

Defined Contribution Plans in Japan

(Draft)

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1 Introduction to the Retirement Structure in Japan

This chapter will provide the overview on the retirement income structure in Japan, before describing the details of the Defined Contribution Plans introduced in October 2001.

1.1 Private Retirement Plan Structure

A structure exists under the Japanese Tax Code and other laws which allow employers, employees and self-employed to adopt voluntarily and contribute to retirement programs.

1.1.1 Employer-Sponsored Retirement Plans

The employer, in general, can provide three types of private retirement plans for their employees and their families as below;

- **Lump-sum retirement payments schemes**
- **Defined Benefit (DB) type corporate pension plans**
- **Defined Contribution (DC) type pension plans**

1) Lump-sum Retirement Payments Schemes

Traditionally, lump-sum retirement payment was most prevalent type before the World War and through out the era of rapid economic growth in Japan. Even now many Japanese large companies are providing lump-sum retirement payment schemes.

In addition to or combined with the lump-sum type, nearly half of the Japanese private employees are offered the DB type corporate pensions. Japanese companies started to establish their tax-qualified DB type corporate pensions in 1960s. The “*Tax Qualified Retirement Pension (TQRP)*”, which is most typical DB type corporate pension plan in Japan, was allowed by Tax Code in 1961. And in 1966, *the Employees’ Pension Fund (EPF)* scheme was also permitted as the another type of DB pension plans by *the Law of Employees’ Pension Insurance*, which mainly describes the public pension plan for all the private sector employees in Japan.¹

Before the enactment of these laws, surely some traditional companies in Japan had its own private pension plans, but they were not authorized by any specific laws or qualified by the Tax Code.

¹ See section 1.7 (p.12).

After the 1960s, many Japanese companies established their TQRP, EPF, or sometimes both of them by the transition of their traditional lump-sum payment schemes.

This historical fact is one of the main reasons why the retiring employees usually choose to be paid in the mixed form of lump-sum payment and annuity.

2) DB-type Corporate Pension Plans

In June 2001, the Diet, the Japanese Congress, passed “*the Bill of Defined Benefit Corporate Pension*” and “*the Amendments to the Employees’ Pension Insurance Law*”. They were enforced in April 2002. These new legislation provide the common rules for Defined Benefit corporate pensions in Japan, which had not existed. Under the new laws, three types of DB pension plans are categorized as following;

- “**Foundation Type**”; which has the foundation established solely in order to manage the pension plan, investments and distributions.
- “**Contract Type**”; which is established by the contract between the employer and certain financial institutes to manage the pension plan.
- “**Employees’ Pension Fund (EPF)**”; which is regulated by the revised *Employees’ Pension Insurance Law*. This type pension is required to manage not only its own pension plan but also certain portions of the public pension (*the Employees’ Pension Insurance*) concerning its employees. In this context, this type plan has to have a character of the public pension.²

The current *Tax Qualified Retirement Plan (TQRP)* is to be abolished by March 2012. The company that currently has this plan should transfer its plan to one of the three types mentioned above or DC pension plan by that time.

3) DC-type Pension Plans

The third type of retirement plan was approved last year. *The Defined Contribution Pension Law* was enacted in June 2001 in the same session of the Diet as *the DB Corporate Pension Law* was enacted, and it was enforced in October 2001. For employees, Corporate-type Defined Contribution pension plan which is employer-sponsored, and Individual-type DC pension plan which is contributed by employee itself are available now.

² See section 1.3 (p.7).

1.1.2 Retirement Plans for Self-employed

Aside from employees, self-employed can establish and contribute to its own account under these schemes as below in order to save for retirement.

- **National Pension Fund (NPF)**
- **Individual-type Defined Contribution pension plan**

The scheme of NPF was implemented in 1991 by the amendment of *the Law of National Pension* in 1989, which describes the public pension for self-employed. Self-employed can spontaneously join the NPF, the purpose of which is to provide the supplement plan to the public pension (“*National Pension*” (or “*Basic Pension*”)) for them.

By this law, two types of NPF were established, i.e., Community-type funds and Occupation-type funds.

The participants of *the Community-type NPF* are the self-employed who have their residences in the same prefecture. This means that one *Community-type NPF* is established in each prefecture.

The Occupation-type NPF is organized by the self-employed who work for the same type of business or job, such as doctors, lawyers, and so on. One *Occupation-type NPF* can be established for every occupation through entire nation.

The character of NPF is very complicated.

It has the character of public pension scheme because the Japanese Government is responsible for the overall management of it. But the participation of self-employed is not mandatory.

The benefits are in part pre-defined because the Japanese Government assures the participants of 4% return. On the other hand, the participant can decide how much it contributes to NPF within the limitation of 68,000 yen per month. The benefits are calculated by the amount of contribution and by the insured rate of 4%.

In addition to NPF plans, self-employed can establish its own account of DC pension plan, which was also approved by the new *Defined Contribution Pension Law* as mentioned above. This plan will be described in Chapter 3 (p.25).

1.2 Basic Laws for Private Retirement Plans

There are many laws designed to regulate private retirement payment plans in Japan as following.

1.2.1 Lump-Sum Payment

In general, *the Law about Securing of the Payment of the Wages* has the regulation for lump-sum retirement payment.

1.2.2 Defined Benefit Type³

The Tax Qualified Retirement Pension (TQRP) is designed by *the Corporate Income Tax Law* and *the Individual Income Tax Law*. But, as is mentioned above, this type is to be abolished by March 2012.

The Defined Benefit Corporate Pension Law was enacted in June 2001 and enforced in April 2002. This law provides the common rules for two types of DB plan, i.e., “Foundation Type”, and “Contract Type”.

The Law of Employees' Pension Insurance (EPI) regulates *the Employees' Pension Fund (EPF)*, which is another type of DB Corporate pension plan. *This Law of EPI* was amended to be in accordance with *the Defined Benefit Corporate Pension Law*.

The National Pension Law regulates *the National Pension Fund (NPF)* for self-employed.

1.2.3 Defined Contribution Type

The Defined Contribution Pension Law was enacted in June 2001 and enforced in October 2001.

The Individual Income Tax Law and *the Corporate Income Tax Law* also regulate all the types of private retirement payment plans in accordance with those laws mentioned above, except for the lump-sum payment.

1.3 Outline of the Defined Benefit Plan

The defined benefit plans promise to pay a fixed retirement benefits in shape of lump-sum payment or annuity, pursuant to a formula contained in each plan. The amount of payment is calculated on the basis of following factors, such as the participant's years of services with the specified employer, salary paid to the participant, a common multiplier.

These provisions should be settled by the mutual agreement between employer and employees (which can be represented by the labor union or the majority of employees) in Japan.

