TSG 06/12

Pensions Issues

Introduction

1. There are two main components to the pension system in Ireland. The "First Pillar" State social welfare system comprises contributory pension benefits for those who satisfy the PRSI contribution conditions and non-contributory pension benefits, which are subject to a means test, for those who do not qualify for contributory benefits. The "Second Pillar" system comprises three main types of private pension arrangement – public service "pay as you go" schemes, funded occupational pension schemes and personal pension arrangements. These private arrangements are voluntary in the sense that there is no legal obligation on employers to provide pension benefits for their employees or for individuals to effect any form of pension arrangements for themselves.
2. The State encourages individuals to supplement the State pension with private pension arrangements by offering generous tax reliefs on private pension provision. The tax relief arrangements for private pension provision are long-standing and have helped a significant proportion of the workforce to provide for supplementary pensions thus reducing the pressure on the Exchequer to fund pension needs. Over half of those in employment are currently covered by pension arrangements beyond the State pension arrangement and, while this proportion has not changed hugely, the absolute numbers covered have been increasing in recent years.
3. Tax relief takes the form of relief on amounts contributed to the pension schemes by employers and employees and on the amount of profits and gains generated by the investments held by the schemes. Benefits payable on retirement are taxable subject to an entitlement to take a tax-free lump-sum cash benefit. This system is known as the "EET" system of pension taxation, i.e. **exempt** contributions, **exempt** fund growth and **taxable** benefits. Essentially, contributions to pension investments are tax relieved on the way in and are allowed to grow tax free in the pension fund in the expectation that the pension benefit stream will be taxed on the way out. Fourteen out of the fifteen "old" EU member States operate the EET system and it is the preferred system from the point of view of the EU Commission.
4. The private pension system (excluding the public sector pay-as-you-go schemes) comprises occupational pension schemes and personal pension arrangements. The occupational schemes (comprising defined benefit and defined contribution schemes) are provided on a voluntary basis by employers for their employees and are funded either jointly by employers and employees or by the employer alone. Defined benefit (DB) schemes relate to the final year's salary of the employee while defined contribution (DC) schemes relate to the amount contributed and the investment record of the fund.

5. Personal pension arrangements consist essentially of Retirement Annuity Contracts used by the self-employed and more recently Personal Retirement Savings Accounts (PRSAs). These contracts and accounts operate like defined contribution schemes in that the risk of underperformance lies solely with the individual taking out the contract or account.

Developments in the pensions area over the past year

6. There have been a number of important developments in the pensions area in the past year. These include:

- the 2006 Budget and Finance Act which contained measures to restrict tax relief on pensions for high earners while encouraging supplementary pension provision for those on lower incomes,
- the publication of the National Pensions Review in January 2006,
- the publication of the Internal Review of Tax Relief for Pension Provision in February 2006 (part of the major review of Tax Incentive schemes)
- the publication in August 2006 of a report by the Pensions Board on a mandatory pension system entitled " Special Savings for Retirement", and
- the decision of the social partners to ratify the new social partnership agreement "Towards 2016", which includes commitments on pensions.

Review of tax relief for pensions provision and the 2006 Budget and Finance Act changes

7. A review of tax relief for pension provision was published in February 2006 as part of Volume III of the Review of Tax Schemes undertaken on foot of the Minister for Finance's announcement to this effect in Budget 2005. The review was one of a number of internal reviews of tax schemes carried out by the Department of Finance and the Revenue Commissioners.

8. The review gave rise to concerns that tax reliefs for pension provision were being or could be used by high-income earners in unintended ways. A number of cases came to light which indicated that some high-earners were placing very large sums into pension arrangements, taking out large lump sums tax-free and putting the rest into Approved Retirement Funds (ARFs) where tax could be deferred indefinitely.

9. While the Government has made clear its commitment to pensions incentives (tax reliefs on pensions cost almost €3 billion in 2002), the incentives must be targeted at arrangements for genuine pension provision.

10. The 2006 Budget and Finance Act introduced changes which limit the Exchequer cost in the case of tax relief for pensions for high-earners. Other changes were also introduced which were designed to encourage older people and those on lower incomes to commence or improve their pension arrangements. These changes are:

- A cap on the value of a pension fund allowable for tax purposes of €5 million (or, if higher, the value of the fund on 7 December 2005).

These values are to be adjusted annually from 2007 in line with an earnings index.

