The Taxation of Internationally Portable Pensions: An Introduction to Fiscal Issues and Policy Options

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Introduction

The development in old-age pensions in OECD countries exhibits several characteristic features. First, old-age income[3] consists of a mix of public, occupational, and private retirement incomes whose components have become more diversified and variable. Second, countries encourage occupational and private retirement savings through tax preferences or direct subsidies to compensate for reduced public generosity. Third, the taxation of mandatory and voluntary pension savings deviates from the principles of comprehensive income taxation within and between countries. Finally, individuals spend more of their working life or retirement period abroad, facilitated by the improved portability of benefits between OECD countries, but also within key migration corridors.

As a result, individuals increasingly receive retirement income from national and cross-border entitlements and their tax treatment differs within and across countries. This has two main economic consequences: (i) taxation provokes efficiency losses due to planned tax arbitrage or unplanned exposure to tax distortions as individuals are either motivated to move between countries (or prevented from doing so) or to restructure their retirement income portfolio with little effect on overall retirement savings; and (ii) taxation infringes on equity principles: At the individual level, the application of different tax rules for retirement benefits and savings instruments by different countries violates horizontal equity and is a source of interpersonal fiscal unfairness. At the country level, different, inconsistent, and uncoordinated taxation rules for retirement income create fiscal unfairness between countries and motivate tax competition.

Table 1 highlights for Germany scope and dynamics of pensions paid to and received from abroad. The number of pensioners living abroad on a German pension reached 1.7 million in 2013 (or 6.85 percent of all German pensions). Non-German pensioners living in Germany may also receive a pension for pre-migration insurance periods (as do 1.1 million pensioners, or 4.21 percent of all pensioners with a German pension). This gives a total of 2.8 million potential recipients (or 11.1 percent) of a cross-border pension. Yet these numbers reflect the labor mobility of the past and do not include the higher pan-European labor mobility since the 1990s. Estimates for the European Union of the future share of pensions paid abroad to the current workforce arrive at some 15 to 25 percent (Holzmann 2015).

The traditional instruments to address inequity issues in taxation are: (i) an appropriate income tax reform at the national level; and (ii) the renegotiation of double taxation treaties at the international level. We strongly doubt that uni- and bilateral approaches are promising strategies, even if countries decided to apply deferred income taxation to pension income. While at a national level the call for joint policy analyses of pensions and taxation has been made (most recently by Mirrlees 2010), transnational pensions and their taxation lack both operational understanding and a conceptual framework; this is terra incognita.

Against this background our paper offers an overview of the state of taxing the main forms of old-age pensions in and between OECD countries. We subsequently explain why the taxation of retirement savings has become so complex in OECD countries. Lastly, we argue for inter-

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[3] A pension benefit paid as a lifetime annuity from retirement until death is the main, but not the only form of retirement income. It is dominant, but not omnipresent in mandated schemes; was dominant in occupational schemes at the time of defined benefit (DB) schemes that were gradually replaced by DC schemes, often with no obligation to buy a lifetime annuity at a certain age; and hardly exists for voluntary savings. The remainder of this paper uses "pensions" and "retirement savings" interchangeably unless a differentiation is warranted.

Table 1

Recipients of statutory German pensions

Number of pensioners in millions (% of total pensioners)	2013	2010	2005
Total non-German pensioners	2.562 (100%)	2.367 (100%)	2.032 (100%)
- living in Germany	1.059 (41.3%)	0.944 (39.9%)	0.774 (38.1%)
- living outside Germany	1.503 (58.7%)	1.423 (60.1%)	1.258 (61.9%)
Total German pensioners	22.602 (100%)	22.646 (100%)	22.452 (100%)
- living outside Germany	0.222 (0.98%)	0.206 (0.91%)	0.170 (0.76%)
Total pensioners	25.164 (100%)	25.013 (100%)	22.484 (100%)
- living outside Germany	1.725 (6.85%)	1.629 (6.51%)	1.427 (5.83%)
- non-German pensioners living in Germany	1.059 (4.21%)	0.944 (3.77%)	0.774 (3.44)
- potential recipients of cross-border pensions	2.784 (11.1%)	2.573 (10.3%)	2.201 (9.8%)

Source: Genser and Holzmann (2016), based on Eurostat Online Database (June 2015).

national coordination of pension taxation and suggest replacing the current dominant, but not omnipresent scheme of deferred pension taxation with front-loaded taxation that can be combined with three tax payment options.