³ See section 1.1.1 (p.5)

The employer commits itself to contribute to the defined benefit plan the amount actuarially calculated as necessary to fund the projected benefit liability. In addition, the employer has to keep the plan's assets outside the account of the company. What this means is that the asset of the DB plan should be distributed only for the beneficiaries of the plan.

It is usual, in Japan, that employee can choose the forms of payment, lump-sum payment or annuity. Under the current *Tax Qualified Retirement Pension (TQRP)* plans, annuity can be lifetime or periodical. But, because of the advantage of the tax benefits, the beneficiaries of the TQRP generally prefer the lump-sum payment. This is the same under the new two types of DB pension plans introduced by *the DB Corporate Pension Law*. On the other hand, under *the Employees' Pension Fund (EPF)*, annuity payment for lifetime is designed as the primary payment form.

When the employer chooses to establish the EPF with the agreement of employees, the employer is required to manage the EPF combined with a certain portion of *Employees' Pension Insurance* (the public pension mandatory) of its employees. What this regulation means is that the employer should be responsible for managing, investing and distributing the portion of the public pension for its employees.

In the circumstances of rapid-growing economy where the required interest rates were always lower than the actually achieved performance, the employer could take an advantage of the spread between those interest rates by establishing the EPF. But in 1990s, the Japanese economy was stagnant, which means that the employer should contribute, on the contrary, much more than the amount calculated actuarially because the performance could not reach the level of the required interest rates for the public pension.

In addition, the employer was not allowed to dissolve its EPF without some specific reasons under *the EPI Law*. This was the reason why the Japanese employers who had EPF wanted the new rules for the DB pension plans. Under *the DB Corporate Pension Law* and *the Amendment to the Employees' Pension Insurance Law*, the EPF can be dissolved and transferred to other types of DB pension plan or DC pension plan if the employer and employees agree.

1.4 Outline of the Defined Contribution Plan

The Defined Contribution plan in Japan has just started. From October 2001, employer may establish and sponsor the Defined Contribution type pension plan that meets the requirements of the newly enforced *Defined Contribution Pension Law* and the Tax Code of Japan. The employer makes monthly contribution to the each account of employees following a specific formula, for example, a certain percentage of participant's salary or a certain amount. The commitment of the employer is expressed in terms of the amount contributed to the plan, not in terms of the ultimate retirement benefit to be provided.

The ultimate amount available as a retirement benefit is a function of the contributions made over the term of employment and the investment performance of these amounts.

Under the DC pension plans, a separate individual account is established for each participant and the participant directs the investment. This means that each participant should be responsible for the selection of investment and the performance.

1.5 Concept of “Qualified” and Tax Benefits

1.5.1 Concept of “Qualified”

As in the United States, there is a concept of retirement payment plans being “qualified”, as distinguished from being “non-qualified”.

For a long time, “the qualified retirement payment plan” usually meant the “*Tax Qualified Retirement Pension (TQRP)*” that was one of the DB type pension plans because the TQRP was qualified only by the Tax Code. Another DB type was “*Employees’ Pension Fund (EPF)*” which was regulated by the specific law, i.e., *Employees’ Pension Insurance (EPI) Law*. Of course, EPF was also qualified by the Tax Code. In this context, both TQRP and EPF could be described “qualified” by last year.

Since April 2002, when *the Defined Benefit Corporate Pension Law* was enforced, it can be said that there are three types of DB pension plans, as mentioned before, i.e., “the Contract type”, “the Foundation type”, and revised “Employees’ Pension Fund (EPF)”⁴. All of them are qualified by the new Tax Code, which means the contribution by employer is deductible and is not considered as the employees’ income if those plans meets the requirements of the new *DB Corporate Pension Law* or *EPI Law*.

In addition, *the DC Pension Law* was enacted in October 2001. Before then, some private companies offered a kind of defined contribution plans, while they were not tax-qualified. The contribution was considered the salary to employees to be taxed. At the same time, it was not portable when employees changed their jobs.

Accordingly, “qualified retirement plans” should now mean broadly both DB corporate pension plan and DC pension plan. In order to be qualified, both DB plans and DC plans should be approved by *the Minister of Health, Labor and Welfare*.

1.5.2 Tax Benefits

Tax benefits exist under the Tax Code with respect to the private retirement payment plans that meet the applicable requirements of the related laws. In fact, these tax benefits constitute a principal incentive intended to encourage the private sector employer and employees, and also self-employed to establish private pension plans.

⁴ See p.5.

Followings are the outline of the tax benefits and the taxation for qualified DB and DC pension plans.

1) Contribution by the Employer:

The employer that offers the qualified plans can deduct its permissible contribution to these plans.

2) Assets and Investment Earnings:

There is a taxation rule on the assets of the retirement plans even though they are “qualified”.

For the lump-sum retirement payment, *the Financial Accounting Standards for Business Enterprises in Japan* requires an employer to appropriate the amount that assumed to be necessary for employees' retirement allowances at the end of each accounting term. But, on the other hand, *the Corporate Income Tax Law* ultimately permits the employer to appropriate up to only 20% of the necessary amount as the employees' retirement allowances without taxation.

For the DB and DC pension plans, there is a notorious taxation on their assets, which is called “*Special Corporate Tax*”. Basically, each pension plan is required to pay 1.173% of the amount of assets as this tax. Even Individual-type DC plan is subject to this taxation.

For FY 2001-2⁵, this taxation is suspended by the special tax treatments decided by the Diet. Nevertheless this taxation is still criticized as the disincentive to establishing private plans because no one knows whether “*Special Corporate Tax*” will be abolished forever or revived in future. The Ministry of Finance never intends to abolish this *Special Corporate Tax* in the reason of the fairness of taxation. It insists that the beneficiaries of public pensions and qualified pensions are having big tax advantages at the time of receiving distribution under the current Tax Code as mentioned below.⁶

Now the rate of return in Japan is so low that the performance is far from satisfying. In addition to the lower performance, this taxation should be the heavy burden to maintain the plans in case revived. For the Japanese aging society, this distortion of the taxation on the pension benefits is one of the big problems to be resolved as soon as possible.

⁵ Japanese Fiscal Year is from April to March.

⁶ See p.11.

3) For Employees:

- **Contribution by the employer**

If the private plan is employer-sponsored, the participant does not have to include the employer contribution in its income at the time the contribution is made.

- **Contribution by the employee or self-employed**

Under the qualified Individual-type DC pension plans, the contribution by the individual employee or self-employed is considered to be made on a “before tax” basis.

- **Distribution**

The beneficiaries of qualified private plans may be eligible for tax exempt. Under *the Individual Income Tax Law* of Japan, the benefits from the public pension and qualified private ones can be deducted to a large extent. In fact, only small portion of beneficiaries pays income tax. For lump-sum retirement payment, in general, the recipient has much more tax advantage than for annuity.

