Irish Association of Pension Funds

Budget Submission

October 2005

Executive Summary

The Irish Association of Pension Funds (IAPF) has prepared this submission with a view to making constructive observations and recommendations which the IAPF believe will be useful to the Minister and his officials in framing the forthcoming budget as well as in the Government's general deliberations on pension policy matters in Ireland.

The association would very much welcome the opportunity to discuss the contents of this submission with the Minister for Finance and members of the Department. This submission looks at a number of key areas:

1. Taxation
2. State Annuity Fund
3. Regulatory Regime and Semi-State bodies
4. Special Savings Investment Accounts
5. Approved Retirement Funds and Defined Contribution Schemes
6. Simplification
7. CAT and Double Taxation

The IAPF supports the primary taxation policy underlying the Irish second pillar pension system. The relief given to contributions and the deferral of taxation has broadly been successful in encouraging retirement saving and research published by Prof. Shane Whelan of UCD projects that the most significant return for the Exchequer from the crystallisation of deferred taxation is to be expected over the coming 10 – 20 years as the substantial asset base in second pillar defined benefit schemes begins to switch from net build up to net draw down.

However, the success of this approach is not yet universal. Whilst second and third pillar retirement provision is significant amongst middle and high income workers, the proportion of those on lower incomes who are saving adequate funds to provide for their retirement is low.

1. Taxation

Expanding coverage

The IAPF believes that important lessons can be learnt from the success of the SSIA initiative. We believe that the success was based on four factors:

- The Exchequer incentives;
- The short life span of the investment;
- The simplicity of the scheme;
- The deadline for applications; and
- Media interest.

The IAPF believes that the latter three points are absent from public policy on pensions for structural reasons that can be simply addressed.

While the core taxation advantage of pension plans (deferral of tax) is a key advantage, the IAPF believes that with simplification and additional incentives for the lower paid, substantial improvements can be made in the coverage ratios for those sections of the community with the lowest coverage.

Submission:

The IAPF recommends that tax relief on all pension contributions be allowed at the 42% tax rate (with relief on employee PRSI contributions and Health Levies) to encourage retirement savings amongst those on lower incomes.

This relief should be on a basis reflective of the SSIA structure, which captured the imagination of the public with its simplicity.

Such steps would have the following benefits:

- Improve public awareness and understanding of the benefits of providing for retirement;
- Increase pensions coverage;
- Assist in bridging the gap between pre-retirement and post-retirement income for those approaching retirement(projected maturity 20 years plus – contemporaneous with the timing suggested for a decline in the pensions in payment from defined benefit arrangements);and
- Reduce dependency on State benefits.

In summary, the IAPF believes that positive lessons should be learned from the success of the SSIA initiative which was primarily due to its simplicity.

2. State Annuity Fund

The proposed State Annuity Fund for the purpose of funding the payment of pensions, in return for a capital payment of the economic cost of those liabilities, was first raised by the IAPF some time ago and has attracted considerable support from the Social Partners and other quarters.

The basic principle underlining the proposal is that, on a financially neutral basis, the State can provide a cheaper pension arrangement than the open market for the following reasons:

- It is unregulated;
- It can also take a long-term view of capital markets;
- It can be be assured of a full pooling of risk; and
- It can be assured of ongoing cash inflows.

The IAPF calculates the savings on a reasonably conservative asset allocation strategy to be in the order of 30%.

Prof. Whelan's research asserts that the establishment of a State Annuity Fund would enhance pension coverage and adequacy, reduce pensioner dependency upon the State and could underpin the defined benefit pension system as the cost of meeting the Minimum Funding Standard would be reduced. The IAPF believes that the opportunity to ssupport these three critical social policy objectives, at nil cost to the Exchequer, warrants close and urgent scrutiny.

Submission

The IAPF recommends the establishment of a State Annuity Fund to provide pensions to individual members of the public (in return for capital) reflecting the economic cost of such pensions and on a cost neutral basis to the State.

3. Regulatory Regime and Semi-State Bodies

The IAPF believes that the current regulatory regime is unduly complex and onerous and that it is a disincentive to companies to offer company sponsored pension schemes. We believe that the current regime imposes unnecessary costs and cashflow demands on private and Semi-State bodies who are maintaining existing defined benefit schemes.

Specifically, the IAPF believes that the Minimum Funding Standard (MFS), as it applies to defined benefit schemes, is a serious barrier to the continuation of such schemes as the MFS is set at too high a level. The IAPF believe that the MFS should not require funding, in line with the commercial cost of securing annuities to cover benefits , in circumstances where such annuities are unlikely to be bought.

Semi-State and other bodies with Defined Benefit pension schemes , are finding that these regulations are resulting in substantially increased demands for contributions to funded pension schemes. Where such bodies receive a subvention from the State, this increased demand for funding could have an immediate negative impact on the States's finances.The State Annuity Fund (referred to earlier) is one initiative which could reduce pressure on the existing system and negate the anticipated increases in pension costs for the Semi-State sector resulting from the EU Pensions (IORPs) Directive which came into law last month.

Alternatively, the Minimum Funding Standard could be replaced with a standard which take account of the economic cost of the benefits being funded. In this regard, the level of the funding standard adopted in the UK is instructive.

Submission

The IAPF recommends that the Department of Finance call for an immediate review of the current Funding Standard in order to protect the interests of the Exchequer and current members of defined benefit pension schemes.

