TSG 07/11

Pension Taxation Issues

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.

3. Tax relief takes the form of relief on amounts contributed to pension schemes and personal pension plans by employers, employees and the self-employed. 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 to pension investments are 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. This paper sets out (i) the nature of private pension provision, (ii) the cost of tax and other reliefs in this area, (iii) ongoing issues in pensions taxation and (iv) matters which will be considered in the forthcoming Green Paper on pensions. Chapter 7 of the soon to be published Green Paper takes a comprehensive look at pension taxation and sets out a range of possible options for consideration. Once published, the Green Paper will be the subject of a consultation process which may extend to the summer of 2008.

The Private Pension System

5. The private pension system comprises occupational pension schemes and personal pension arrangements. These occupational schemes are generally provided on a voluntary basis by employers for their employees— in the sense that there is no legal requirement for an employer to establish a scheme (other than a legal requirement to offer a PRSA to his or her employees)—

and are funded either jointly by employers and employees or by the employer alone.

6. In the past, the most common form of occupational pension scheme was a *defined benefit (DB) scheme*. Under this type of scheme the pension and other benefits to be paid to members and/or their dependants are specified in the scheme rules and are generally linked to final salary. However, there has been a growing trend in employers closing off DB schemes to new members and occupational pension schemes are now becoming increasingly *defined contribution (DC) schemes*. Under DC schemes, the individual member's benefit is determined solely by reference to the contributions paid into the scheme and the investment return earned on those contributions. In these schemes, in contrast to DB type schemes, the scheme member takes the risk of any poor investment performance by the fund.

7. Over the last year or so, the Irish pension environment has also seen the emergence of innovative new models of pension scheme design. These "Hybrid" pension schemes seek to encompass the positive elements of both traditional DB and DC arrangements while adjusting the costs and risks to the parties involved. In that regard, the Pensions Board, as part of the social partnership agreement *Towards 2016,* was asked to research benefit design options in the occupational pensions area; this has resulted in their recently published "Guide to Hybrid Schemes".

8. Personal pension arrangements consist essentially of Retirement Annuity Contracts (RACs) used by the self-employed and more recently Personal Retirement Savings Accounts (PRSAs) which were designed, among other things, to suit the needs of groups with low occupational coverage, such as women, low paid/part time workers and workers in sectors where occupational schemes are not traditionally offered. These RACs and PRSAs operate like defined contribution schemes in that the risk of underperformance lies solely with the individual taking out the contract or account.

Cost of the current tax relief arrangements.

9. As part of the work on the preparation of the Green Paper on pensions (see 20 below) a review was carried out of the current regime of incentives for supplementary pension provision with a view to developing more comprehensive and reliable estimates of the cost of reliefs in this area. The review was carried out by an informal working group made up of officials of the Department of Finance, the Revenue Commissioners, the Department of Social and Family Affairs and the Pensions Board.

10. The working group examined, among other things, the current reliefs and incentives for investment in supplementary pensions and the data available on which to base reliable estimates of the costs in revenue foregone to the Exchequer. This exercise was facilitated, in particular, by the availability of more reliable data for 2006 on contributions by employers and employees to pension schemes arising from a requirement introduced in the 2004 Finance Act which, among other things, requires employers to include details of pensions contributions in their annual P35 returns from 2006.

11. The total estimated cost of tax and PRSI (including health levy) relief for 2006 is €2.9 billion. A breakdown of this figure is set out hereunder:

Estimate of the cost of tax and PRSI reliefs for private pension provision 2006

	Estimated costs €million
Employees' Contributions to approved Superannuation Schemes	540
Employers' Contributions to approved Superannuation Schemes	120
Estimated cost of exemption of employers' contributions from employee BIK	510
Exemption of investment income and gains of approved Superannuation Funds	1,200
Retirement Annuity Contracts (RACs)	380
Personal Retirement Savings Accounts (PRSAs)	120
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	220
Gross cost of tax relief	3,220
Estimated tax yield from payment of pension benefits	320
Net cost of tax relief	2,900

12. The breakdown and make-up of the estimated cost of reliefs in the table differ from previous presentations of costs in this area and the main differences are set out in **Annex 1** to this paper.

<u>Ongoing issues and changes introduced in recent years</u>

13. Despite the existence of generous tax reliefs for private pension provision and while the absolute numbers of individuals covered by supplementary pension arrangements has increased over the years, there are still about 1 million people in the workforce without private pension arrangements. Many of these are on low incomes or in part-time employment.