1.6 Assets of Plans

Assets of employer-sponsored DB or DC plans subject to the relevant laws should be held either in a trust arrangement or pursuant to an insurance contract. This provision means that the assets of those plans are protected only on behalf of the participants and the beneficiaries of the plans. In this context, the trustees or insurance companies must be considered as fiduciaries under those plans.

In the Individual-type DC plans, *the Association of National Pension Funds (ANPF)*⁷ assumes the primary role of the custodian of the assets. However, ANPF is allowed to designate some financial institutes as the substitutes to hold the assets under these plans.

Assets of lump-sum retirement payments do not needed to be held in a trust arrangement or pursuant to an insurance contract. According to *the Financial Accounting Standards for Business Enterprises in Japan*, the employer is required to appropriate on the balance sheet the amount that assumed to be necessary for employees' retirement allowances at the end of each accounting term. But, on the other hand, *the Corporate Income Tax Law* ultimately permits the employer to appropriate up to only 20% of the necessary amount as the employees' retirement allowances without taxation. In this context, the lump-sum retirement payment schemes turned out to be “not-qualified” in Japan.

⁷ See note 17 (p.25).

1.7 Government-Provided Social Security (Public Pension)

The Pension Insurance Law for Workers was enacted in 1942, amid the World War to provide public pension for employees. This Law's name was revised to *the Employees' Pension Insurance Law* in 1944. In addition, *the National Pension Law* was fully enforced in 1961 to cover all the citizens in Japan.

The Japanese public pension system is divided into two tiers.

First is the “*Basic Pension*” (or “*National Pension*”) benefit that is provided for all the people age 65 and over who has paid the premium for 25 years or more.

Second is the “*Remuneration-Proportioned*” benefit that is only for retired employee age 65 and over who has paid the premium for 25 years or more. This portion is not provided for self-employed and dependent spouse. Instead, self-employed can voluntarily be the participant of “*National Pension Funds (NPF)*”⁸, so-called the third tiers provided by the government as a supplement to the Basic Pension.

1.7.1 Finance for the Public Pensions

1) “**Basic Pension**” (or “**National Pension**”) benefits

It is a complete “pay as you go” system. One third of the amount to be paid as the benefits is financed by the general revenue of the Japanese Government. Two-thirds are financed by the premiums evenly paid by all the participants of the public pensions.

2) “**Remuneration-Proportioned**” benefits

While it was designed to be a funding system at the beginning, it has come to be a kind of “pay as you go” system. In fact, there is a fund of 170 trillion yen to provide for the payment of retirement benefits but it is far from full-funded. According to the estimation by the Japanese Government, the shortage is 330 trillion yen as of the end of FY 1999. In this context, the “Remuneration-Proportioned” benefits can be said a pay-as-you-go system.

1.7.2 Benefit Levels

In general, the public pension benefit level of Japan is higher than that of other advanced countries. To be eligible to receive the public pension benefits, the individual must have worked and contributed for 25 years before reaching 65 years old.

⁸ See section 1.1.2 (p.6).

1) “Basic Pension” (or “National Pension”) benefits

The monthly premium for the Basic Pension is 13,300 yen for each self-employed. The benefit levels depend on the duration of each participant’s contribution. According to the calculation of the Japanese Government, self-employed can receive 67,017 yen per month if it had contributed for 40 years.

2) “Remuneration-Proportioned” benefits

The premium imposed on employee is now 17.35%, which includes the “Basic Pension” portion. It is paid on the employee’s wage and shared by half with the employer. According to the calculation of the Japanese Government, retired employee can receive altogether 238,125 yen per month, which includes the “Basic Pension” benefits of itself and its dependent spouse, if it has worked and contributed for 40 years. This benefits level is nearly 60% of the monthly salary earned by Japanese current employees.

1.7.3 Efforts to Modify the System

Under *the Amendment to the Public Pension Laws of 2001*, the total amount of the benefits to be paid in future was reduced by 20%. But even this big modification is not so helpful to avoid the rapid increase in premiums. According to the estimation by the Government, the premium of the Employees’ Pension Insurance should be raised up to 27.8% in 2025. For the Basic Pension, the premium should be raised up to 25,200 yen per month, nearly the double of the current level.

After the amendment of the public pensions of 2001, the ruling coalition made a promise to raise by FY2004 the proportion financed by the Government general revenue from 33.3% to 50% of the amount of the payment for the Basic Pension benefits. But it is still unclear when it will be raised and how the Government will finance the increase.

1.7.4 Retirement Plans for Government Employees

For the employees of central and local governments, there are lump-sum retirement payment schemes as well as the public pensions, which are called the “*Mutual Aid Pensions*”. These public pensions are designed to include a special portion for civil servants adding to the “*Basic Pension*” benefit and the “*Remuneration-Proportioned*” benefit, both of which are calculated by the same formula as for private employees. As a result, their total public-pension benefits are roughly 20% more than those of private employees.

2 Employer-Sponsored Defined Contribution Plans (Corporate-type)

The Defined Contribution Pension Law was enacted in June 2001 and enforced in October 2001. Since then employer-sponsored (**Corporate-type**) Defined Contribution pension plans came to be eligible in Japan.

For long time, the employer can establish only the Defined Benefit type pension plans with tax qualification. Before this legislation, some Japanese companies had a kind of DC type plans, which were not tax-qualified though.

Under this Corporate-type DC pension plan, it is prohibited for employees to contribute to their own accounts.

On the other hand, there is the Individual-type DC pension plan, which should be contributed only by employees or self-employed. This type will be explained later in Chapter 3 (p.25).

2.1 Basic Scheme of Corporate-type DC Plan

Under the new *DC Pension Law*, there are some special requirements for establishment, management and investments of DC pension plans, for examples;

- First of all, employer should have an agreement with the labor union or the majority of employees to establish the employer-sponsored DC pension plan.
- The eligibility of participants should not be discriminative.
- Three or more choices of investments should be presented.
- The direction of investments can be made at least once during three months.
- All of the assets should be transferred when the eligible participant resigns.

At the same time, the DC plan should designate the “*administrative institutes*” and the “*trustee*”.

The *administrative institutes* assume the responsibility;

- to keep records, to list the choices of investments,
- to provide financial information,
- to collect the directions from participants and beneficiaries,
- to instruct the *trustee* to invest following the participants’ directions, and

- to decide beneficiaries.

The Law prohibited the *administrative institutes* from;

- promising participants to compensate all of or a part of their losses,
- promising participants special advantages or benefits,
- misleading participants intentionally,
- providing specific choices of investments in order to bring benefits to others than the participants,
- advising participants to invest in specific financial products, and so on.

