Irish Association of Pension Funds

Briefing Paper

Survival of Irish Private Pensions Threatened if Tax Reliefs Reduced

iapf
the voice of Irish pensions

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Executive Summary

- Much of the recent commentary on the issue and cost of tax relief available for pension provision has been misinformed.
- The oft-quoted cost of €3 billion is out-of-date and includes both double counting and invalid assumptions. The maximum the Government could raise by adjusting the system of tax relief is in the region of €300 million.
- Occupational Pension Schemes in Ireland are already in crisis with defined benefit schemes in deficit to the order of €30 billion and defined contribution members seeing their funds drop by over 30% in the last year.
- The majority of individual tax-payers who benefit from reliefs are not the "super-wealthy" but the 800,000 members of occupational pension schemes.
- Any changes to the tax relief system now will remove the only incentive available to those individuals to continue pension provision.
- Any changes to the relief available on member contributions will have a disproportionate impact on public servants as it will increase the cost to them of the pensions levy.
- The system cannot be allowed to support or assist abuse by the "super-wealthy". Current limits on benefits (which limit the salaries on which relief can be claimed and impose a maximum on the fund that can be accumulated) are in line with maximum benefits available in the public sector.
- Any aspects of the system that turn legitimate pension arrangements into wealth accumulation or inheritance planning vehicles should be viewed as an abuse of the purpose of tax relief and should be reviewed by the Commission on Taxation.

Introduction

This paper analyses the issue of tax-relief in a comprehensive manner and outlines the dangers and effects of removing or adjusting the system of reliefs. Pension provision in Ireland needs support and does not need action that could destroy it completely.

The Irish Association of Pension Funds (IAPF) has serious concern that the Government could destroy Irish private pension provision if it were to reduce tax relief in next month's supplementary Budget. It says that a reduction in relief on pension contributions to the standard rate would attack middle income workers hardest.

There has been a lot of commentary and debate recently in the media on this issue. By and large, this acknowledges the significant level of pension funding being built up by Irish workers. However, some of what has been aired is misinformed and it is therefore important to put this in context. The main focus of the public commentary is that the Government "spends" almost €3 billion on tax relief on pensions and this goes to the "super-wealthy".

The fact is that there are over 800,000 ordinary tax payers contributing to occupational pension schemes whose prospects for retirement would be shattered by radical adjustments to the current system of pension incentivisation. The vast majority of these ordinary people are not the "super-wealthy" but individual taxpayers who either have had the foresight themselves to set up a pension plan or are lucky enough to work for an employer who has put a plan in place for them.

Tax relief on pension contributions is one of the few areas of tax relief available to ordinary PAYE workers and is there to help fulfil the socially desirable objective of ensuring that individuals can sustain themselves in retirement without a need for State support. IAPF has consistently argued that the system should encourage pension planning by all and not exist to facilitate tax planning for the well off.

It is also important to remember that the reason tax relief is given on pension contributions is to provide an incentive for individuals to save for the long-term. Even with the existing system of tax-relief it has proved difficult to encourage individuals to set aside savings for something that they cannot access for up to 40 years. Any changes to that system are likely to make a difficult task impossible, particularly where those individuals have less available disposable income.

At a time when Irish employees are concerned about their current financial security, IAPF believes that tax changes which result in reduced pension provision by employees in general will reduce confidence in their future financial security.

Many steps have already been taken, particularly over the last couple of years, to curb the extent to which the “super-wealthy” can avail of pension tax reliefs. As stated earlier, IAPF welcomes such steps to ensure the integrity of the system and maintain the overall objective of assisting all employees in accumulating assets to support them in retirement.

What curbs are in place?

It is important to recognise the steps already taken to limit the amount of relief available. Individuals get relief on the contributions they make to pension arrangements that are approved by the Revenue Commissioners.

However, the amount of salary on which an individual can make contributions and receive relief is capped at €150,000 (having been reduced from €275,239 in the 2008 budget). In addition, in 2005 a cap of €5 million was introduced as the maximum value of a pension fund that could be funded out of tax-relieved contributions and the maximum tax free lump sum on retirement was restricted to 25% of this limit. This amount has been indexed from 2007 and currently stands at €5,418,085.