The state of pension taxation within and between OECD countries

Income taxation in most OECD countries is codified according to the Schanz/Haig/Simons principle of comprehensive income (CI) taxation, which regards any annual increase in personal wealth as taxable income. This is also true for pension claims which increase individuals' ability to pay and should therefore be taxed under a CI tax. To compare national pension tax practices we distinguish between the usual three phases where taxation can be applied: Contributions, returns and disbursement. Technically CI taxation of pensions can be characterized by a T-T-E income tax, where T is the individual income tax rate and E indicates that an income flow is tax exempt. We use t to indicate that a reduced tax rate $t < T$ is applied.

Table 2 reveals that no country in our sample applies T-T-E taxation to statutory pensions, as all of them provide tax relief either by deferring income taxation or by subjecting pension income to lower rates. The taxation of occupational pensions is similar and exhibits an even greater scope of complexity, although no country fully exempts occupational pensions from income tax. Private pensions are granted particular tax preferences that differ between specific pension savings vehicles. Surprisingly, none of the OECD countries in our sample offers expenditure taxation for private pension savings.

The complexity of the tax treatment of pensions increases when pensions accrue across borders. The avoidance of international double taxation of cross-border pensions is codified in bilateral double taxation treaties. Although these treaties usually follow the recommendations of the OECD model convention treaty, there is room for variance in income tax assignments for different forms of foreign income. Table 3 reveals the tax assignment of cross-border pension flows in treaties signed by Germany and Switzerland. There is a marked dominance of the residence principle, but statutory pensions are frequently assigned to the source country exclusively. Shared tax assignments allowing for limited source country tax credited in the residence country are rare.

A closer look at the bilateral network of double taxation treaties reveals three fundamental complexities of cross-border pension taxation. First, both countries tax cross-border pension benefits differently for different forms of retirement income. Second, both countries tax inbound cross-border pension benefits differently depending on the source country. Third, outbound pension benefits paid by Germany or Switzerland are taxed differently depending on the residence country of the pensioner.

Table 2

Income taxation of pensions in OECD countries

Tax regime	Statutory pension	Occupational pension	Private pension	Characterization of tax regime
T-T-E		US	SE	Comprehensive income tax
t-T-t		IT, SE	IT	CIT with partially deferred savings taxation
T-E-T		CA, MT	FR, MT	CIT with deferred return taxation
E-T-T		DK, DE, PT, US	DK, SE	CIT with deferred savings taxation
t-E-T	FR, IR, CA, MT, NL, UK	BE, EE, FI, FR, IR, LT, AT, SI, UK, CY	BE, EE, FI, FR, IR, CA, LT, LU, CH, SI, UK, CY	Deferred CIT with double taxation relief
T-E-t		FR	DE, FI, FR, MT, ES	CIT with deferred preferential savings taxation
E-E-T	BE, DK, EE, FI, GR, IT, LT, LU, AT, PL, PT, SE, CH, SI, ES, CZ, CY	DE, GR, CA, LU, NL, AT, CH, SI	none	Fisher/Kaldor expenditure tax, deferred income taxation
T-E-E	LI	PL	PO, US	Prepaid expenditure tax
t-E-t	DE, US	DE, LI, AT, PT, SK, ES, CZ, HU, US	DE, LT, LI, LU, NL, AT, PT, CH, SK, ES, CZ, HU, US	Partially deferred prepaid expenditure tax
t-E-E	HU	GR, LI, LU, AT, HU, CY	GR, LT, LI, AT, CH, HU, CY	Reduced prepaid expenditure tax
E-E-E	SK	none	none	Full income tax exemption

Source: The authors, based on Genser and Holzmann (2016), IBFD (2015), and Wellisch et al. (2008).

Explaining diversity, complexity, and the inconsistency of taxing global pensions

Our analysis identified three driving factors for the disarray of the status quo.

The diversity of the taxation of national pensions

A first reason is the legalistic view that pension benefits from unfunded pensions are regarded as deferred labor income and taxed on a cash-flow basis, viz. E-E-T. Pension benefits from funded pensions are regarded as withdrawals from accumulated pension wealth and taxed as capital income upon accrual, viz. T-T-E. There is, however, no distinct dividing line between the two forms of pensions, particularly with respect to occupational pensions and their funded or unfunded nature.

A second argument for the diversity in taxation is the incomplete move from CI taxation towards consumption-type income taxation. The CI tax approach has been the global guideline for the rational design of progressive income tax schedules for over 100 years and received political support for its concordance with the ability to pay principle. As far as the taxation of retirement income is concerned, however, CI taxation has a number of pitfalls that have contributed to its partial demise in income tax codes. The proposals for expenditure taxation (Fisher 1930; Kaldor 1955), the results on the non-optimality of same-rate taxation of labor and capital income, and the operational feasibility of a cash-flow design approach that avoids taxation of the normal returns to capital (Bradford 1986) also contributed to the weakening. Nevertheless, no industrialized country has ever tried to replace CI tax with an expenditure tax regime. However, pension taxation is one remarkable exemption and expenditure tax is seemingly the widely-accepted benchmark for tax lawyers and pension economists.