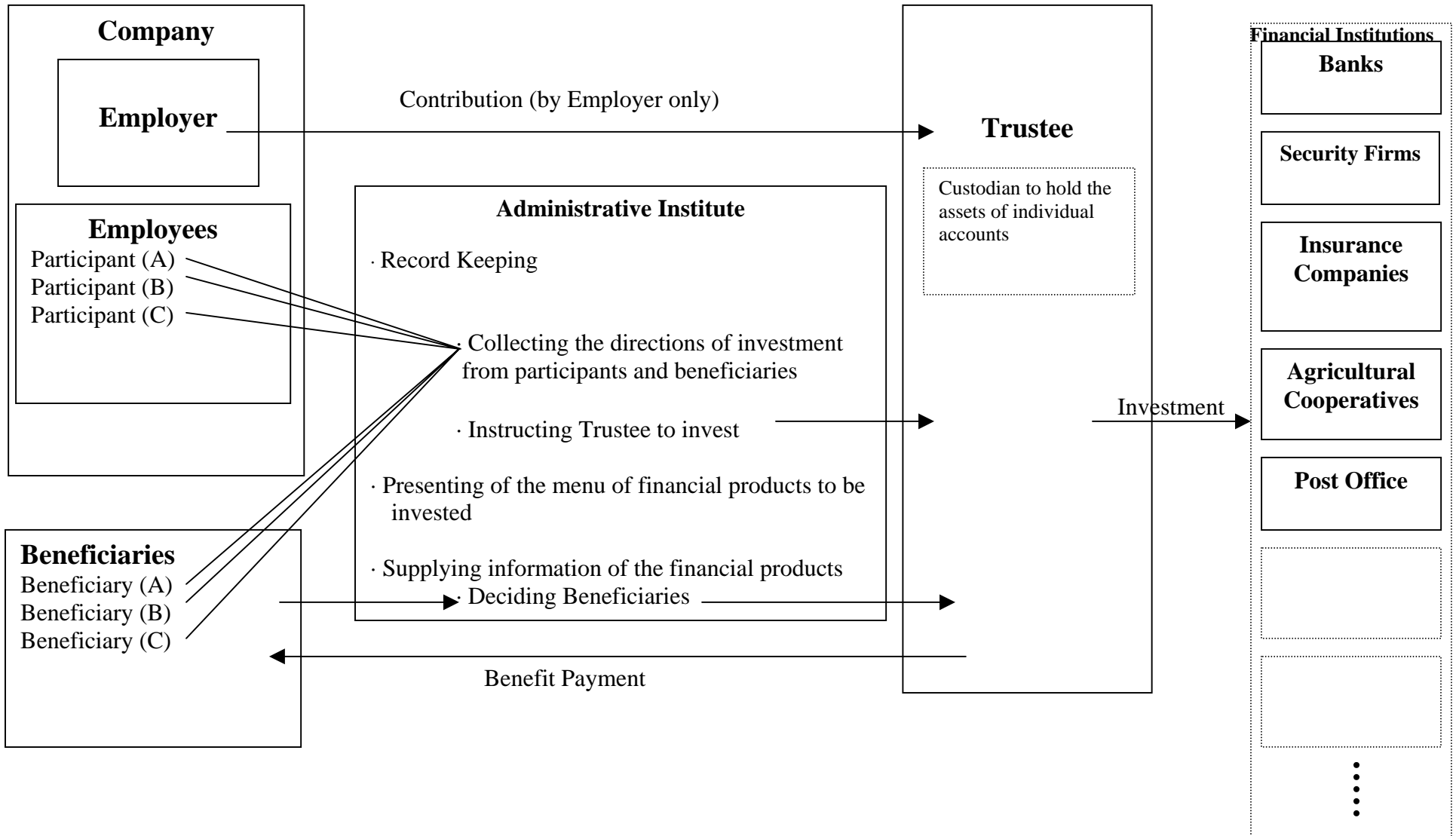
The *trustee* assumes the role of the custodian to hold the assets of individual accounts of the participants and of benefit payment to the beneficiaries.

If the plan meets the requirement of *the DC Pension Law*, it will be also qualified to have some tax advantage as below.

- Employer contributions are not included in participants' taxable income.
- Subject to certain limitations, the employer is entitled to deduct contributions at the time of making to the plan.

The basic scheme of Corporate-type DC pension plan is on the next page.

Basic Scheme of Corporate-Type DC Pension Plan



2.2 Participants

In the case of establishing the DC plan or modifying it, the employer should get the agreement with the labor union or the majority of the employees. This agreement between employer and employees could be the most basic character of the DC pension plans in Japan.

Employer can provide the rules as to who are the eligible employees. But the provision should not be discriminative in comparison with the other retirement payment plans that are already offered by the employer.

In addition, the Law regulates that the participants should be under the age 60. This is because the participant can apply for the benefits when it reaches age 60 and over.

The Law does not require the minimum coverage of employees.

2.3 Vesting

Regarding the employer's contribution, the participant should become 100% vested at the time when the participant has served for three years. In other words, all of the assets in the participant's account should be transferred to the account of other DC pension plan if it has worked for three years or more to resign.

According to the new *DC Pension Law*, employer can set the provision that all of or a part of the assets in the individual account of participant can be refunded to the employer if the participant has worked for less than three years at the time of its resignation. In order to set this kind of provision, of course, the employer should have an agreement with labor union or the majority of the employees.

2.4 Contribution

Under *the DC Pension Law* and the Tax-Code, different limits apply by the contribution sponsor. All of these contributions are deductible.

2.4.1 Corporate-type DC plan

- The contribution limit to the individual account is 18,000 yen⁹ per month (216,000 yen per year) if the employer offers the qualified DB pension plan in addition to DC plan.
- The contribution limit is 36,000 yen per month (432,000 yen per year) if the employer offers no qualified DB pension plan.

⁹ 1 dollar = 132 yen as of Jan. 31, 2002.

· It is prohibited for employees to contribute to their own accounts under the Corporate-type DC pension plans.

2.4.2 Individual-type DC plan (for reference)¹⁰

· Employee may spontaneously establish the account of DC pension plan only if its employer offers neither DB pension plan nor DC pension plan. In this case, the contribution limit is 15,000 yen per month (180,000 yen per year).

