TSG 09/21

Pension Taxation

Introduction

1. The overall objectives of our pensions system are to provide a basic standard of living in retirement through direct state supports (the Social Welfare or State pension) and to encourage people to make private pension provision to supplement the State pension.

2. The State encourages individuals to supplement the Social Welfare pension with private pension arrangements by offering tax reliefs on private pension provision. These tax relief arrangements have helped a significant proportion of the workforce to provide for supplementary pensions for their retirement. It is estimated that over half of those in employment are covered by supplementary pension arrangements. There is also, however, a significant proportion of the workforce who currently make no supplementary pension provision.

Background

3. Tax relief on supplementary pension provision takes the form of relief on amounts contributed to occupational pension schemes by employers and employees and to personal pension plans by the self-employed. Tax relief on employee contributions to approved occupational pension schemes and individual contributions to personal pension plans is provided at the taxpayer's marginal income tax rate. Employee contributions also benefit from relief from PRSI and the Health Levy. Contributions by employers on behalf of employees are deductible in computing the income for tax purposes of the employer's business and are generally not treated as a benefit-in-kind in the hands of the employee. There is also relief on the amount of profits and gains generated by the investments held by the schemes and personal pension arrangements. Benefits payable on, or after, retirement are taxable subject to an entitlement to take a tax-free lump-sum cash benefit. Contributions in respect of investments in pensions are, therefore, tax relieved on the way in (subject to limits) 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.

4. The significant issues generally raised in connection with supplementary or private pension provision are in the areas of coverage, adequacy and the equity of the existing tax relief arrangements.

5. Targets for supplementary pension coverage across the workforce were proposed in the Pensions Board's National Pensions Policy Initiative (NPPI) report in 1998 and reaffirmed in the National Pensions Review in 2006. A

70% pensions coverage target was set for all employees over 30 years of age in the top 70% of the income distribution (on the basis that the State pension would provide an adequate replacement income for the remaining 30%). The latest CSO QNHS data for quarter 1 of 2008 indicates that:

- Pension coverage has remained largely static since the previous coverage figures (Q4, 2005). Coverage is now at 54%, down slightly from 55% (2005) but up from 52% (2002).
- NPPI set a target of 70% coverage for those in employment aged 30 to 65. The new figure for this group is 61%, down from 62% (2005) but up from 59% (2002).
- Pension coverage for employees aged less than 30 years remains low at 37%
- Pension coverage for female workers has increased significantly over the last number of years. In 2002, 45% of female and 57% of male workers had a pension. By Q1, 2008, the rate for female workers had increased to 50% and the rate for male workers was 56%
- The highest rate of pension cover is in the public administration and defence sectors at 93% where, typically, pension scheme membership is mandatory. Coverage is very low, however, in the hotel and restaurant sector (23%) and in the wholesale and retail trade (36%).

6. CSO data also indicates that the two main reasons why people are not investing in supplementary pensions are inertia and the fact that they cannot afford it.

7. There are also concerns that those already investing in private pensions are not investing enough to provide for an adequate replacement income in retirement. Issues to do with the investment performance of pensions funds over recent years may also be relevant in this regard but these are separate from the matters on which tax policy may have an influence. Moreover, the adequacy issues in relation to replacement income in retirement seem less amenable to direct influence through structural change and incentives in the tax system than coverage issues. In addition, while full data is not available to provide the statistical proof, the indications from the data that is available show that higher income earners and those paying tax at the higher marginal income tax rate benefit most from the existing tax relief arrangements for supplementary pensions. This latter issue relates to the equity of the existing tax relief arrangements.

Recent developments informing the debate on future policy

8. There have been a number of recent developments (some ongoing) that inform consideration of future policy in this area in the context of dealing with some of the issues mentioned above. These are the Green Paper on Pensions, the Commission on Taxation Report, the Renewed Programme for Government and the National Pensions Framework.

9. The **Green Paper on Pensions Report** (published in October 2007) outlined the challenges facing the Irish pensions system in the years ahead, including the sustainability of the system over the longer term in light of demographic change and the adequacy of contribution levels and benefits. Specific issues in relation to State pensions were also set out, as well as considerations in relation to key aspects of the system including tax treatment, security of pension provision, the regulatory regime, public service pensions and work flexibility in retirement. It also set out key questions to be addressed in formulating the Government's response to these challenges.

