Pension Taxation Issues

Introduction

1. Over half of people in employment are covered by supplementary or private pension arrangements, including close to 850,000 private and public sector employees in occupational pension schemes. There is also, however, a significant proportion of the workforce who currently make no supplementary pension provision. The pensions industry in Ireland is estimated to employ between ten and fifteen thousand people and has responsibility for private pension fund assets of over €70 billion.

2. This paper deals with a number of topical issues in the general area of pension taxation. These issues are:

   - The cost of the tax relief arrangements for private pension provision and the real scope for making Exchequer savings in this area.
   - Pension taxation policy issues arising from the National Pensions Framework published in March 2010 with particular emphasis on those aspects where early (2011) implementation is envisaged.
   - Extension of the deferral arrangements for the purchase of annuities by members of Defined Contribution occupational pension schemes.
   - Taxation of retirement lump sum payments.
   - The case for lowering the maximum allowable pension fund on retirement for tax purposes (the Standard Fund Threshold – SFT).
   - Pre-retirement access to pension fund savings.
   - Investment by Irish pension funds in the Irish corporate sector

The cost of tax relief for private pension provision and the scope for change

3. The estimated net cost of tax, PRSI and health levy relief on private pension provision ranges between €2.5 to €3 billion per annum depending on variables such as the levels of individual/employer pension contributions made and the accrued returns on pension fund investment. The latest year for which the most up-to-date estimates are available is 2007 and the net estimated cost amounts to over €2.6 billion (see Appendix 1)

4. However, discourse on the cost of pension tax relief can be misleading and often creates a false impression of the potential for real cost savings that could be delivered by way of adjustment to these reliefs.

5. There are three significant elements in the estimates of the gross cost of tax and PRSI/Health levy reliefs for private pension provision as outlined, for example, in table 7.2 of the Green Paper on Pensions. These are:

(i) the estimated costs of tax relief on employee/self-employed/individual contributions to pension savings (over €1 billion),

(ii) the estimated cost of tax exemption for employer contributions as Benefit–in–Kind (BIK) in the hands of employees (about €500 million),

(iii) the estimated cost of exempting from tax the accrued income and gains growth of pension funds (about €1 billion).

6. Reducing income tax relief, for example, to the standard income tax rate would impact on employee/self-employed/individual contributions to pension savings and the full year saving from this would amount to about €500 million. Abolishing tax relief on these contributions would save the Exchequer about €1 billion in a full year. None of these changes take account of the behavioural change which would likely result from alterations of this magnitude to the existing tax relief arrangements. Arguably, however, it is only in this area that any change of significance would deliver real tax savings to the Exchequer in the short to medium term.

7. The estimated cost of tax exemption on the accrued income and gains of pension funds is a *"notional or imputed"* cost. 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. In the absence of specific information, an estimate or assumption has to be made of the rate of investment return earned on pension fund assets. An added difficulty is that there can be significant volatility in the rate of return earned on pension funds from year to year. This factor together with other factors such as the asset-mix of pension funds and the cost of management fees would have a bearing on the estimated rate of return used for modelling the cost of tax relief in this area. Moreover, since pension fund growth is not actually subject to tax, an assumption also has to be made on the rate of tax that might otherwise apply to the income and gains (for example, the standard 20% income tax rate was used for the Green Paper costing exercise).

8. Pension fund growth, in common with ongoing contributions to such funds, is generally viewed as deferred income – the pension fund rolls up gross to provide a higher pension value which is then taxed in the hands of the pensioners as the pension is paid. Imposing an actual tax charge on pension fund growth would not yield anything like the imputed cost of relief (€1 billion) and would effectively reduce the pension in the hands of the pensioner and the tax take at that point.

9. As regards the remaining significant element in the cost estimates for pension tax relief (the BIK exemption for employer contributions), removing that

exemption from employer contributions to occupational pension schemes would remove the rationale for making those contributions in the first place from the point of view of the employee members of such schemes.

