\theta}\frac{\underline{p}}{\underline{\hat{r}}}$$

This is in the absence of a wealth tax. Focusing for clarity on continuous returns, and introducing a potential wealth tax, the fundamental relation will write as:

$$\underline{\hat{r}}' = \underline{\hat{r}}(1-\theta) - \theta\,\underline{p} - \varphi$$

where θ is the tax rate applying to the nominal return and φ the annualized rate of a possible wealth tax.

This enables us to compute the gap between GRRR and NRRR in the case of general taxation and tax-favoured schemes. It will write:

$$\underline{\hat{r}}' - \underline{\hat{r}} = -\theta\,\underline{\hat{r}} - \theta\,\underline{p} - \varphi$$

Tax law generally makes a distinction according to the form return concretizes: a regular flow, such as interest coupons, dividends, rental income, or capital gains (sometimes negative), which are generally taxed when they are realized.

The way the tax system deals with the return on investments is described in Annex 3.

For a 2% gross real rate of return and a long term inflation rate equal to 2%, a 30% tax on investment income or capital gains (French flat tax for example) chops 1.2% from the net real rate of return.

6 The taxation of life annuities

In tax-differed schemes, it is generally possible to transform the accumulated savings into annuities at retirement. Those annuities are subjected to income tax in the same conditions as withdrawals.

In other schemes, the saver will end up with a pension pot. To secure a regular stream of income, she will want to transform at least part of this pot into annuities. The operation will consist in the exchange of a capital for a stream of revenues with a counterpart that we will call an insurer. The terms and conditions of this exchange will be based on two factors:

- The prospective mortality rates of the person
- The prospective return the insurer will earn from investing the capital received.

Life annuities will therefore have two components: a reimbursement of the capital alienated and a return on investments. The taxman will generally target the return component and subject it to income tax.

In the US, UK and Canada, it seems that the taxable part of the annuity is computed using fair actuarial valuation. As a result, the nominal return on the investments is taxed at the marginal income tax rate when retired. That is generally not a bargain compared to the tax-differed schemes and tax-favoured channels during the saving period.

However, those regimes seem Edenic compared to the French case (Maillard, 2012). In that country, the share subject to income tax (plus social levies) is determined according to the age at which the annuity starts, with no consideration given to the rate of return.

A portion k of the life annuity is subject to income tax and the social security contributions applicable to "investment income". This portion depends on the annuitant's age when the first annuity is paid, as follows:

Age at which the first annuity is paid	Portion (k) of annuity subject to income tax and social security contributions
Under 50	70%
50-59	50%
60-69	40%
70 and over	30%

Table 2 below gives the transition between the pre-tax nominal return of the annuities (GNRR) to the post-tax nominal return (NNRR), for various levels of gross nominal returns.

Table 2

After-tax nominal return

Age at annuity start date	Pre-tax nominal return												
	0,0%	0,5%	1,0%	1,5%	2,0%	2,5%	3,0%	3,5%	4,0%	4,5%	5,0%	5,5%	6,0%
45	-1,92%	-1,51%	-1,09%	-0,68%	-0,28%	0,12%	0,52%	0,91%	1,30%	1,69%	2,07%	2,44%	2,82%
50-	-2,15%	-1,74%	-1,32%	-0,92%	-0,51%	-0,11%	0,29%	0,68%	1,07%	1,45%	1,84%	2,21%	2,59%
50+	-1,48%	-1,04%	-0,60%	-0,17%	0,26%	0,69%	1,12%	1,54%	1,96%	2,38%	2,79%	3,20%	3,61%
55	-1,67%	-1,24%	-0,80%	-0,37%	0,06%	0,49%	0,91%	1,34%	1,76%	2,17%	2,59%	3,00%	3,41%
60-	-1,92%	-1,49%	-1,06%	-0,62%	-0,20%	0,23%	0,65%	1,08%	1,49%	1,91%	2,33%	2,74%	3,15%
60+	-1,51%	-1,07%	-0,62%	-0,18%	0,27%	0,71%	1,15%	1,58%	2,02%	2,45%	2,88%	3,31%	3,74%
65	-1,77%	-1,33%	-0,88%	-0,44%	0,00%	0,44%	0,88%	1,31%	1,75%	2,18%	2,61%	3,04%	3,47%
70-	-2,12%	-1,68%	-1,24%	-0,80%	-0,36%	0,08%	0,51%	0,94%	1,37%	1,80%	2,23%	2,66%	3,09%
70+	-1,57%	-1,11%	-0,66%	-0,20%	0,25%	0,70%	1,15%	1,60%	2,05%	2,50%	2,94%	3,39%	3,83%
75	-1,92%	-1,47%	-1,02%	-0,57%	-0,12%	0,33%	0,77%	1,22%	1,67%	2,11%	2,55%	3,00%	3,44%

τ = 50%

The result for the holder is disastrous, and particularly clear in the case of a zero nominal return (which is presently the basis for the computation of annuities). Zero gross nominal return leads to -2% net nominal return. This would translate into -4% net real return under the assumption of 2% yearly inflation.