- A cap on the maximum value of the tax-free lump sum of €1.25 million which is 25% of the new maximum pension fund amount of €5 million. (This change was introduced by way of Financial Resolution with effect from Budget Day – 7 December 2005.)
- Approved Retirement Funds (ARFs) are funds managed by qualifying fund managers into which certain persons (i.e. proprietary directors, self-employed) can invest the proceeds of their pension fund. Any income or gains accrued in the ARF are exempt from tax but withdrawals are taxable at the ARF owners marginal tax rate. As announced in Budget 2006, an annual 3% imputed distribution is to apply to the value of assets in an ARF at the end of each year and will be taxable at the ARF owner's marginal tax rate. This measure is being phased in over a three year period commencing in 2007.
- An annual adjustment from 2007, in line with an earnings index, of the current annual earnings limit of €254,000 for contributions to pension products.
- A Pension Incentive Credit to encourage SSIA holders on lower incomes to put some or all of the proceeds of their accounts on maturity into a pension product. For each €3 invested in a pension product, the Exchequer will contribute €1 (to a max of €2,500) together with a proportion of the exit tax deducted from the SSIA on maturity.
- An increase in the rate of age-based tax relief for pensions contributions to all pension products for contributors aged 55 years or over (i.e. from 30% to 35% of net relevant earnings/remuneration for those aged 55 or over but under 60; and from 30% to 40% of net relevant earnings/remuneration for those aged 60 or over).

National Pensions Review

11. The National Pensions Review (NPR) report by the Pensions Board was published by the Minister for Social and Family Affairs in January 2006. The purpose of the NPR was to review the current national pensions system with particular reference to the targets set out in the National Pensions Policy Initiative (NPPI) completed in 1998. The NPPI formulated a strategy incorporating targets and recommendations for a fully developed national pensions system.

12. The main targets recommended in the NPPI report for retirement income were for :

- a target replacement income of 50% of pre-retirement income before tax
- an overriding minimum income of 34% of gross average industrial earnings (GAIE)

NPPI also concluded that in order to achieve the replacement income target, supplementary pension coverage would be needed for 70% of the working population aged over 30 by the year 2013.

13. In the NPR , the majority of the Pensions Board supported the NPPI targets of 50% of pre- retirement earnings to secure income adequacy in retirement and of 34% of GAIE as the minimum target for the Old-age contributory pension. The Board also accepted the NPPI coverage target of 70% of the working population over 30 years of age by year 2013.

14. The NPR highlighted the fact that considerable progress had been made by budgetary increases towards the NPPI target of 34% of GAIE for "first pillar" pensions and to ensuring long-term sustainability through the National Pensions Reserve Fund. However, the NPR concluded that supplementary pension coverage (at 59% - according to a 2004 CSO survey) was insufficient and a cause for concern, in particular for women and the lower paid. The NPR acknowledged that the significant increase in the workforce in recent years made the "coverage" percentage lower than it would otherwise have been and that nearly twice as many people have supplementary provision today compared to 1995.

15. As part of its examination of the strategic options for achieving the NPPI targets, the Pensions Board examined 5 wide-ranging pensions systems in depth as potential alternatives to the existing arrangements. Briefly, these were:

(i) a system similar to the current pension system but with tax relief on supplementary pensions provided at the top 42% income tax rate for lower rate and non-taxpayers,

(ii) a system with mandatory contributions (at 10% ; split 50:50 between contributors and employers) to a private sector financial institution for earnings between the current PRSI threshold and twice GAIE,

(iii) a mandatory system similar to (ii) but with contributions paid to a State defined contribution arrangement,

(iv) a mandatory system paying benefits based on average career earnings (with relevant earnings for contributions being the same as in alternative (ii) above), and

(v) increasing the old-age contributory pension to 50% of GAIE with the required long-term contribution rate calculated separately from the PRSI contribution rate.

The Pensions Board did not recommend any one of these alternatives over the other but set out the most notable points emerging from the NPR examination of these various alternatives which were:

- with the exception of alternative (iv) the projected benefits would be considerably less than the NPPI replacement income targets,
- alternative (v) and in particular alternative (iv) would involve a considerable increase in total pension contributions from current levels, and
- any increase in pensions contributions will have the effect of reducing GNP growth and increasing unemployment with alternatives (iv) and (v) showing the greatest projected impact in this regard.

16. The NPR favours a number of changes to the voluntary system of supplementary pension provision with the aim of enhancing its attraction to the public. Among the changes suggested by the NPR is that the State incentive for PRSA personal contributions should be provided by means of a matching contribution of €1 for each €1 invested (subject to a maximum amount). For other forms of supplementary pension provision, tax relief at the higher (42%) rate for all personal contributions is recommended. The cost to the Exchequer of implementing these recommendations would be very considerable.

"Special Savings for Retirement" – a report on issues associated with the introduction of a mandatory pension scheme

17. This report by the Pensions Board was published in August 2006 having been requested by the Minister for Social and Family affairs as a follow-on to the NPR published six months earlier. The report comprises a *technical* examination of the practical issues associated with the introduction of a mandatory pension scheme.

18. The Pensions Board considered a number of different mandatory pension scheme options which are detailed in the report. Briefly, these were:

- an increase in the State Pension to 50% of GAIE,
- a mandatory supplementary model with a 15% contribution rate (including a 5% Exchequer contribution in lieu of tax relief),
- a "soft" mandatory / automatic enrolment scheme with opt-out (9% contribution rate), and
- a "hybrid" model combining an increase in the State Pension to 40% of GAIE and a mandatory supplementary system for those at work who are not making supplementary provision (15% contribution rate including 5% Exchequer contribution)

19. The last model described above (the "hybrid") was recommended by the report as the most appropriate and practical approach to improving the position of pensioners in Ireland by means of a mandatory system (the report does not make a recommendation for or against the introduction of a mandatory system as there was no consensus among the Pensions Board on this issue.)