National Pensions Framework – Pension taxation policy aspects

10. The National Pensions Framework (NPF) was published in March 2010. Among the stated aims of the NPF is an increase in supplementary pension coverage among low to middle income groups and to ensure that State support for the pension system is equitable and sustainable.

11. The key developments proposed in the NPF which impact on private pension taxation policy are:

- The introduction in 2014, subject to prevailing economic conditions, of a soft mandatory auto-enrolment pension arrangement for employees who have no or inadequate supplementary pension arrangements and to which the State would contribute the equivalent of 33% income tax relief.

- Current marginal tax relief for contributions to existing occupational and personal pension arrangements to be replaced by a State contribution equal to 33% income tax relief.

- Flexible options on retirement (e.g. access to Approved Retirement Funds – ARFs etc.) to be extended to all Defined Contribution (DC) pension arrangements.

12. A Steering Group has been established to oversee the implementation of the NPF. A number of sub-Groups have also been established to examine specific aspects of the implementation process. This Department is represented on all of these various Groups as are the Revenue Commissioners. The auto-enrolment scheme and replacement of the existing marginal tax relief arrangements are not immediate priorities for implementation. The extension of the flexible options at retirement has, however, a 2011 implementation target date.

13. The main issues surrounding the extension of the flexible options on retirement to all DC pension arrangements are:

i. Whether and the extent to which the current specified or guaranteed income limit of €12,700 per annum (which determines access to an ARF prior to age 75) should be increased.

ii. In the context of allowing already retired individuals to change from an Approved Minimum Retirement Fund (AMRF) to an ARF before age 75 as outlined in the NPF and provided they meet the specified income limit, whether the increased limit should be satisfied or the limit in force at the point of their retirement (e.g. the current limit of €12,700).

iii. The case for retaining the AMRF option as part of the extension of the flexible options on retirement (the NPF suggests doing away with this option).

iv. The need for independent advice and appropriate regulation of the extended arrangements.

14. The detail of these various issues are set out and discussed at Appendix 2 to this paper.

Extension of the deferral arrangement for the purchase of pension annuities

15. In December 2008, the Minister for Finance introduced an option for members of DC occupational pension schemes to defer the purchase of a retirement annuity with their pension funds for a specified two year period. Under the arrangements applying up to that time, members of such schemes were, in general, obliged to purchase an annuity immediately upon retirement with their pension fund after taking their tax-free lump sum. The deferral option was introduced against a background of falling pension fund and asset values, generally.

16. Under the deferral arrangement, which is operated on an administrative basis by the Revenue Commissioners, members of DC occupational pension schemes who retire in the period from 4 December 2008 to 31 December 2010 have the option of taking their tax-free lump sum and purchasing a retirement annuity immediately on retirement or to take the lump sum and defer the annuity purchase, subject to agreement with their scheme trustee, up to and including 31 December 2010 by which date the concession of an option will end. Figures from the Irish Insurance Federation (IIF) indicate that some 285 individuals availed of the deferral arrangement in the period to mid-October 2010.

17. Were the extension of the flexible options to members of DC occupational pension schemes to proceed next year and provided those options included the AMRF option, this would represent a permanent solution to the timing of annuity purchase for those who chose the AMRF route. There would be no need, in these circumstances, to consider a lengthy extension of the deferral arrangements operated administratively by Revenue.

18. If a decision is made to extend the flexible options in 2011, a short extension of the administrative arrangement will be needed to cover the *interregnum* between end-2010 and the effective date of the extension of the flexible options in 2011. If the flexible options are not extended in 2011, consideration may have to be given to a longer extension of the deferral arrangement.

Taxation of retirement lump sum payments

19. 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.