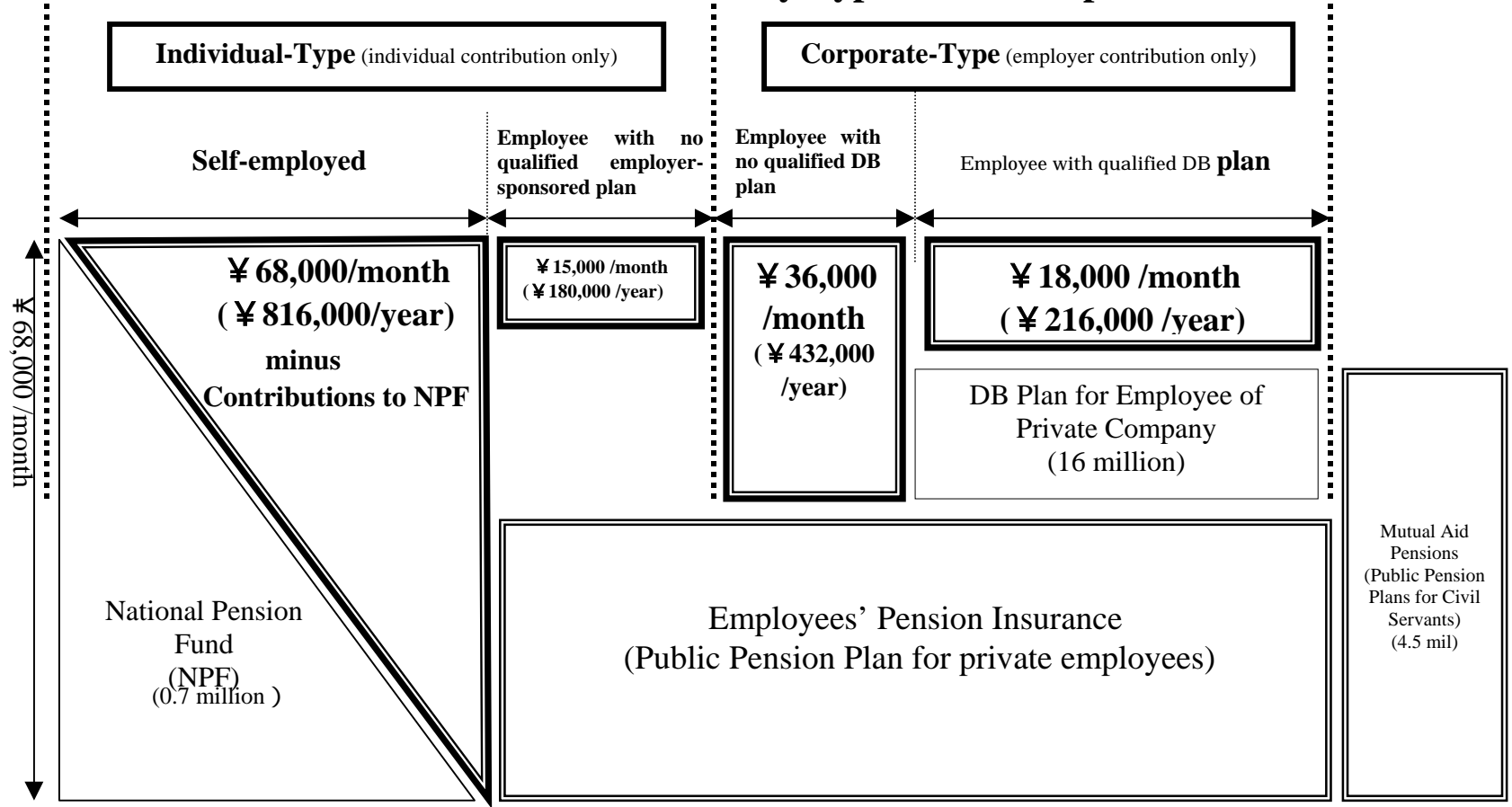
· Self-employed may establish the account of DC pension plan. The contribution limit for self-employed is 68,000 yen per month (816,000 yen per year). This figure applies to the sum of the contribution to DC pension plan and that to *the National Pension Fund (NPF)*¹¹ if he/she joins it.

The detailed table is attached on the next page.

¹⁰ See section 3.3 (p.28).

¹¹ See section 1.1.2 (p.6).

Limitation of Contribution to DC Plans by Type and Participant



Basic Pension (National Pension) (Public)

Dependent Spouse
(12 million people)

Self-employed
(20 million people)

Employee
(39 million people)

2.5 Plan Distribution

2.5.1 Timing

The DC Pension Law defines the timing of distributions of DC pension plans. The benefits are distributed only when;

- **the participant reaches age 60 or over,**
- **the participant turns to be disabled, or**
- **the participant deceased.**

The beneficiary may choose not to apply for the distribution when it reaches age 60 or over. It is prohibited that distribution begins before the participant reaches age 60, turns to be disabled or dies.

The participant can apply for the benefits on and after its birthday of 60 years old. Although it can retain the application even after the 60th birthday, the benefits distribution must begin before the time when it reaches age 70.

Early distribution should be considered as the violation of *the DC Pension Law* and Tax Code. The plan with the provision of early distribution must not be qualified. The *administrative institute* that decides the early distribution should be penalized by suspension from operation for less than 6 months or by cancellation of its registration.

Under the Japanese Tax Code, in general, there is no concept of the penalty tax as that of the United States. So there is no provision like the 10% penalty tax on early withdrawal in the US.

2.5.2 Form

1) Benefits for Elderly

The distribution to those who is age 60 or over should be in two forms, i.e., annuity or lump sum. According to the Law, annuity payment is defined as the primary distribution form. A lump sum form is available only if the DC pension plan agreement between employer and employees has the articles that allow the plan to distribute in lump sum form.

2) Benefits for Disabled

The ways of distribution to the participant who turns to be disabled are just the same as those to elderly.

(3) Benefits for Decease

The distribution to the survivor should be in the form of lump sum.

2.6 Assets and Investment

Three or more choices of investment should be presented to the participants of the DC plan. The participant can direct the investment through *the administrative institute* at least once during three months. *The administrative institute* collects those directions from participants and beneficiaries to instruct *the trustee* to invest. *The trustee* assumes the role of the custodian to hold the assets of individual accounts.

Under *the DC Pension Law*, the qualified Corporate-type DC plan may offer the employer's stock or bond as one of the choices for investments. In order to do so, however, the employer should have an agreement with the labor union or the majority of the employees. In addition, the plan should offer at least three other choices than the employer's stock or bond.

The employer's stock or bond can be chosen by participants but not automatically.

2.7 Portability

There are provisions for portability under *the DC Pension Law*.

2.7.1 From Corporate-type to Corporate-type

When a participant of qualified employer-sponsored DC pension plan moves to a new company *with* qualified DC pension plans and gets eligibility, all the assets in its account of previous plan are transferred to the new DC plan.