10. The key questions from a tax perspective included:

- Can tax incentives be better targeted to encourage improved coverage in a cost-effective way?
- Should the over-riding principle be coverage or equity and should incentives be offered at the marginal, standard or a hybrid rate?

A further issue covered in the Green Paper was a review of the estimated costs of tax and PRSI etc relief for supplementary pension provision. An estimate of the cost of the reliefs for 2006 (net €2.9 billion) was provided in Table 7.2 of the report (pps 106 and 107). An update of this table incorporating estimates of the 2007 costs (estimated at €2.6 billion) is at Appendix 1 to this paper.

11. Part 10 of the **Commission on Taxation** Report (published in September 2009) is devoted to tax incentives for retirement savings. This part of the Commission's Report contains 14 recommendations which are set out at Appendix 2 to this paper. The most significant recommendations, insofar as the issues already raised in this note are concerned, include:

- The <u>current tax relief</u> for personal retirement provision should, in the medium to long-term, be replaced by a matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer.
- The <u>matching contribution</u> should apply where an individual has relevant earnings including where, because of the level of his or her earnings, the individual is not liable to tax.
- A <u>soft-mandatory (auto-enrolment) approach</u> could make a significant contribution to increasing pension coverage and should be considered.
- A <u>retirement savings scheme</u> along the lines of the former SSIA scheme, that is easily understood and which involves an Exchequer contribution, should be considered.

12. A number of points should be noted in relation to these recommendations. Firstly, the Commission's Report states that the recommendation regarding a move to a matching contribution approach "is appropriate to a more stable economic and retirement savings environment than exists at the time of publication of our Report" (p.376.) The Report also states that "The focus of any new reliefs should be on those who are not currently saving for their retirement and on those who are not saving enough. Care is needed so as not to discourage those with existing savings for retirement from continuing to save." (p.391). A matching Exchequer contribution of €1 for every €1.60 contributed by an individual to pension savings is the equivalent of providing tax and PRSI etc relief of close to 38.5% under the existing arrangements.

Standard rate PAYE taxpayers paying employee PRSI and the health levy currently get relief at 28%, while higher rate PAYE taxpayers get relief at 49%[1]. Finally, while a soft-mandatory approach may solve the pension coverage problem (though opt-out is provided for), this would involve significant additional Exchequer cost.

13. In October 2009, following a review of the *Agreed Programme for Government 2007-2012,* the Government published its ***Renewed Programme for Government.*** The renewed programme includes a commitment in relation to the tax treatment of pensions to "introduce a single 30% rate for tax relief on private pension provision in the context of the national pensions framework." The detail of this commitment together with the complex logistical and consultative processes set out in paragraph 15 below will have to be examined in the context of the timing of this change.

14. Finally, a **National Pensions Framework** responding to the wide spectrum of issues raised in the Green Paper on Pensions is being finalised by the Department of Social and Family Affairs for submission to Government, possibly by Christmas. It is understood that the Framework will take account of the recommendations in the Commission on Taxation Report and of the commitment contained in the Renewed Programme for Government.

15. It is important to highlight the fact that, whatever the future changes to tax incentives for pension provision, any move away from the delivery of tax reliefs in the pensions area through the existing "net pay" arrangement[2] to a Tax Relief at Source (TRS) approach will involve fundamental reform and would give rise to significant administrative, technical and IT development costs and resource investment for both Revenue and other affected parties (i.e. companies, organisations and individuals concerned as well as the wider pensions industry) In addition, these changes would require a substantive consultation and change management processs and a significant lead-in time. Revenue tentatively estimate that it would take a minimum of one year to deliver.

Other issues in the pension taxation area

ARFs for All

16. There have been ongoing calls for an extension of the **Approved Retirement Fund (ARF) option** to all members of Defined Contribution (DC) occupational pension schemes in respect of the main retirement benefits from such schemes. Prior to the Finance Act 1999, any person taking a pension under a DC scheme or a Retirement Annuity Contract (RAC)[3] was required

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[1] PRSI relief does not arise in all cases due to the employee PRSI ceiling of €75,036.

[2] Under the existing "net pay" approach , tax and PRSI etc. relief is provided seamlessly to the PAYE members of occupational pension schemes in the sense that pension contributions for such employees are deducted from gross pay before applying tax and PRSI. This automatic granting of tax relief is generally only possible where relief is being granted at the standard income tax rate or at the higher 41%

to purchase an annuity with the pension fund moneys remaining after the drawdown of the appropriate tax-free lump sum.