20. The 2009 Report of the Commission on Taxation recommended that retirement lump sum payments in excess of €200,000 be taxed at the standard rate of income tax. In his 2010 Budget Speech, the Minister for Finance stated that he accepted "the Commission on Taxation's recommendation that pension lump sums below €200,000 should not be taxed. The treatment of sums above this level, and the tax treatment of pensions, including the consolidated 33 per cent rate of relief will be considered in the Government's National Pensions Framework….".

21. 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.

22. 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) 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.

23. In the case of members of occupational pension schemes, generally, it is only those on final salaries of close to €133,500 per annum or those with a pension fund in excess of €800,000 in the case of of holders of an RAC/PRSA who would be affected by the taxation of lump sums in excess of €200,000.

24. The retirement lump sum arrangements, as described above, 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.

25. 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. The absence from public sector schemes of the option available in private sector schemes is one legal issue to be considered.

There may also be other legal issues to consider in the context of any decision to change the tax treatment of retirement lump sums.

Lowering the Standard Fund Threshold

26. 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.

27. 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. Given the level of the SFT, the thresholds are only relevant in practice for high earners.

28. On each occasion that an affected individual becomes entitled to receive a benefit under a pension arrangement, that individual uses up part of their SFT or PFT. Where the capital value of the aggregate of such benefits exceeds the SFT or PFT, a "chargeable excess" arises equal to the amount by which the threshold is exceeded which is subject to an upfront income tax charge at 41%. This charge is without prejudice to any other income tax charge that might arise on the balance of the chargeable excess as and when benefits are actually taken under the scheme. The effective tax rate that might therefore apply to a chargeable excess could potentially amount to over 65%.

29. The 2009 Report of the Commission on Taxation recommended that there should be a correlation between the annual earnings limit for pension contribution purposes and the SFT and that "the reduction in the annual earnings limit suggests that there should be a corresponding reduction in the standard fund threshold". There are a number of ways in which such a reduction could be approached in line with the Commission recommendation.

30. The annual earnings limit for tax-relieved pension contribution purposes has been reduced from the level of €275,239 at which it stood for the tax year 2008 to a level of €150,000 for 2009 (and for 2010) representing a reduction of 45.5%. Applying this level of reduction to the current SFT (€5,418,085) would result in a revised threshold of just over €3m.

31. Another possible approach (incorporating the correlation suggestion) would be to base a revised SFT on the level of pension fund required to provide a pension of two-thirds of the annual earnings limit using a standard capitalisation factor. Under current rules, the maximum benefit that an individual can receive from an occupational pension scheme at normal retirement age is a pension of two-thirds of final remuneration. Tax legislation already provides for the use of a capitalisation factor of 20 (unless a higher factor has been approved by the Revenue Commissioners) in cases where pension fund administrators are required to determine if the capital value of the pension benefits of members of a Defined Benefit pension scheme has exceeded the current SFT. This formula would produce a revised SFT of about €2 million (two-thirds of €150,000 X 20).

32. Any reduced limit however arrived at may have to take account of the pension funds of individuals above the newly reduced amount in the same way as the PFT was provided for in 2006.

33. As with changes to the tax treatment of retirement lump sums, there may also be legal issues to consider in the context of any decision on the scale of the reduction in the SFT.

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

Corporation and Pensions Tax Policy Section

November 2010.

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

Details of issues relating to the extension of the flexible options on retirement to DC pension arrangements.

Background

1. Prior to Finance Act 1999, any person taking a pension from a DC occupational pension scheme or personal pension plan was required to purchase an annuity with the pension fund money remaining after taking the appropriate tax-free lump sum. Finance Act 1999 introduced a considerable degree of control, choice and flexibility to certain individuals in relation to the draw down of benefits from their pension plans. These choices include the options to purchase an annuity, to invest in an Approved Retirement Fund (ARF) or an Approved Minimum Retirement Fund (AMRF), as appropriate, receive the balance of the pension fund in cash (subject to tax) or a combination of these options.