14. There are a number of factors which stand in the way of increasing private pension provision despite the existence of tax relief incentives. These include inertia, the profile of many of those entering the work force in recent years, education, awareness, marketing, other forms of retirement provision (property investment) and the capacity of individuals to make the necessary contributions to a pension product. A combination of these factors is likely to be involved in militating against higher private pension provision.

15. Issues and concerns that have been raised in relation to the existing tax relief arrangements include the following:

- A perception that the current system is geared towards benefiting the better off. Tax relief on personal or employee contributions is at the individual's marginal income tax rate so that the relief is of greater value to individuals on higher marginal tax rates. There are ongoing calls for changes to the system in order to make investment in private pension provision more attractive to those on lower incomes;

- The tax relief arrangements are too complex or difficult to understand and that a pension scheme along the lines of the SSIA savings scheme, involving a direct "matching contribution" subvention from Government would be more attractive to lower income groups;

- The existing arrangements will not result in the pension coverage or adequacy targets set out in the National Pensions Policy Initiative (NPPI) report of 1998 being met. These NPPI targets were broadly supported by last year's National Pensions Review report of the Pensions Board. The targets envisage a target replacement income of 50% of pre-retirement income before tax and a supplementary pension coverage target of 70% of the working population which should be met sometime after 2013. (It should be noted that the latest CSO Quarterly National Household Survey for the last quarter of 2005 indicates that the private pension coverage level of those in the workforce aged between 30 and 65 was close to 62%);

- Options introduced in 1999 which allow certain categories of individual (mainly the self-employed and proprietary directors) considerable flexibility, control and choice in relation to the drawing down of their pension benefits should be more broadly available to, for example, members of defined contribution occupational pension schemes in respect of the main pension benefits from those schemes. These options allow the individuals concerned to invest their pension funds in Approved Retirement Funds (ARFs) and/or Approved Minimum Retirement Funds (AMRFs) instead of requiring them to purchase a pension annuity which is perceived to deliver poor value for money at the present time.

16. Following a review by this Department and the Revenue Commissioners of the tax relief arrangements in the pensions area in 2005, a number of changes were introduced in the 2006 Budget and Finance Act which were designed to limit the Exchequer cost of tax relief for pensions for high earners. These changes included a cap on the value of a pension fund allowable for tax purposes of €5 million (subject to indexation from 2007); a cap on the maximum value of the tax-free lump sum of €1.25 million (also subject to indexation from 2007); and the taxation, with effect from this year, of notional distributions from ARFs.

17. Other changes were also introduced to encourage older people and those on lower incomes to commence or improve their pension arrangements. These included the Pensions Incentive Tax Credit scheme which was designed to encourage SSIA holders on low incomes (gross income not exceeding €50,000 in the tax year before the year the SSIA matured) to put some or all of the proceeds of their accounts into a pension product by offering an Exchequer contribution of €1 for every €3 transferred to a pension product from an SSIA (subject to a limit of €2,500).

18. Take-up of the scheme (which terminated in July of this year) was low due possibly to the fact that SSIA holders had already decided what to do with the proceeds of their SSIA before the scheme was introduced and also to the likelihood that many SSIA holders already had private pension arrangements in place.

19. With the exception of some technical amendments in the 2007 Finance Act, no substantive changes were made this year to the tax arrangements affecting pension provision. This was due in part to the work which commenced late last year on the production of the Green Paper on pensions policy into which the Department of Finance, among others, has made an input. As part of the new Social Partnership Agreement *"Towards 2016",* the Government made a commitment to publish a Green Paper outlining the major policy choices and challenges in the pensions area. The Green Paper is expected to be published in mid- October.

Green Paper on pensions and the Agreed Programme for Government .

20. The **Green Paper on pensions** will consider, among other things, the options for possible change to the existing voluntary tax incentive arrangements for private pension provision as well as options which would involve the introduction of mandatory pension schemes. Consideration of these options will form part of the broader framework for developing future pensions policy in Ireland.