17. The Finance Act 1999 introduced significant changes which gave a considerable degree of control, flexibility and personal choice to certain categories of individual in relation to the drawing down of benefits from their pension plans. These choices include the options to purchase an annuity, receive the balance of the fund in cash (subject to tax, as appropriate), to invest in an Approved Retirement Fund (ARF) or Approved Minimum Retirement Fund (AMRF)[4], as appropriate, or a combination of these. At present, these options are primarily available to personal pension holders (i.e. mainly the self-employed with RACs or Personal Retirement Savings Accounts - PRSAs), employees who have made AVC contributions (in respect of those contributions) and proprietory directors (i.e. 5% directors) who are members of occupational pension schemes.

18. In view of the considerable losses sustained by pension funds, generally, in 2007 and 2008 and combined with the then existing requirement on DC occupational pension scheme members to purchase annuities at the point of retirement, the Minister for Finance agreed in December 2008 to provide such scheme members with an option to defer the purchase of annuities. The period of deferral ends on 31 December 2010 so that a longer-term solution to the compulsion to purchase annuities is required. The Commission on Taxation Report recommends the extension of the ARF option to members of DC occupational pension schemes.

<u>PRSAs as alternatives to ARFs</u>

19. On a loosely related issue, there are some concerns that **migration from pension arrangements such as occupational pension schemes and RACs PRSAs are being recommended by pension providers** originally as a means of accessing the ARF option and more recently as an alternative to an ARF – the latter to avoid the tax on imputed or notional distributions from ARFs. Finance Act 2006 introduced the concept of a "notional distribution" from an ARF of 1% of the fund assets in 2007 rising to 3% in 2009 and susequent years. The notional or imputed distribution amounts are taxable at the ARF-owners marginal income tax rate. This was a response to a concern that ARFs were being used as long-term tax-exempt investment vehicles rather than as an alternative income stream to annuities.

20. PRSAs compare quite well with ARFs in many respects (PRSA assets are beneficially owned by the individual, 25% of PRSA can be taken as a tax-free lump sum, remaining benefits can be drawn down at the discretion of the owner between age 60 and 75 after benefit payments have commenced or, if owner chooses, funds may be left undisturbed until he/she reaches 75). In addition and unlike ARFs, there is no annual tax on imputed distributions and

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[3] RACs and PRSAs are personal pension arrangements used by the self-employed and by individuals in non-pensionable employment and, in character, are effectively defined contribution pension schemes.

[4] ARFs and AMRFs are not pension schemes, per se. They are investment options into which the proceeds of certain pension arrangements can be invested on retirement.

tax-relieved contributions to PRSAs can continue even after benefits have commenced (provided the owner has a source of relevant earnings).

21. The extent of this potential problem is still being looked at by the Revenue Commissioners.XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXX

<u>ARFs and non-residents</u>

22. A further issue concerning ARFs relates to the tax treatment of distributions out of ARFs to ARF-owners who are non resident for Irish tax purposes. In line with our "EET" system of pension taxation, Qualifying Fund Managers are required to deduct income tax at the ARF owner's marginal tax rate from any distributions made from an ARF. However, the case has been made that where the ARF owner is non-resident the terms of Ireland's double taxation agreements bestow the taxing rights on such distributions on the country of residence under either the "pensions" or "other income" articles of our Double Taxation Treaties.

23. It is being argued that PAYE exclusion orders should be provided to such individuals to enable distributions from ARFs to be paid gross to non-residents. The Revenue Commissioners position is that ARFs are not pensions but investment accounts and that the nature of the distributions from ARFs reflect the income and gains generated by the underlying investments. Thus, in Revenue's view ARF distributions do not fall within the "pensions" or "other income" articles of Irelands DTAs and PAYE exclusion orders are not appropriate. At present relief from Irish taxation is given by way of a refund on condition that the non-resident can demonstrate either that the distribution is taxable in the country of residence or that the distribution comes within a <u>specific article</u> of the relevant DTA (other than pensions/other income). Revenue's concerns in this regard are the risk that ARF distributions (because of their novelty) may not be taxed in any jurisdiction giving rise to double "non-taxation" and also that the granting of PAYE exclusion orders would provide the opportunity for the owners of large ARFs in particular to become non-resident and to move entire ARF funds abroad by way of one-off distributions with no tax take for the Exchequer notwithstanding the tax relief granted in building up the pension funds to which the ARFs relate. Revenue are considering how best to protect the Exchequer while at the same time putting a workable system in place for those non-resident ARF owners who draw relatively modest amounts from their ARFs on a regular basis.