These measures have been introduced in order to limit the benefits that individuals can receive from the tax relief and have been effective in dealing with particular situations which caused public outcry where individuals had been able to accumulate funds of €100 million and take a tax-free lump sum of €25 million. Therefore, steps have been taken to deal with the “abuses” of the system that many commentators talk about. The steps that have been taken have not impacted on the ordinary PAYE workers who benefit from tax relief without ever threatening to reach those salary levels or fund values. However, changing the system of tax relief and only applying it at standard rate would impact on those ordinary workers.

The setting of such maximum salary levels, contribution rates and fund values is a matter for the Government in the context of developing an equitable system of pension support. While the maximum figures are high, it is also important to put these in context. Very few people are in a position to pay the maximum contributions allowable, particularly early in their careers. That is why the percentage of salary that can be paid rises with age as, the older people get, the more likely they are to be able to pay more towards their pension provision and the more important it will rank in their financial priorities.

Research has suggested that PAYE workers on an average wage would have to make contributions at the maximum allowable rate for the entirety of their working life in order to achieve a pension close to the average public service pension.

IAPF understands that the cap of €5 million, when it was first introduced, was intended to be broadly equivalent to the value of the pension fund that would be required to provide benefits for the highest paid public servants. IAPF would suggest, should any amendment to the maximum cap be introduced, that it would apply in a fair and equitable manner across public as well as private sector employees.

Much of what is written about tax relief refers to the “super-wealthy” as if they are the only people who can avail of tax relief on contributions at marginal tax relief. However, it must be remembered that most of the individuals who avail of tax relief at higher rate are among those on average wages who pay higher rate tax once they earn €36,400 per annum.

Taxing the benefits

Much of the recent commentary has ignored the fact that pensions are subject to taxation in payment. We are no different to the majority of other European countries in the system which we employ. This approach is called the EET approach and is advocated by the EU as the approach which should be maintained by all Member States (EET = tax **e**xemption on contributions, tax **e**xemption on investment returns and **t**ax charge on pensions in payment). Under our system, middle income earners get the most relief (not high earners) as their contributions are relieved at the marginal rate (41%) and their pension is either outside of the tax net or taxed at standard rate.

On the other hand, high earners are similarly relieved at the marginal rate (41%), while their pension, because they have saved more, is typically also taxed at the marginal rate.

Independent actuarial research has shown this to be the case i.e. middle income earners on €45,000 per annum benefit most from the current system of tax relief. Thus the system is not one of tax relief on contributions but one of tax deferral. In 2006 the State collected an estimated €320 million in tax from pensions in payment and this would be expected to continue to increase over time as the numbers of retirees in receipt of a privately funded pension increases in line with the demographic bubble (of middle aged active employees) which currently exists in private sector defined benefit schemes).

How should the distribution of reliefs benefit the lower paid?

In 2008, 32.3% of all earners paid no income tax as they earned less than €18,300. This continues the Government’s policy to remove a substantial number of employees from the income tax net. As such individuals don’t have any tax to get relief from they don't see the State providing any incentives towards their pension provision, hence the view that this is inequitable. For many in this group, the State pension will provide adequate replacement income in retirement.

It must be recognised that PRSI contributions by the lower paid are not expected to be sufficient to actually fund the State Pension payable to these workers and thus, in line with social policy, these workers are effectively subsidised by the Exchequer in so far as the State Pension is concerned rather than by way of relief on personal retirement savings.

However, some lower paid workers will also want or need to have additional retirement savings and we believe that it is a reasonable policy objective to provide incentives for this group. In the long term framework proposed by the IAPF in its response to the Green Paper, we proposed that tax credits (akin to the SSIA model) be used to incentivise this group to save for retirement.

It also makes sense to incentivise pension savings amongst those for whom the State Pension will not provide an adequate replacement income in retirement (i.e. middle income workers and those who subject to tax on their incomes) and the current system of tax reliefs is targeted to incentivise these workers.

What does tax relief cost?

The Government's Green Paper on Pensions analysed the cost of reliefs in the taxation system as at 2006 and came up with a significant sum of almost €3bn. IAPF believes that this figure does not reflect the true cost of supporting the system which must be determined net of the deferred taxation falling due when the underlying pensions come into payment. This would give a substantially lower figure.