21. The options (which have previously been set out in broad terms in various reports published by the Pensions Board) are aimed at addressing the issues and concerns set out at 15 above and include :

- The State incentive for PRSA personal contributions being granted by means of a matching contribution of €1 for each €1 invested rather than through tax relief, subject to a maximum amount;

- Tax relief for other forms of supplementary pension provision (other than PRSAs) being allowed at the higher rate for all personal contributions. This should apply through the current method of granting relief at source or through a method of refundable tax credit, where appropriate;

- The introduction of a "soft" mandatory / automatic enrolment pension scheme with an opportunity to opt-out after a period. The scheme would be obligatory on all employees entering employment after the introduction of the scheme who did not otherwise join a pension scheme. The contribution rate to the scheme would be 9% of employee earnings shared between the employee, employer and the Exchequer with the employer and Exchequer both contributing 2%. The Exchequer's direct contribution to the scheme would be in lieu of tax and PRSI relief on employee contributions. Members could opt to leave the scheme after 3 months ; and

- A "hard" mandatory option (without opt-out) involving a "hybrid" pension scheme combining an increase in the State Pension to 40% of Gross Average Industrial Earnings (GAIE) <u>and</u> a mandatory supplementary system for those at work earning between €15,000 and €60,000 pa who are not making supplementary provision. Under this scheme, based on a contribution rate of 15% of employee earnings, the employee, employer and Exchequer would each make a contribution of 5%. The Exchequer's contribution would be in lieu of tax and PRSI relief.

- The arguments for and against the further extension of the flexible ARF/AMRF options introduced in 1999.

22. In regard to changes to the voluntary tax arrangements, it should be noted that the Government has included a commitment in the **Agreed Programme for Government** to *"develop imaginative proposals in the context of the Green Paper….and in consultation with the social partners, to provide an SSIA type scheme in an effort to make supplementary pension provision more attractive to those on low incomes".*

23. The Green Paper options for change to the voluntary tax incentive regime for pension provision would involve additional costs to the taxpayer over and above the cost of existing tax reliefs. The extent of the additional costs would depend on take-up, if or when, introduced.

24. The cost of the "soft" mandatory scheme would depend on take-up while the additional cost of the "hybrid" scheme could be as much as €2.5 billion per annum (including the cost of higher social welfare pensions) if or when fully operational.

25. The costs of all these various options must also be put in the context of the significant sustainability challenges which an ageing population already poses. Sustainability of the pension system over the long term will also be addressed in the forthcoming Green Paper which will emphasise that the projected ageing of the population will give rise to a substantive increase in age-related expenditure of which expenditure on pensions is expected to be the single largest component. Moreover, a further consequence of demographic change in future years is that the task of financing increasing pension spending will fall to a diminishing share of the population. By 2050, it is projected that there will be fewer than two workers per pensioner.

26. The essential purpose of the Green Paper on pensions is to stimulate debate on the future direction of pensions policy over the long term. Publication of the Green Paper will be followed by a period of consultation which may extend to the summer of 2008 and views will be requested from interested parties and the public alike on all aspects of the Paper.

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

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Annex 1.

The main differences between the costs set out in the table in this paper and previous presentations of the cost of tax relief for private pension provision are:

- The estimated 2006 costs of tax relief on employee and employer contributions to approved pension schemes are based on the aggregate data of such contributions obtained from employers' P35 returns for 2006. *Previous estimates of costs in this area tended to over-estimate the level of pension contributions on behalf of employees and, in particular, by employers which also resulted in an over-estimate of the cost of tax relief involved.*

- The investment income and gains of pension funds are exempt from income tax and capital gains tax. Previous estimates of the cost of tax relief for pension funds also included a notional charge to tax of the net cash flow income of pension funds (contributions less benefit pay-outs). The rationale for this notional charge was linked to the assumption for tax costing purposes that pension funds are separate taxable entities. However, since the (net) contributions income to which the notional charge applied has historically been exempt from tax in the hands of employees and employers, it is considered that the charge should not be ascribed to this income in the hands of the pension funds. *The estimate of the cost of exemption of investment income and gains of pension funds does not include any notional charge to tax of the net contributions income of those funds.*

- Estimates of the cost of benefit-in-kind (BIK) exemption of employers' contributions, the estimated cost of tax relief on lump sum payments, the cost of PRSI and health levy relief on employee and employer contributions and a tentative estimate of the tax yield from the payment of pension benefits *have not been included* in previous presentations of the Exchequer costs of supplementary pension provision *but are included in the estimates of the 2006 cost in the table.*