To cope with this situation, some insurers have imagined second-best solutions. Part of the capital will be subject to programmed withdrawals, over a period of say twenty years which will be subject to the more benign treatment of life insurance, the rest will be transformed into annuities starting after that period of programmed withdrawals (and thus subject to the unfavourable regime of annuities taxation).

7 Conclusions

The impact of the tax system on the future income of retirees may be huge. People who decide to complement what they are offered by official pension schemes by saving in the prospect of retirement should therefore pay attention not only to the investments in which their savings will be channelled but also to the vehicles of this channelling and their tax treatment.

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Annex 1

General income tax: main features and rate schedules

The general scheme of income tax is to add the income from various sources at the individual or family level, and to subject the result to a progressive rate schedule (which correspond to marginal) rates.

There are obviously complications around this scheme. The result of applying the rate schedule may be subject to rebates or extra charges.

In the US and Canada, there exist income taxes at the state and provincial levels, in addition to the federal income tax. In France, a so-called social levy applies.

In general, contributions to tax-differed plans are deductible from state (US) and provincial (Canada) income taxes. There are not deductible from the social levy in France.

Rate schedules are important as a (small) contribution to a tax-differed will be deductible at the marginal rate when the person is active, and a (small) withdrawal will be taxed at the marginal rate when the person is retired.

1) United states

The tax schedule applying for a single in 2018 is given in table A1.1

Table A1.1 – Income tax rate schedule - US

Marginal rate	Lower band	Lower band*	Lower band**
0%		0	0.000
10%	0	10400	0.226
12%	9525	19925	0.433
22%	38700	49100	1.067
24%	82500	92900	2.020
32%	157500	167900	3.650
35%	200000	210400	4.574
37%	500000	510400	11.096

(*) Including standard deduction and personal exemption

(**) As a share of average wage

The value of the lower band is in US dollars. To make things comparable among countries, and catch an idea of where the limits of the bracket stand in relation to the income

distribution, we have divided those limits by the average wage in the country. For the US, we have retained 46,000 US$ for the average wage.

2) France

Marginal rate	Lower band	Lower band	Lower band*
0%	0	0	0,000
14%	9807	9807	0,272
30%	27086	27086	0,752
41%	72617	72617	2,017
45%	153783	153783	4,272

(**) As a share of average wage

3) United Kingdom

4) Canada

Annex 2

Tax-differed plans

1) **Unites states**

2) **France**

3) **Canada**

The main tax-differed plan in Canada is the Registered Retirement Savings Plan (RRSP). Contributions to the plan are deductible from income tax and withdrawals added to income for the purpose of taxation.

Contributions on the RRSP are up to 18 % of previous year income, with a ceiling of 26500 C$ (around 70% of average wage)

Annex 3

General taxation of nominal return according to how return materializes

	US	France	UK	Canada
Rental income	IT (Income tax)	IT+17.2%	IT	IT
Own occupied	nil	nil	nil	nil
Interest	IT	30%	IT	IT
Dividends	15-20%	30%	0-38.1%	IT-TC
Capital gains real estate	15-20%	19%+17,2%	18-28%	50%*IT
Own occupied	15-20%/thres.	nil	nil/thres.	nil
Capital gains financial assets	15-20%	30%	10-20%	50%*IT

	France		
Life insurance	17.2%-24.7%		
PEA (Equity Saving Plan)	17,20%		
	Canada		
TFSA (Tax free savings acco	0%	5500C$	Financial assets
	UK		
ISA (Individual savings accou	0%	20000£	Financial assets

Annex 4 – Tax-favoured envelopes

1) Unites States

Roth-IRA. No tax on return. Contribution ceiling 6000-7000 US$. Income ceiling to contribute : 139000 $ (single) – 206000 $ (married couples)

2) France

Except for the “livret A” (ceiling), and “LDD (ceiling), the are no remaining tax envelopes where the return is untaxed.

The PEA (equity, ceiling) have been subjected to a social levy which reaches 17.2% in 2020 on the return.

The same for the PEL (interest-bearing, ceiling), and now is subject to a flat tax of 30%.

3) Canada

TFSA

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