4. Special Savings Investment Accounts

The IAPF believes that the maturity of SSIA accounts represent an opportunity to convert many SSIA contributors into long-term retirement savers and an opportunity for the account holders to address any under-funding that may already exist in their retirement planning. Without suitable roll-over options there is a risk that the SSIA outflows on maturity could have a negative impact on inflation and give rise to short-term profiteering in non-essential goods and services.

While account holders could divert ongoing payroll income to a pension scheme and drawdown SSIA balances as replacement income (giving rise to enhanced relief), such relief mechanisms are complicated and as such unlikely to attract most account holders.

Submission

The IAPF recommends that transfers of some or all of the monies from maturing SSIAs into pension funds be permitted without the imposition of the exit tax penalty.

5. Approved Retirement Funds and DC Schemes

The IAPF believes that members of a defined contribution pension schemes who have full flexibility regarding the investment of their fund prior to retirement should have similar flexibility post retirement rather than being forced into annuity purchase at times when interest rates and the subsequent low bond yields and high cost of annuity products may significantly reduce the purchasing power of their retirement savings.

The IAPF believes that it is illogical that the Finance Act should distinguish between stand-alone PRSA products that operate on a defined contribution basis and trust based defined contribution schemes by only attaching ARF retirement options to PRSA products. Such a policy puts hundreds of thousands of workers at a disadvantage for no logical reason.

The IAPF believes that it is important to underpin minimum income security within the ARF framework and believe that the AMRF limits ought to be increased to take account of inflation since the scheme's introduction in 1999.

Submission

The IAPF recommends that the ARF (Approved Retirement Fund) and AMRF (Approved Minimum Retirement Fund) retirement options be extended to Defined Contribution (DC) schemes.

The IAPF also recommends that AMRF limits should be increased from the original levels set in 1999 and index linked going forward.

6. Simplification

The IAPF strongly supports the ongoing initiatives to simplify the pensions system.

It is a financial fact of life that many people are constrained by many financial pressures (such as the high cost of housing, raising young families etc.) with the result that many people are unable to save adequately for their retirement on a uniform basis throughout their careers.

The contribution limits for employees of 15% to a maximum of 30%, together with additional employer contributions, are currently sufficient limits to provide adequately for retirement. However, to ensure that a reasonable proportion of SSIA holders transfer all or part of their accumulated SSIA savings to a pension plan, a higher contribution ceiling may be desirable for a transition period.

However, the application of the these limits to PRSAs (where the limit is inclusive of employer contributions) does not reflect the following realities:

- Interest rates are at all time lows with most commentators forecasting that increases will not exceed 0.5% by the end of 2006.. This has significantly increased the cost of providing for retirement.
- On average people retiring in their 60s are living well into their 80s and the trend towards improvements in longevity is expected to continue.
- As mentioned above, people who cannot afford to save adequately for their retirement early in their careers should be afforded the opportunity to make up for lost time as the pressures of housing and family costs ease.

The IAPF believes that a review of the rules pertaining to limits on contributions and the resulting pension benefits is the most appropriate way of dealing with the above realities.

Submission

The IAPF recommends the harmonisation of Revenue limits and retirement options across PRSA and trust based Defined Contribution schemes.

7. Capital Acquisitions Tax and Double Taxation

Under existing provisions, a spouse is exempt from Capital Acquisitions Tax (CAT) liability. This means that in the event of the death of a pension scheme member, where a spouse receives a pension, there is no CAT liability, but, of course, an income tax liability does arise.

The position in relation to couples in non-marital situations is very different. An increasing number of pension scheme rules provide for a non-marital partner to qualify for pension benefits on the death of the "member" partner. However, as the couple is not married, a CAT liability arises on death based on the aggregate of the capitalised value of any resulting pension and any lump sum payment.

A further anomaly arises because ongoing pension payments remain subject to income tax. So, in effect, the pension is taxed twice – firstly as a capital amount and then as an income receipt. This is a clear case of double taxation. Indeed at the current levels of CAT and Income Tax a pension paid in these circumstances could end up being taxed at a combined rate of 64%.

This anomaly is compounded by the fact that although the CAT liability relates to anticipated future pension payments it has to be funded, as a lump sum, presumably by borrowing or by the disposal of other assets. Conceivably this liability could result in the surviving partner refusing the benefit.

In the UK, Capital Transfer Tax is payable on the lump sum benefit amount only. Whilst recognising that the blanket tax treatment of non-pension asset transfers to non-marital partners may not be desirable, the IAPF feels that if a pension benefit is granted by the trustees of an occupational pension scheme (whether by way of a discretionary exercise of power or otherwise), the resulting benefit should only be taxed once.

Submission

The IAPF recommends that Capital Acquisitions Tax on pensions payable to non-marital partners following upon the death of a pension scheme member be disregarded but that the benefit continues to be subject to income tax

The Irish Association of Pension Funds

The Irish Association of Pension Funds (IAPF) was established in 1973 and is a non-profit, non-commercial organisation. Our members provide retirement security to over 200,000 employees, pay pensions to nearly 70,000 people and are responsible for some €50 billion in retirement savings.

As the voice of Irish pensions our principal aims are:

- To represent the interests of pension scheme members, trustees and sponsoring employers;
- To promote financial security for all retired people; and
- To provide a forum for discussion and debate of pension issues.