2.7.2 From Corporate-type to Individual-type

When a participant of qualified employer-sponsored DC pension plan moves to the company *without* DC plan or turns to be self-employed, its all assets in the account of previous plan should be transferred to the Individual-type DC pension plan.

If the participant does not apply to the prior trustee for transferring its amount within six months after it leaves the company, the fund is obliged to be transferred to *the Association of National Pension Funds (AFPN)*¹² which generally manages the account of Individual-type DC Plan.

¹² See section 3.1 (p.25).

2.7.3 From Individual-type to Corporate-type

When a worker who has its account in the Individual-type DC plan changes the job and turns to be a participant of Corporate-type DC plan, all the assets must be transferred to the new Corporate-type DC plan.

2.8 Taxation

2.8.1 Contribution

The employer that offers the qualified plans can deduct its permissible contribution to these plans¹³. The participant does not have to include the employer contribution in its income at the time the contribution is made.

2.8.2 Assets and Investment Earnings:

“*Special Corporate Tax*” is imposed on the assets of DC pension plans even though they are “qualified”.¹⁴

2.8.3 Distribution

In general, a certain portion of the amounts distributed is deductible. According to the Tax Code, the ways of taxation are different by the benefits type and by the form of distribution. For any types of benefits, the taxation can not be deferred.

1) Benefits for Elderly

In the case that the benefit is distributed in annuity form, the way of taxation is the same as that of the public pension benefits and the qualified DB plans benefits. If the benefit is distributed in lump-sum form, the way of taxation follows that of the lump-sum retirement payment.

2) Benefits for Disabled

Benefits for disabled should not be taxed regardless of the distribution forms.

3) Benefits for Decease

Benefits for decease should be distributed in the form of lump-sum payment and the Inheritance Tax is imposed on it¹⁵.

¹³ See section 2.4.1 (p.17).

¹⁴ See section 1.5.2 (p.10).

¹⁵ See section 4.1 (p.31).

2.9 Transition to the DC Plan

As mentioned in Chapter 1¹⁶, there have been lump-sum retirement payment schemes and defined benefit pension plans, both of which are now prevalent in Japan.

After the enforcement of *the DC Pension Law* in October 2001, some of major companies and small and medium sized companies may introduce the Corporate-type DC plans. Aside from the small and medium sized companies that do not offer any retirement payment plans, most Japanese companies may consider the transition from the existing retirement payment schemes to the DC plans if they want to introduce the DC plans. Very few companies may additionally introduce the DC plans while maintaining the existing retirement payment schemes in terms of the amounts of benefits.

In addition to the enactment of *the Defined Benefit Corporate Pension Law* and *the Defined Contribution Pension Law* in 2001, Japanese companies endeavor to review and restructure their whole compensation systems in order to remain in the worldwide competitive markets. The executives of the Japanese firms are considering that the restructuring of compensation is not only the way of lowering costs but also one of the most important management strategies for revitalizing its human resources, recruiting talented workers and retaining them.

In these circumstances, it is very much important to provide the rules of transition from the existing schemes to the DC plans.

Under *the DC Pension Law*, all of or a part of the assets of the existing lump sum retirement payment schemes or DB plans can be transferred and allocated to the individual accounts of Corporate-type DC plans. The outlines are;

- 1) Only the employer's contribution that has been made can be transferred to the DC plan. The employee's contribution is not allowed to be transferred because the Corporate-type DC plan should be contributed only by the employer.
- 2) In the case of dissolution of the existing DB pension plan, whole assets may be transferred to the newly established DC plan within the limitation as mentioned at 5), the bottom of this section. In case of diminishing the existing DB plan, the remaining DB plan should be fully funded before the residual assets can be transferred to the DC plan.
- 3) In case of abolishing or modifying the existing lump-sum retirement payment schemes, the necessary assets should be transferred evenly for 3-7 years. This term of the transfer is to be decided on the agreement between employer and employees.

¹⁶ See section 1.1.1 (p.4)

- 4) The amount of transferred assets should not be considered as the income. What this means is that the transfer is exempt from taxation.
- 5) Regarding the allocation of the transferred assets to the individual account, *the DC Pension Law* sets the limitation, which is calculated as if the maximum contribution had been made by the employer while the participant were hired. The interests should also be taken into consideration.

2.10 Borrowing or Withdrawal

There is no provision in *the DC Pension Law* to allow the participant to borrow or withdraw any amounts from the DC plan. This is because *the DC Pension Law* is required to accord with the Japanese Tax-Code.

In the traditional context of the Japanese Tax-Code, the withdrawal or borrowing from the retirement plans which can defer the taxation should be considered as receiving a kind of benefits before retirement.

If you refer to *the DC Pension Law*, you can find the first provision that the purpose of this law is to support the initiatives of the people to secure their income *after* retirement. In this context, the Tax-Code allow the tax-deferred contribution to the DC pension plans just as well as to the DB pension plans. What this means is that Japanese employees can receive the benefits only *after* attainment of age 60 which is considered as the normal retiring age for most employees.

It is the same in the case of the participants of Individual-type DC pension plan.

3 Individual-Established Retirement Accounts (Individual-type)

3.1 Basic Scheme of Individual-type DC Plan

First of all, *the Association of National Pension Funds (ANPF)*¹⁷ should make a total provisions of Individual-type DC plan and get the approval from the Minister of Health, Labor and Welfare.

All the individual accounts should be established in the ANPF. The ANPF should be responsible for supervising individual accounts in general. For example, checking the amount of contribution, confirmation of the payment of the public National Pension premium¹⁸. It will be also responsible for the benefit payment to the beneficiaries.

At the same time, the ANPF should have the primary responsibility as *a trustee* or a custodian. In this context, the ANPF could be considered one of the fiduciaries. The Law, however, allows it to entrust these roles to some financial firms.

The ANPF is required by *the DC Pension Law* to nominate *the administrative institutes* to keep records, to list the choices of investments, to collect the directions and instruct ANPF or the financial institutes to invest, to provide financial information, and to decide beneficiaries¹⁹.

¹⁷ National Pension Funds (NPF) is to provide the supplement plan to the public pension for self-employed (see p.6). ANPF was acting for the payment of pension or lump sum for self-employed who seceded from the NPF before retirement but was entitled to receive the payment.

¹⁸ See section 1.7.2 (p.13).