A third argument for the diversity in pension taxation is the varying scope and composition of tax preferences for pension savings within countries. While there is an economic justification for subsidizing voluntary pension savings as a merit want, political motives for tax preferences are manifold and are triggered by electoral campaigns, by lobbying of financial industries or by piecemeal policy steps to cope with financial pressure on unsustainable public pension systems.

The lack of fiscal fairness across countries

The OECD model tax convention as a blueprint for bilateral double taxation treaties does not feature a general

consistent rule how portable pensions should be taxed. Article 18 only addresses pension benefits and assigns the right to tax them to the residence country. An escape clause allows the source country (Article 19/2) to tax benefits from public pensions, which are paid by public authorities or public funds. But the model tax convention does not address pension taxation in the contribution and accumulation phases. Fiscal unfairness felt by treaty partners has triggered attempts to unilaterally override treaty rules and to recoup tax losses from pension tax preferences of migrants, but such measures were ruled discriminatory and thus illegal by the European Court of Justice as they hamper labor mobility.

The coordination dilemma of bilateral double taxation treaties

Model tax conventions by the OECD and the UN have led to tax coordination with bilateral treaties, but the international network offers ample room for tax arbitrage and treaty shopping. Yet bilateral treaty negotiations are unlikely to serve the multi-national coordination requirement and two aspects do not help: A conceptual framework is lacking for how best to integrate pension savings consistently into the OECD model convention to mitigate the conflict between individual equity and inter-country fiscal fairness. Even if such a framework existed, the renegotiations of roughly 100 bilateral double taxation treaties for each OECD member country would be a daunting task in view of the historical evidence on the duration of treaty renegotiations and the room for bargaining between any pair of countries.

The separation of social and fiscal responsibility at a national and an international level

In most countries social policy and tax policy are assigned to different ministries, while an economic approach calls for a concerted policy design to meet the distributional objectives efficiently and to ensure fiscal sustainability. But political evidence at a national level suggests little conceptual and administrative coordination and overall government guidance. The situation is even worse at the EU Commission, where pension issues are split across a number of Directorates General (DG) and separated from income taxation issues handled by the DG Taxation and Customs Union. And no international organization (like the ILO, IMF, World Bank or OECD) has used its mandate to explore, analyze, and guide pension design and pension taxation coherently at a national and an international level.

New policy options

To address the complexities and inconsistencies of global pension taxation, the identified drivers of the prior sections offer guidance for innovative policy options. First, there is no hope that a revision of double taxation treaties alone will provide the break-through: There is no conceptual framework to guide such revisions and bilateral negations alone will not be able to curb the treaties' patchwork. Second, the international trend toward an expenditure-type treatment of retirement income offers a level playing field for statutory, occu-

Table 3

Tax assignment of cross-border pensions in German and Swiss double taxation treaties

Tax assignment in German treaties	Statutory pensions	Occupational pensions	Private pensions
Residence country exclusively	CA, CH, CZ, EE, ES, FI, GR, HU, IR, IT, LU, PT, SE, SI, UK, US	AT, BE, CH, CZ, EE, ES, FI, FR, GR, HU, IR, IT, LU, MT, NL, PL, SE, SI, UK, US	AT, BE, CH, CZ, DK, EE, ES, FI, FR, GR, HU, IR, IT, LU, MT, NL, PL, PT, SE, SI, UK, US
Source country exclusively	AT, BE, DK, FR, IT (citizens), MT, NL, PL, SE	FR (mandatory)	
Tax credit in residence country		CA, DK	CA, DK (rents)
Tax assignment in Swiss treaties			
Residence country exclusively	CA, CH, CZ, EE, ES, FI, GR, HU, IR, IT, LU, PT, SE, SI, UK, US	AT, BE, CH, CZ, EE, ES, FI, FR, GR, HU, IR, IT, LU, MT, NL, PL, SE, SI, UK, US	AT, BE, CH, CZ, DK, EE, ES, FI, FR, GR, HU, IR, IT, LU, MT, NL, PL, PT, SE, SI, UK, US
Source country exclusively	AT, BE, DK, FR, IT (citizens), MT, NL, PL, SE	FR (mandatory)	
Tax credit in residence country		CA, DK	CA, DK (rents)

Source: The authors, based on Genser and Holzmann (2016), Wellisch et al. (2008), and tax treaties.

pational and private pensions and promises reduced distortions. However, the back-loaded E-E-T approach is in conflict with international mobile labor, the resulting unequal revenue allocation, and also creates administrative and compliance problems that grow with an aging population. Third and luckily, our proposed front-loaded pension tax shares several welcome properties of an expenditure tax, decouples tax liability creation and tax payment, and offers additional flexibility while reducing compliance and control costs. Front-loaded taxation produces transparent records of tax-liability for each retirement saver at each point of time and makes it possible to settle tax-balance problems without painful renegotiations of double taxation treaties.