<u>Lump Sums</u>

24. Under statutory pension schemes and pension schemes approved by the Revenue Commissioners, there is no liability to income tax in respect of **gratuities or lump sums paid to members of such schemes on retirement,** provided the lump sum payments comply with statutory requirements and Revenue rules in this area. On the same basis, lump sum payments arising from personal pension plans such as RACs and PRSAs are tax-free.

25. In the case of most members of occupational pension schemes, the amount of a retirement lump sum benefit is dictated by length of service and final remuneration with the relevant employer. The usual basis of accrual is 3/80ths of final remuneration for each year of service subject to a maximum lump sum benefit of 120/80ths or 1.5 times final salary. For certain members of occupational pension schemes (i.e. proprietary directors) and members of personal pension plans (RACs and PRSAs), a tax-free lump sum calculated on the basis of 25% of the pension fund is available. There is an overall maximum life-time limit on the amount of a tax-free lump sum that an individual can draw down from pension arrangements. This currently stands at 25% of the Standard Fund Threshold (currently €5.418 million – see paragraphs 27 and 28 below) and amounts to about €1.35 million. Lump sum payments in excess of this amount are taxed at the taxpayer's marginal rate of income tax

26. The above arrangements apply in respect of pension schemes in both the public and private sectors. One significant difference between public sector and private sector schemes is that private sector schemes invariably allow scheme members the option of commuting part of their pension fund for a tax-free lump sum. This option is not available to members of public sector schemes. Were the tax treatment of retirement lump sums to change, then depending on the rate of tax to be applied, the option to commute part of a pension fund may no longer be exercised by private sector scheme members or may be exercised in a manner that reduces the value of the lump sum taken to minimise or avoid any immediate tax charge. There may also be other legal issues to consider in the context of any decision to change the tax treatment of retirement lump sums. The Commission on Taxation Report recommends that retirement lump sum payments in excess of €200,000 should be taxed at the standard rate of income tax.

Lowering the Standard Fund Threshold

27. Budget and Finance Act 2006 introduced a maximum allowable pension fund on retirement for tax purposes. An initial **Standard Fund Threshold (SFT)** limit of €5 million was placed on the total capital value of pension benefits that an individual can draw upon in their lifetime from tax-relieved pension arrangements. A higher limit (known as the Personal Fund Threshold –PFT) was introduced at the time for those individuals whose pension fund values exceeded the SFT on the date the SFT was introduced (7th December 2005) on the grounds that those individuals had built up those funds in good faith over the years while availing of tax reliefs available at that time.

28. Finance Act 2006 also introduced indexation for both the SFT and PFT from 2007 onwards in line with an earnings factor to be designated by the Minister for Finance each December. As a result, the value of the SFT for 2008 was increased to over €5.4 million. No indexation of the SFT or PFT was undertaken for 2009. There have been calls for a reduction in the limit of the SFT. The Commission on Taxation report recommends a reduction in the SFT in line with the reduction this year in the annual earnings limit for tax-relievable pension contributions. XXXXXXXXXXXXXXXXXXXXXXXX

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Data on Pension Contributions

29. There has been criticism of **the absence of detailed data on the <u>actual</u> cost of tax relief on private pension provision,** in particular in relation to pension arrangements for higher earners. The significant part of the concessionary tax treatment of private pension provision takes the form of tax relief for employee and employer contributions to statutory and approved pension schemes (subject to limits on tax-relievable employee contributions) and tax exemption on the investment growth of pension funds. Tax relief for employee contributions to occupational pension schemes (which schemes cover the majority of PAYE workers with pension coverage) operates under the "net pay" arrangement whereby pension contributions for PAYE employees are deducted from gross pay before applying tax and PRSI. Data on tax-relieved pension contributions to occupational pension schemes by employers on behalf of employees are not generally required to be supplied to the Revenue Commissioners in respect of each individual scheme member. (An exception to this relates to small self-administered schemes (SSAS) – see paragraph 32 below). Of course, in the context of any decision to change the structure of the delivery of tax incentives for pension contributions, the availability of detailed data could become less of an issue over time.