2. Access to an ARF and to the other flexible options on retirement is currently available to qualifying individuals who are either over 75 years of age or who have a guaranteed pension/annuity income in payment for life of at least €12,700 per annum (the specified income limit). Where the minimum specified income test is not met, the first €63,500 of a pension fund or the whole of the net fund (after taking the tax-free lump sum), if less than €63,500, must either be used to purchase an annuity or invested in an AMRF. The capital in an AMRF is not available to an individual until he or she reaches 75 years of age, though any income generated by the fund can be drawn down subject to tax.

3. The flexible options are not available to members of Defined Benefit or Defined Contribution occupational pension schemes in respect of the main benefits arising under such schemes. PAYE taxpayers who are members of occupational pension schemes must purchase an annuity on retirement with the main benefits arising from their pension fund, after taking a tax-free lump (although an option to defer annuity purchase has been operated by Revenue since December 2008 and this option is available until 31 December next).

NPF proposals on flexible options

4. The Government has committed through the NPF to provide all individuals in DC pension arrangements with access to similar options on retirement. The published NPF envisages the following developments and parameters to give effect to this commitment:

    - The balance of DC pension funds remaining following the taking of the appropriate tax-free lump sum can be invested in ARFs (subject to a minimum "specified income" test) or used to purchase an annuity.

    - The NPF makes clear that it is not intended to extend the flexible options on retirement to members of DB pension schemes.

- The current minimum specified income limit of €12,700 will be examined with a view to possibly increasing it to 1.5 times the maximum rate of State Pension (Contributory).

- The AMRF requirement will no longer apply.

- The revised arrangements are to apply to new retirees only and will not impact on existing pensioners.

- Existing pensioners under the age of 75 who did not meet the minimum specified income conditions at retirement but who subsequently meet the conditions will be allowed move from an AMRF to an ARF.

5. The NPF implementation Steering Group has indicated that there is some flexibility around the above parameters, including, for example, on the extent of any increase in the specified income limit and on the issue of retaining the AMRF requirement.

Changing the Specified Income Limit

6. The specified income limit of €12,700 per annum has not been changed since the introduction of the flexible options. The purpose of the specified income limit is to ensure, before individuals can have unfettered access to their remaining retirement funds via an ARF for example, that they have the security of an adequate guaranteed income throughout their retirement.

7. The following are possible options with regard to the **specified income limit** :

   (i) Leave the limit at its current level (€12,700 per annum).
   (ii) Increase the current limit by reference to the increase in the CPI in the period 1999 to 2009 bringing it up to €17,285 and indexing the amount to the CPI thereafter.
   (iii) Set the limit to an increased ad hoc amount e.g. €15,000 or €18,000 per annum.
   (iv) Set the limit at 1.5 times the maximum rate of State Pension (Contributory) as per the NPF which would bring it up to €17,963 per annum currently and the limit would adjust by reference to changes in the pension rate thereafter, or
   (v) Stagger the increase to 1.5 times the maximum rate of State Pension (Contributory) (e.g. increase to €14,000 in 2011, €16,000 in 2012 and to 1.5 times the State Pension from 2013 onwards)

8. The option at 7(i) above does not seem viable. The “at risk of poverty” rate identifies the proportion of individuals who are considered to be in danger of poverty based on their level of income and taking account of their household composition. The rate is calculated at 60% of the national median income which, based on the latest available (2008) figures, amounts to €12,455. The current specified income limit is only marginally above the 2008 “ at risk of poverty line”

and leaving the limit at its current level would not represent an adequate guaranteed income amount for qualifying individuals in the future.

9. The current specified income limit was largely arrived at on an ad hoc basis when the flexible options were introduced in 1999. The options at 7(ii) and (iii) represent variations based on the original ad hoc approach. Option 7(iv) above may be a preferred option for a revised specified income limit. As well as ensuring an adequate buffer over the “at risk of poverty” line, it also provides (in the event of the AMRF option being retained), a clear link between the specified income limit and the ceiling amount that should be set-aside under the AMRF option. This ceiling amount is currently €63,500 which was also set on an ad hoc basis in 1999.