Intertemporal neutral front-loaded pension taxation

A front-loaded T-t-E scheme of pension taxation shares the intertemporal neutrality property of a back-loaded Fisher/Kaldor-type expenditure tax E-E-T. T-t-E income taxation exempts pension benefits withdrawn from accumulated pension wealth, but taxes income spent on pension savings when contributions are made and returns on pension wealth when they accrue and exceed normal capital returns. Both tax systems are also equivalent under a set of simplifying assumptions and their present values of the tax burdens are lower than those under comprehensive income taxation with the same tax schedule.

Compared to deferred income taxation, a front-loaded system by definition avoids pension tax revenue losses when individuals migrate (as workers or retirees). If source and residence countries implement front-loaded regimes, double taxation of cross-country pensions is avoided because any migrant's tax balance is known upon emigration and can therefore be settled accordingly.

A front-loaded tax scheme normally implies that tax liabilities must be cleared immediately upon income tax assessment. While the present value of taxes, and thus net income across the life-cycle, is the same as under a back-loaded scheme, the earlier tax payment may be seen as unduly reducing the net income of pension savers and thus an unacceptable loss of purchasing power. For this reason, we complement the T-t-E front-loaded pension tax with options for a decoupling of tax liability and tax payment, i.e. we propose variants where the tax payments of the T-t-E income tax liability can be shifted to future in an actuarially fair manner.

Three tax payment options

Under the **front-loaded tax payment** option all tax liabilities are settled when they occur (Genser 2015). The front-loaded loss of individual net income can be compensated for by reducing the mandatory or voluntary contributions to pension systems by the marginal tax rate. Consequently investments in pension wealth are reduced by the personal tax factor (1-T). The same is true for accrued non-normal pension wealth returns. Pension funds are obliged to pay income tax on that return to the tax authority and pension wealth growth is reduced by the tax factor. Pension benefits are pre-taxed and no further income tax is due when disbursed after retirement. Since all income tax liabilities on pension wealth are settled at any time, no revenue loss arises in the emigration country.

Under the **deferred tax payment** option all tax liabilities are accumulated and turned into a tax annuity on retirement that must be paid to the tax administration in line with the disbursement of the monthly pension benefits (Holzmann 2015). If a pension saver leaves the country and no arrangements exist with the new residence country to continue postponing the payment until retirement, then the accumulated tax liability becomes due as a form of exit tax.

The approach combines a formal front-loading of taxation (T-t-E) with a material back-loading (E-E-T), as the tax is only due when benefits are disbursed. This deferral might increase political support for such a tax reform, as it reduces time inconsistency, i.e. the temptation to charge pension benefits again when benefits are paid out. Keeping track of deferred tax liabilities, taxes already paid, and the net amount of pension wealth across an individual's lifecycle imposes an additional cost on tax administration, but provides a valuable data base for long-term pension and tax planning.

Under the **distributed tax payment** option tax payments are spread evenly across the whole pension cycle by charging the same tax rate t* on contributions, pension wealth returns, and pension benefit pay-outs. Applying t* to these bases creates the present value of tax payments, which exactly covers the present value of the front-loaded pension tax liability, but the rate is only half the rate of the other payment regimes. The lower tax rate might increase political support and facilitate revenue sharing between source and residence countries if individuals migrate. However, administrative costs will be similar to pension benefit related tax collection.

Conclusions

The taxation of internationally portable pensions and other retirement savings is characterized by astonishing diversity, complexity, and inconsistency. This disarray reflects a conceptual void in terms of how to tax global pensions, national autonomy in the taxation of retirement income, but also flexibility in bilateral rules for avoiding double taxation via different forms of old-age pensions.

A successful reform approach needs a conceptual framework for global pension taxation, supported by a major group of OECD members; the willingness to agree on a multilateral approach (e.g., at the EU level); and the readiness to take up economic recommendations for a coordinated tax and pension policy at both the national level and that of international organizations.

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