



Occupational pension plans

Evaluation of taxation and of risks for pension coverage of lump sum payments from the pillars 2 and 3a

Key facts

Whereas the period since the introduction of mandatory occupational pension plans in 1985 was dominated by asset accumulation, for demographic reasons, the coming years will increasingly be marked by benefit payment. This increasingly poses the question, in what form should the benefits be provided?

Since 1995 legislation has extended the possibilities of capital withdrawal. If one examines all legal capital withdrawal options as a whole (age, death, invalidity, promotion of the ownership of residential property, becoming self-employed, leaving Switzerland for good and holding less than a year's worth of saved pension capital), annually one third of second pillar benefits are claimed as a lump sum and two thirds as a pension annuity. The overwhelming part of the pillar 3a benefits is claimed as lump sums. The only other country where there is such a high occurrence of pension lump sum payments is in the US.

Today, the average amount of saved pension capital is approximately CHF 400,000 – CHF 500,000 at the time of going into retirement. An increasing number of beneficiaries now have the possibility of claiming this as a lump sum. The first revision of the Federal Act on Occupational Old Age Survivors' and Disability Pension Fund (BVG), concluded in Autumn 2003, provided all of those insured in the second pillar with the possibility, upon retirement, of receiving up to 25% of saved pension capital as a lump sum, even if the regulations of their pension welfare institution does not provide such form of distribution (Art. 37 par. 2, new Federal Act on Occupational Old Age Survivors' and Disability Pension Fund [BVG]). For many people, a cut in the conversion rate and in the minimum interest rate renders capital withdrawal compared to a pension more attractive, to an extent that lump sum payments may become more popular in the next few years.

In its evaluation, the Swiss Federal Audit Office (SFAO) placed the emphasis on lump sums linked to age, disability and death but without being negligent of other legal capital withdrawal options. The SFAO examined the following aspects more closely:

- the risks involved in fiscal saving practices and fiscal rules and processes for the government,
- the risks involved in lump sum payments concerning pension coverage of the beneficiaries.

Risks involved in fiscal saving practices for the state

Under direct federal taxes, capital withdrawals are taxed separately from other income at a fifth of the normal income tax rate. The annual federal revenues amount to approximately CHF 120 million. Of greater financial significance is the taxation of lump sums by the cantons, although the difference in the level of taxation between one canton and the next may be as much as sevenfold.

The evaluation of the SFAO led to the following conclusions:

- The decision to opt for a pension annuity or a lump sum payment, which in general must be taken three years before retirement, is difficult for the beneficiaries. This decision is influenced by a series of factors (state of health and anticipated life expectancy, the desire to bequeath the pension capital, anticipated rate of return should the capital withdrawn be invested and taxation). To a large extent how well informed the claimant is on financial matters relating to pensions is commensurate with the saved pension capital, i.e. the bigger the amount saved is, the better the claimant is informed.
- For the majority of beneficiaries, taxation of the pension fund benefits is of secondary importance in the choice between a lump sum payment and a pension annuity. The exception to this rule is represented by claimants with an amount of saved pension capital well above the average. In this case the lump sum option has considerable tax advantages over the pension option, tax advantages that are even greater if the capital withdrawn is placed in investments exempt from taxation. This is why the top 20% of the most affluent pensioners more often claim the saved pension capital in full or partly as a lump sum.
- Some of the lump sum payments escape taxation when they are made to beneficiaries abroad. These beneficiaries can claim back the tax in Switzerland if they can prove that they have reported the lump sum payment to their country of residence. The payment of a tax abroad is not required. Due to the fact that France and Germany do not tax lump sum payments from occupational pension plans, this is leading to unequal treatment of claimants who are domestic residents and those who are resident abroad, as well as to tax losses for the Confederation and the cantons.
- It only seldom happens that claimants move from one canton to another or move abroad for tax reasons. However, the SFAO considers the future tax loss risk in this context as something that should not be overlooked, as both saved pension capital/lump and mobility will continue to soar.
- The most significant substantive fiscal saving practice is that of staggering diverse capital withdrawals in occupational pension plans and secured funds over several years that break fiscal progression. The opportunity to stagger arises from promoting the ownership of residential property, being affiliated to a basic or executive pension scheme, semi-retirement, taking out diverse (pillar 3a) products and timed capital withdrawals of jointly taxed partners. An intense debate has been ignited between the tax authorities, taxpayers and their representatives covering all of these topics since the possibilities for capital withdrawal were extended. Whereas low tax bills are of prime importance for taxpayers, together with a range of options to spread the burden, some tax authorities try, by applying and interpreting the law, to reduce revenue losses by working towards a single lump sum payment.

In occupational pension plans the principle of tax exemption for contributions and full taxation of benefits reigns. Taxation should treat beneficiaries equally, avoid revenue losses and be geared towards the long-term pension plan goal.