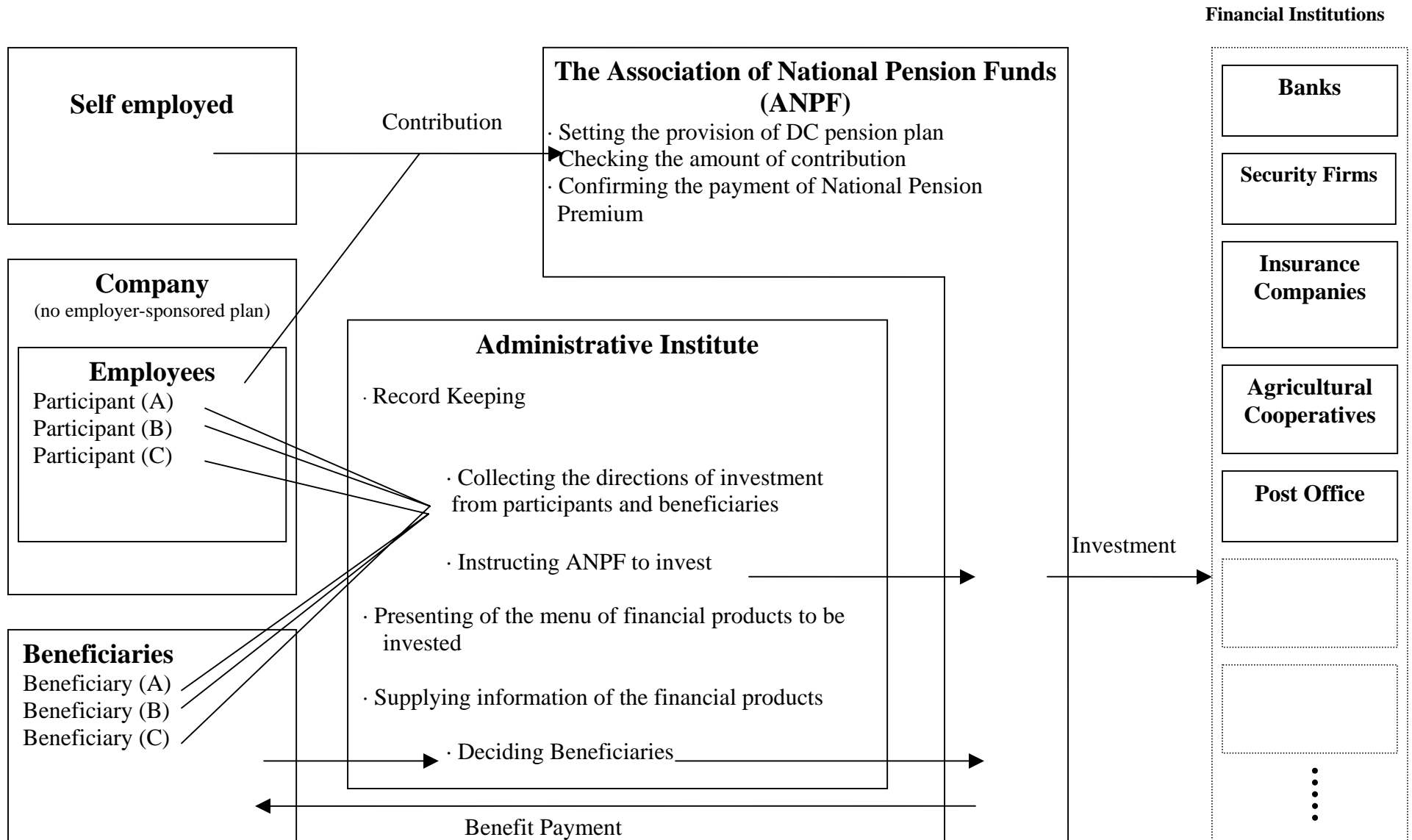
¹⁹ Regarding *the administrative institutes* for the Individual-type DC plans, *the Law* has a special provision that the Japanese Government can assume the role of *administrative institute*. This is because the national *Post Office* may be *the administrative institute* for Individual-type DC plans.

The Law prohibited *the administrative institutes* from;

- promising participants to compensate all of or a part of their losses,
- promising participants special advantages or benefits,
- misleading participants intentionally,
- providing specific choices of investments in order to bring benefits to others than the participants,
- advising participants to invest in specific financial products, and so on.

The basic scheme of Individual-type DC pension plan is on the next page.

Basic Scheme of Individual-Type DC Pension Plan



3.2 Participants

The person as below is permitted to establish the individual account in the Individual-type DC pension plan.

- Employee who is working at the company that offers neither qualified Corporate-type DC plan nor qualified DB pension plan
- Self-employed who pays the premiums for the public “*National Pension*”

In other words, employee with any kind of qualified employer-sponsored pension plan, dependent spouse, and central and local governments worker are prohibited from establishing the accounts of Individual-type DC plans. Dependent spouse is defined as those whose annual income is less than 1,300,000 yen.

3.3 Contribution

3.3.1 For employee with no employer-sponsored pension plan

The employee can establish the account of Individual-type DC plan only if its employer offers neither qualified DB plan nor Corporate-type DC plan.

For the employee who establishes the account of Individual-type plan in *the Association of National Pension Funds (ANPF)*, the employee can contribute by paying to the ANPF by itself or through the payroll deduction program. It is not allowed by *the Law* for the employer to refuse the payroll deduction if the employee applies. Under the deduction program, the employer can deduct the amount contributed in the previous month from the current month payroll of the employee.

Contribution by the employer to the Individual-type DC plan is prohibited.

The limit of contribution is 15,000 yen per month (or 180,000 yen annually)²⁰, which is deductible.

3.3.2 For self-employed

Self-employed can also establish the account of Individual-type DC plan.

Contribution to the account should be made with the payment of the premium of the public “*Basic Pension (or National Pension)*”²¹. In other words, self-employed must pay the premium of the public pension if it want to contribute to its account of Individual-type DC plan.

²⁰ See p.19.

²¹ See section 1.7.2 (p.13).

The limit of contribution is 68,000 yen per month (or 816,000 yen annually)²² unless the self-employed contributes to *the National Pension Fund (NPF)*²³. If it contributes to NPF, this limit (68,000 yen per month) is applied to the sum of the contribution to DC plan and that to NPF. The contribution to the Individual-type DC plan is deductible.

3.4 Distribution

The distribution of the Individual-type DC plan is defined as the same as that of Corporate-type DC plan²⁴.

And it is prohibited to withdraw or borrow from the individual accounts at any time or in any form before the distribution of benefits.²⁵

3.5 Portability

When the participant leaves the company that offers Corporate-type DC plan and turns to be self-employed or the employee of the company which offers no employer-sponsored pension plans, the participant can transfer the amount accumulated to the account of Individual-type DC plan. Similarly, the funds in the account of Individual-type DC plan can be transferred to the account of Corporate-type DC plan when the participant turns to be the participant of qualified Corporate-type DC plan.²⁶

3.6 Taxation

3.6.1 Contribution

The contribution to the account under the Individual-type DC pension plan can be deducted from the taxable income. The limitation of the deduction is the same as the limitation of the contribution to the Individual-type DC plan.²⁷

3.6.2 Assets and Investment Earnings

There is the taxation on the assets of the Qualified DB and DC pension plans. Basically, each pension plan is required by the Tax-Code to pay 1.173% of the amount of assets at the

²² See p.19.