20. The report confirms that substantial costs would arise from the implementation of the "hybrid" mandatory model even if introduced on a phased basis. Economic analysis from the ESRI and a firm of economic consultants which is included in the report highlights the potential for significant adverse economic consequences for competitiveness, employment and GNP from all of the "hard" mandatory options examined.

21. The Pensions Board identified a number of key principles which a mandatory pension system should satisfy, including:

- It must not damage existing supplementary pension provision,
- Both adequacy and coverage targets should be met, and
- An examination of costs and economic impacts

22 The favoured ("hybrid") option of the report may have difficulties in meeting the criteria outlined above.

New social partnership agreement "Towards 2016"

23. A number of major themes recur through the various reports and developments detailed above. These include the issue of the **adequacy** of post-retirement income particularly for those currently on lower rates of pay, the extent of the **coverage** of supplementary provision across the working population and the **cost** and **economic impact** arising from any changes which may be considered to improve the pension adequacy and coverage situation.

24. The recently ratified agreement between the social partners ("Towards 2016") includes commitments in relation to future pensions policy. In particular, the Government is committed to producing a Green Paper on Pensions Policy outlining the major policy choices and challenges in this area. The Green Paper, which will be prepared by the Department of Social and Family Affairs, will take account of the views of the social partners. Other Departments, including the Department of Finance and the Department of Enterprise, Trade and Employment will also be involved in the Green Paper process. The Government is also committed to responding to the consultations arising from the Green Paper with a framework for addressing the pensions agenda over the long term. This framework is to be developed within 12 months of the ratification of the new social partnership agreement.

25. "Towards 2016" also includes a number of other specific commitments in the pensions area including;

a. an examination of the annuity market and funding standards,

b. the production by the Pensions Board of guidance on hybrid forms of defined benefit/defined contribution schemes, and

c. the development of options by which the provision of pensions under the Transfer of Undertakings Directive could be transposed into Irish law (consideration of this issue to be finalised by end-

2007). The issue here involves the options for transposing into Irish law the responsibilities for pension provision in the Transfer of Undertakings Directive in situations, for example, where one company takes over another company (or a part of a company). The views of the trade unions and the employer groups differ considerably on this issue.

Other issues relating to taxation and pensions

26. There are a number of other more immediate issues concerning taxation and pensions which are under consideration by the Department in the context of the 2007 Budget and Finance Bill, some of which have been raised by the Revenue Commissioners and by other organisations and individuals. These issues include:

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(b) **XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXX**

(c) **XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX**

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(d) Standard approval conditions for Occupational Pensions Scheme "products": Current legislation obliges Revenue to approve all occupational pension schemes in order that both the scheme and the contributor can avail of tax relief. In contrast, in the case of personal pensions i.e. retirement annuity contracts and PRSAs, Revenue approve the terms of a standard contract with the Life Office or PRSA provider which can then be marketed to individuals without the need for further Revenue approval of each individual contract. Many occupational pension schemes are standard single member insured schemes administered by Life Offices. For reasons of administrative efficiency, Revenue are proposing that the law be amended so that in future where such schemes use standard documentation approved by Revenue and where contributions (both employer and employee) do not exceed the age-based % limits for tax relief, the schemes will qualify as exempt approved schemes for tax purposes without the need for individual Revenue approval.

(e) Joint-life ARFs : It has been pointed out that prior to the introduction of ARFs, when the purchase of annuities was compulsory , a Joint-Life annuity could be purchased whereby the annuity (or a reduced annuity, as appropriate) would remain in payment to the surviving spouse on the death of the pensioner. In those circumstances, the spouse did not suffer an interruption in the flow of pension funds from the joint annuity. However, there is no provision for an ARF to be taken out in joint names. When an ARF owner dies there is no automatic reversion to a spouse as the ARF is personal property and must pass through the estate. Even if the ARF has been left by way of the owner's will, the administration of the estate may take some time and the availability of income to a spouse

and dependants could be interrupted. There may be tax issues which would get in the way of allowing joint-life ARF arrangements, in particular in the case of non-spouse relationships. This matter would require very careful consideration.

(f) **Right of spouse to ARF pension fund in the event of death of pension fund beneficiary;** Instances can arise where a person eligible to take out an ARF dies before the process of transferring the pension fund into an ARF can be effected. In these circumstances, the bulk of the pension fund would compulsorily be used to purchase an annuity for the spouse. If the pension fund beneficiary had died after transferring the fund into an ARF, his or her spouse would in due course become the owner of the ARF and be able to deal with the investment as his or her property. The case is being made that in such circumstances, the spouse should be allowed to ARF the pension fund. The significant issue here is that in allowing for such a development, the scope of the definition of those entitled to take out an ARF would be considerably widened, leaving the way open for further widening down the road.

(g) **XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXX**

27. The TSG may wish to consider the various issues raised in this paper.