Risks involved in methods of taxation

The Swiss Federal Audit Office (SFAO) examined the different taxation procedures used in lump sum payments (reporting procedures and withholding tax deductions). In the case of the reporting procedure, annually over 100,000 forms are forwarded from pension institutions by the Federal Tax Administration (FTA) to the cantonal authorities. The SFAO welcomes the efforts of the FTA, the Swiss Federal Statistical Office (SFSO) and different pension institutions to computerise this flow of information and to make the data available for pension fund statistics (MELAP project). In this evaluation it has been shown that the data on the different legal capital withdrawal options (retirement, leaving Switzerland for good, becoming self-employed, etc.) is insufficient.

According to the unanimous response of experts interviewed by the SFAO, the taxation system works satisfactorily, therefore it is unlikely that a capital withdrawal from an occupational pension plan or from pillar 3a would escape taxation for administrative reasons, apart from cases of fraud. A problem in the reporting procedure is posed by the long period of time between the payment of the lump sum and the taxation thereof, due to the fact that numerous cantons only process the applications once on an annual basis.

Lump sum payments to beneficiaries resident abroad constitute the main risk, especially if the lump sum is transferred shortly before they leave or their pension scheme does not deduct withholding tax not being aware of the beneficiary's residency abroad. The auditors of the pension scheme do not always systematically pursue this point. It is difficult to recover the unpaid tax in the foreign country after the event.

Capital withdrawals and their risks for pension coverage

As any capital withdrawal leads to a corresponding reduction in pension benefit and shifts the risks associated with longevity, investment and inflation from the pension institution to the individual claimant, there is still the question of the ramifications involved regarding pension coverage. This all the more so in view of the fact that it is saved pension capital amounting to less than CHF 200,000 that is most often claimed as a lump sum. Yet another surge in capital withdrawals is to be witnessed in saved pension capital amounts exceeding CHF 700,000. The data available shows no significant negative influence on pension coverage when the capital withdrawal option is exercised. In evaluating the results obtained from statistics, however, the following three points should be noted:

Firstly the results of the survey come from pensioners who, at the time they took part in the survey, had only been in retirement for 3 – 8 years. The risks associated with longevity will only begin to be clearly understood in the later stages of retirement when the capital withdrawn has more or less been used up and there is no pension. Retrieving data from further back in the past would, however, not supply viable data because when today's long-term pensioners went into retirement, the capital withdrawal option was little used and involved relatively small amounts and from this no quantifiable negative influences on the standard

of living can be expected. The average capital withdrawal only started to rise at the end of the 1990s to just above CHF 100,000, which chopped CHF 600 off the monthly pension. Retirement lump sums are still too much of a novelty for the vast majority of those insured to be able to empirically establish the long-term effects.

Secondly, the results have only relevance for pensioners who do not receive supplementary benefits or individual premium reductions in sickness insurance. With recipients of supplementary benefits, there is a likelihood of capital withdrawal leading to additional supplementary benefits. This is probably to do with the fact that half of the cases where there is saved pension capital up to the value of CHF 160,000 are withdrawn which reduces the pension by CHF 1,000 per month and results in accordingly higher supplementary benefits when these smaller lump sums are used up in a matter of a few years. The assessment by the offices concerned of this phenomenon varies: whereas in general terms the opinion is that the problem is substantively not significant enough to justify countermeasures, the canton of Geneva only pays supplementary benefits if the claimant has not exercised the right to withdraw the accumulated pension assets in the second pillar.

Thirdly it should also be noted that after collating the statistical data in Spring 2002 that lead to the aforementioned conclusions, the stock market crises continued for nearly a year and countless recipients of accumulated pension assets caused losses which have only partially been recovered.

The capital market risk factor has probably had more of a negative effect since 1995 on investing withdrawn pension capital than the actual adverse trends of the equity markets. During the boom years from 1997 to 1999, there was only a below average increase in lump sum payments so that only a few of the upward movements of that period were put to good use. Only in 2000, when stock markets had scaled speculative heights, lump sum payments increased by approximately 50%. There was a renewed spurt in 2001. This increase was due to investments being looked upon favourably and the assessment gap due to the change to taxation based on present income. In 2002 capital withdrawals fell back to 1997 – 1999 levels. Spanning a period of time, it can be assumed that a higher than average number of people who withdrew capital suffered losses due to the falling stock markets without even having benefited from the upward movements.

The risks associated with full pension capital withdrawal should not be underestimated. An international comparison shows that in some countries a gradual capital withdrawal is possible. Gradual capital withdrawal spread out over a number of years is less risky than one single withdrawal in spite of the fact that claimants can plan their pension individually. Mixed benefit plans with an annuity and lump sum component are rare in Switzerland but should gain in significance in the future because they cleverly combine flexibility and pension security and are less susceptible to fiscal abuse than the one-off lump sums.

Conclusion

In the past twenty years, considerable efforts have been made for the development of occupational pension plans and for the accumulation of pension capital. But in which form the corresponding payments should be made has not been carefully examined yet. In particular, the fiscal treatment of withdrawals and their coordination with supplementary benefits are not coherently regulated.

The recommendations of the SFAO are included in chapter 6.2. They concern the following fields:

- improvement of statistics,
- addition of gradual withdrawals,
- computerization of reporting procedures,
- improved taxation of withdrawals to beneficiaries that reside abroad,
- to do certain minimal payments as pension annuity only,
- promotion and preferential treatment of mixed payments instead of one-off lump sums.

The original text is in German