²³ See section 1.1.2 (p.6).

²⁴ See section 2.5 (p.20).

²⁵ See section 2.10 (p.24).

²⁶ See section 2.7 (p.21).

²⁷ See section 3.3 (p.28)

end of the taxation period as the “*Special Corporate Tax*”. Even “Individual”-type DC plan should do the same.²⁸

3.6.3 Distribution

Participants of the qualified private plans may be eligible for tax exempt for the distribution. Under the Individual Income Tax Law of Japan, the benefits from the public pension and qualified private ones can be deducted to a large extent.

The ways of taxation are different by the form of benefits distribution. These are the same as those for the Corporate-type DC plans.²⁹

²⁸ See section 1.5.2 (p.10).

²⁹ See section 2.8.3 (p.22).

4 Inheritance, Transfer and Attachment

4.1 A Beneficiary in the event of Death

The list of those who can be a beneficiary is following;

- 1) Spouse
- 2) Children, Father/Mother, Grand Children, Grand Father/Mother, Brothers/Sisters who was dependent of the participant at the time of death of the participant
- 3) Relative other than above that was dependent of the participant at the time of death
- 4) Children, Father/Mother, Grand Children, Grand Father/Mother, Brothers/Sisters who was *not* dependent of the participant at the time of death

The priority to receive follows the order above.

The participant can designate someone among spouse, children, father/mother, grand children, grand-father/mother and brothers/sisters as the beneficiary and register it at *the administrative institutes* of the DC plan when the participant is alive.

The benefit for decease of the DC plan account owner is to be considered as the inheritance of the survivor who receives the benefit. This survivor should follow the general Tax Code to pay the inheritance tax on the total amount of inheritance that includes the benefit for decease of DC plan. There is no special consideration for the taxation on the benefit for decease under the DC plan.

These rules apply to the case of both the Corporate-type DC plans and the Individual-type.

4.2 Transfer to Others

Any parts in the account of DC plans can not be transferable to others. It is prohibited for the participant to assign the receipt right to others, or to give it as security. However, the authorities can attach the right of the benefit for elderly and decease if the participant did not pay the national taxes.

4.3 Attachment by Employer

Usually, the Japanese traditional lump-sum retirement payment schemes and the qualified DB pension plans have the rules to attach funds in the case of criminal acts or contract breach by the employee.

But, under the case of the qualified DC pension plan, the employer may set those provisions to attach the funds only if the participant has served with the company for less than three years. The participant should be 100% vested at the time when it has served for three years.³⁰

In order to set up those provisions, the employer should make an agreement with the labor union or the majority of the employees, and should obtain an approval of the Minister of Health, Labor and Welfare.

³⁰ See section 2.3 (p.17).

5 Investment/Fiduciary Provisions

5.1 Participant Directions

Under *the Defined Contribution Pension Law*, all of the individual participants both in Corporate-type plans and in Individual-type plans are permitted to direct their investments of amounts accumulated in their accounts.³¹

Basically, the employer should make the agreement with the labor union or representatives of the majority of employees regarding the provisions of respective DC pension plan. *The DC Pension Law* requires that these provisions must include the designation of *the administrative institutes* to present the menu of choices for the participant to invest the amount of its individual account. The employer may assume the role of *the administrative institutes*.

The administrative institute is required to list three or more financial products, among which at least one should be the product that secures the principal. If specific security, such as the employer's stock, is listed as a choice of investment, the menu should contain three or more financial products other than that specific security.³² On this occasion, the designated *administrative institutes* should follow the two rules;

- 1) One is *the DC Pension Law*, in which categories of financial products are listed as qualified to invest.
- 2) The another is the provision of each DC pension plan. The plan provision is required to include the rules of investment.

The administrative institutes collect the directions from participants to invest in the financial products and instruct *the trustees* or the ANPF which have the custody of assets of individual accounts.

The participant can direct its investment at least quarterly.

5.2 Investment, Record-keeping and Other Plan Services Provision

In general, two institutes provide these plan services. One is *the administrative institute*, which provides the services of record-keeping, presenting the menu of choices for employees to invest, information of the financial products and assets, providing education for employees, and so on. The another is *the trustee*, which has the custody of the financial assets as the participants'.

³¹ See p.16 & p.27

³² See section 2.6 (p.21).

The employer and the labor union should set an agreement with the provisions of DC pension plan before starting it. The agreement is required to designate *the administrative institutes* and *the trustee*.

The administrative institutes' services can be provided as a bundled service or unbundled services. In addition, the employer may assume the role of *administrative institutes* if the labor union agrees.

For self-employed or employee with no employer-sponsored qualified pension plan, *The Association of National Pension Funds (ANPF)* plays the role as a *trustee*.

5.3 Fiduciary Liability

Under the Corporate-type DC plans, the employer, *the administrative institutes* and the *trustee* are considered as the plan fiduciaries. Regarding the matters of the plans, all the fiduciaries are required to act exclusively on behalf of the participants and the beneficiaries, not for the third persons or parties. However, at the same time, it is prohibited by *the DC Pension Law* for *the administrative institutes* to make up or promise to make up the losses that result from the participants' directions of investments.³³ In this context, the fiduciary liabilities seem to be limited because participants direct the investments.

5.4 Information for Investment

In order to help the participants to direct their investments, *the administrative institutes* are able to present general information about investments, financial products, assets allocation on behalf of the employer who is primarily required by *the Law* to try to do so. This service can be considered as the investment education for participants.

In addition, *the administrative institutes* should present to the participants the particular information of the respective financial products listed on the menu, such as;

- prospect of profits and possibility of losses
- formula of distribution of interests, dividend
- performance during the past 10 years
- commission
- applicability of the Deposit Insurance
- possibility of the loss of principal

³³ See p.15.

But, under *the DC Pension Law*, it is prohibited for *the administrative institutes* to advise a participant to invest or not to invest its amounts in a particular financial product that is listed on the menu unless the administrative institute is the registered investment advisory company.

5.5 Administrative Costs

Regarding the Corporate-type DC pension plan, *the DC Pension Law* requires that the employer should provide the way of the payment of the administrative costs of the DC pension plan with the agreement of the labor union or the majority of employees. For the Individual-type, the ANPF should do so.

In the Diet session of 2001, the Ministry of Health, Labor and Welfare declared that the administrative costs, i.e., direction cost, investment information fee, education service fee, would not be included in the amount of contribution.

(End)