Retaining the AMRF requirement

10. Removal of the **AMRF requirement** for new retirees from DC pension arrangements is proposed in the NPF. In general terms, for those new retirees who cannot meet the specified income limit on retirement this would leave annuity purchase as the only remaining option. This arguably restricts the choices available for individuals retiring instead of increasing choice and flexibility. Retention of the AMRF requirement would give individuals the option to place their remaining pension funds in an AMRF instead of effectively imposing a requirement to immediately purchase an annuity. It would allow for deferral of annuity purchase to a time of the retiree’s own choosing and thus promotes flexibility. An existing annuity purchase deferral arrangement being operated on an administrative basis by the Revenue Commissioners is due to end at 31 December 2010.

11. The options in relation to the AMRF requirement amount to the following:
    - (i) Abolish the AMRF for new retirees in line with the NPF. The broad implications of this have already been referred to.
    - (ii) Retain the AMRF option but with a revised maximum set-aside requirement above the current amount of €63,500 or the remainder of the pension fund after taking the tax-free lump sum, if lower.
    - (iii) Retain the AMRF option with a set-aside requirement of the lesser of 10 times the maximum rate of State Pension (Contributory) (about €120,000) or the remainder of the pension fund after taking the tax-free lump sum.
    - (iv) Retain the AMRF option with a set-aside requirement of 10 times the difference between the revised specified income limit (see 19(iv) above) and the actual amount of an individual’s guaranteed pension/annuity income at the time he elects for an AMRF. This would give a maximum set-aside amount of close to €180,000 (if guaranteed pension income was zero).

12. The option at 11(iii) above would seem preferable on the grounds, firstly, that an increase in the set-aside amount from €63,500 to €180,000 would be excessive and, secondly, that a maximum set-aside amount of €120,000 should be sufficient

(at long-term average interest rates) to purchase an annuity of €6,000 at age 65 which would bridge the gap between the maximum rate of State Pension (Contributory)[1] and a revised specified income limit of 1.5 times that rate of pension. This option provides a link and ensures a broad equivalence between the specified income limit and the maximum set-aside requirement under the AMRF option.

Transitional arrangements

13. Current AMRF holders have no access to the capital in their fund before age 75 and it is proposed in the NPF that the AMRF can be changed to an ARF if those individuals meet the specified income test before that age. The question arises as to which specified income limit existing pensioners will have to satisfy:

    - the limit in force when they retired (€12,700), or
    - a revised specified income limit (1.5 times the maximum rate of State Pension (Contributory)).

    There is a case for stipulating that the specified income test to be satisfied in all cases should be the one in force at the time the opt-out or move from the AMRF is proposed to be exercised. This is particularly relevant if the specified income limit at the proposed higher level is to be viewed as providing an <u>adequate</u> guaranteed income in retirement. On the other hand, the NPF states (p.40) that "these new arrangements [revised specified income limit] are to apply to new retirees only….. There would be no impact on current pensioners who may have an income stream of more than €12,700 but less than 1.5 times the State Pension (Contributory)". The alternative approach (having regard to the wording of the NPF referred to above) would be to apply the specified income limit in force at the date of the individual's retirement.

Residual issues

14. The ARF/AMRF route may not be suitable for everyone to whom the extension of the options are proposed in the NPF and carries a significant longevity risk. The immediate purchase of an annuity providing a guaranteed stream of income may be more suitable for many individuals. There would seem to be a case for individuals to have some source of independent advice available to them on the appropriate choices to make. In addition, where the ARF/AMRF option is chosen by individuals with a relatively small pension fund and little experience of managing or tracking investment performance, the question of the appropriate regulation of the fund managers and the levels of fees charged arises. The details of these issues, however, are non-tax related and are outside the scope of this paper.

[1] The majority of individuals to whom the flexible options are being extended would qualify for the State Pension (Contributory).

Appendix 3

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