Dear Mr. Biaggi:

This is in response to your letter dated June 6, 1975 concerning a suggestion made on behalf of the Uniformed Fire Officers Association of New York which would permit pension recipients to have the same flow-through treatment for tax-exempt income as is presently available for beneficiaries of a private trust. I apologize for the long delay in responding.

The purpose of the Association's suggestion is to encourage retirement plans to purchase tax-exempt bonds. It is not clear, however, how the flow-through treatment would operate. Assuming that all retirement plan participants, i.e., the current employees participating in the plan and the retirees in pay status, would share in the tax-exempt income, there would be complex accounting and recordkeeping problems. In the case of defined benefit plans, which do not maintain separate accounts for participants, there could not be an accurate allocation. In the case of defined contribution plans, where separate accounts for participants are maintained, records reflecting the allocation of tax-exempt income would have to be maintained for all participants until the termination of their rights.

It would be possible to restrict the flow-through treatment to retirees so that the benefit of tax-exempt income would immediately become available to plan participants. This approach, however, might limit the amount available for investment in tax-exempt obligations and result in some allocation problems.

Apart from the problems of allocating income and recordkeeping, it would appear that in the case of a defined contribution plan, the tax advantages of the Association's suggestion would not, from a participant's point of view, compensate for the lower yield on the tax-exempt obligations. A tax-qualified retirement plan accumulates funds on a currently tax-free basis. The higher yield on taxable obligations accumulated tax-free means that a substantially larger amount will be accumulated over a period of time, resulting in a greater net retirement benefit upon distribution (even with tax) than will be available with tax-exempt bonds and tax-free treatment upon distribution. Similarly, in the case of a defined benefit pension plan, the lower yield might produce lower pension benefits, particularly where contributions are fixed and benefits are based upon the available plan assets.

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Moreover, with flow-through treatment, taxpayers in the higher brackets would derive the greatest benefit since the higher the tax bracket, the less net after-tax dollars taxpayers will have if they receive a taxable distribution. As a rule of thumb, an individual will have to be in at least the 35 percent income tax bracket before it becomes advantageous for him to invest in tax-exempt obligations. Retirees, however, are generally in a much lower income bracket, in part due to the retirement income credit and additional personal exemptions.

I do appreciate the Association's suggestion and hope that this has been helpful to you.

Sincerely yours,

William E. Simon

The Honorable
Mario Biaggi
House of Representatives
Washington, D.C. 20515