30. Actual data is available in respect of the cost of tax relief on pension contributions made to RACs and PRSAs by self-employed individuals and individuals in non-pensionable employment, to the extent that such individuals submit claims for tax relief to the Revenue Commissioners in their annual income tax returns. One of the drawbacks with the availability of this data is the time-lag between the tax year to which the cost relates and the time at which the full information becomes available which can be significant.

31. The investment income and gains of statutory and approved pension schemes are also exempt from tax. There is no requirement on pension fund managers or administrators to make returns to the Revenue Commissioners in respect of the tax-relieved investment income and gains of pension funds.

32. As referred to above, pension contribution and other data is required to be provided on an annual basis in respect of small self-administered pension schemes (SSAS). SSAS are typically single member pension schemes with the scheme member normally also being the owner/proprietary director of a business and the trustee of the scheme. The Revenue Commissioners have special rules in relation to the approval, operation and supervision of these schemes. Among other requirements, SSAS are required to submit annual accounts to Revenue which detail the pension contributions made to the scheme and the investment income and gains accrued. There are about 6,500 active SSAS.

33. Difficulties with the current arrangements for data provision for SSASs include the fact that the data supplied is not always relevant for costing purposes and is not capable of being electronically captured by Revenue in a way that would make it possible to provide the cost information requested by way of Parliamentary Questions and other means. One option being considered is to require the administrator or trustees of self-directed "bespoke" pension schemes (including SSAS) to return (electronically) sufficient data for each year of assessment to allow for the tax relief costs of those schemes to be established.

34. The Group may wish to discuss the various issues set out in this paper.

Corporation and Pensions Tax Policy Section

Appendix 1

Estimate of the cost of tax and PRSI reliefs for private pension provision 2007.

	Estimated costs
	€ million
Employees' Contributions to approved Superannuation Schemes	590
Employers' Contributions to approved Superannuation Schemes	150
Estimated cost of exemption of employers' contributions from employee BIK	540
Exemption of investment income and gains of approved Superannuation Funds	900
Retirement Annuity Contracts (RACs)	420
Personal Retirement Savings Accounts (PRSAs)	65
Estimated cost of tax relief on "tax-free" lump sum payments	130
Estimated cost of PRSI and Health Levy relief on employee and employer contributions	240
Gross cost of tax relief	**3,035**
Estimated tax yield from payment of pension benefits	410
Net cost of tax relief	**2,625**

Appendix 2
Extract from Part 10 of Commission on Taxation Report 2009 (p.374) - Recommendations

10.1 The regime for non-funded pensions should be examined to identify the implicit tax cost to theExchequer in the context of an equitable distribution of the tax expenditure on pensions.

10.2 The current tax relief for personal retirement provision should in the medium to long-term be replaced by a matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer.

10.3 The matching contribution approach should be accompanied by a kick-start provision involving a contribution of €1 for each €1 contributed by the taxpayer in the first, say, five years of pension provision by an individual.

10.4 The matching contribution should apply where an individual has relevant earnings including where, because of the level of his or her earnings, the individual is not liable to tax.

10.5 A soft-mandatory approach could make a significant contribution to increasing pension coverage and should be considered.

10.6 An employee's payslip should show the amounts contributed by the Exchequer to the employee's retirement savings.

10.7 A retirement savings scheme along the lines of the former SSIA scheme, that is easily understood and which involves an Exchequer contribution, should be introduced – the scheme is outlined in Box 10.16 of Part 10.

10.8 As the annual earnings limit does not apply to employer contributions, there is a need to retain the standard fund threshold. There should be a correlation between the annual earnings limit and the standard fund threshold, and the reduction in the annual earnings limit suggests that there should be a corresponding reduction in the standard fund threshold.

10.9 A lump sum taken on retirement should be liable to tax as follows:
- An amount of up to €200,000 should be tax free.
- The balance of the lump sum should be subject to tax at the standard rate of income tax.

10.10 The current tax relief rules should be reviewed to ensure that contributions and remuneration levels cannot be manipulated close to retirement to allow individuals to take advantage of unintended and inappropriate benefits.

10.11 Age-related limits on the amount of an individual's relevant earnings should continue.

10.12 The flexibility of an ARF should be extended to defined contribution occupational pension schemes.

10.13 Anomalies in the treatment of different retirement arrangements should be eliminated as far as possible.

10.14 The various ages specified in the legislation governing the time at which benefits may commence should be reviewed and conformed.