The analysis of the costs contained in the Green Paper was as follows:

Table 7.2: Estimate of the cost of tax and PRSI reliefs for private pension provision 2006

	Estimated costs €million
Employees' Contributions to approved Superannuation Schemes	540 [a]
Employers' Contributions to approved Superannuation Schemes	120 [b]
Estimated cost of exemption of employers' contributions from employee BIK	510 [c]
Exemption of investment income and gains of approved Superannuation Funds	1,200 [d]
Retirement Annuity Contracts (RACs)	380 [e]
Personal Retirement Savings Accounts (PRSAs)	120 [f]
Estimated cost of tax relief on "tax-free" lump sum payments	130 [g]
Estimated cost of PRSI and Health Levy relief on employee and employer contributions	220 [h]
Gross cost of tax relief	3,220
Estimated tax yield from payment of pension benefits	320 [j]
Net cost of tax relief	2,900

See Appendix C for footnotes to table 7.2

A number of issues have been identified with this breakdown of the cost.

Firstly, it excluded the cost of reliefs for public sector workers. The cost of tax relief on public sector employee contributions can be approximated as €147 million which should be added to the first figure in the table of €540 million to give a total cost of tax relief in 2006 on employee contributions of €687 million.

The introduction of the pensions levy on public sector workers will substantially increase this figure.

The inclusion of the amount of €510 million as the cost of exemption of employers' contributions from employee BIK is questionable. As the cost of tax relief on employer contributions was already included, there was an element of double counting as employers could pay additional salary to employees rather than make a pension contribution which would not be subject to BIK. This is likely to be the reaction of employers in any case if employees no longer received marginal rate relief and any employer contributions were taxed as BIK. In addition, if pension provision is to be regarded as a form of deferred pay, IAPF would argue that such payments should (like pay) receive comparable corporation tax treatment.

The biggest element of the cost is the calculation of the tax foregone by exempting the investment income and gains of pension funds' assets from tax (estimated by the Government to be €1.2 billion). It is debateable as to whether a tax foregone is a cost but in any case it is clear that it would be impossible for the State to turn this amount into revenue at the present time given the depressed returns on global investment markets.

The basis for the Government's calculation was taking the estimated value of pension fund assets (€80 billion at the time) and assuming a long–term rate of return of 7.5% per annum after charges and taxing that return at a rate of 20%. The assumed rate of return is unjustifiably high in any circumstance, given the asset mix of pension fund investment and even more so given recent investment experience. This is an important point as many commentators assume that removing tax relief from private pensions will release €2.9 billion into Exchequer funds.

Furthermore, as 80% of pension fund assets are related to defined benefit schemes this would remove perhaps €1 billion from funds at a time when over 90% of these do not have sufficient assets to meet the statutory funding standard.

Clearly this would be impossible at this time and difficult to justify at any time.

What would be the consequences of removing reliefs?

Actuarial advisors have suggested that the immediate effect of removing the relief on investment gains would be to increase the level of deficit within defined benefit schemes by €20bn. This would result from a reduction in the expected future investment income meaning that greater assets would be needed by such funds to match the value of current benefits. If these estimated future returns are depressed by a 20% tax charge, the current capital cost in the defined benefit sector is estimated to exceed €20bn.

With the survival of these schemes already under severe strain, there are very few scheme sponsors that could afford to maintain their defined benefit pension scheme if such an additional deficit were to appear overnight.

The effects are no different for those in defined contribution schemes and those in receipt of pensions from annuity providers, just not as obvious. Defined Contribution schemes don't have deficits – it's just that with less money they buy poorer pensions.

It would also be necessary to consider the taxing of equivalent yields on annuity contracts resulting in an effective tax on pensioners in receipt of pensions. This important distinction would be necessary as it would be inequitable and impracticable to treat investment return on assets used to buy-out pensions differently from the investment return on assets used to fund pensions on an ongoing basis. IAPF presume that it would be politically impossible to tax the annuity yield of pensioners in the current environment.

In the event of the removal of income tax relief on contributions, IAPF believe that many employers and employees would agree to amend salaries in lieu of the pension contribution being paid. This increased salary would be a deductible expense for corporation tax purposes and the Exchequer would be no better off. It is even more likely however, in the current economic environment, that the pension contribution would be abandoned without an equivalent salary increase.

On a more practical basis, IAPF believes that BIK on pension contributions is impractical to implement for two reasons. Firstly, defined benefit schemes cannot allocate contributions across individual employees as all liabilities are pooled and repairing deficits will be equally attributable to pensioners and deferred members. Secondly, there would be enormous operational and political difficulties in applying notional BIK on the cost of providing public sector pensions across all public and civil servants.

The removal of corporation tax relief on employer contributions to pension schemes would have a significant impact on the balance sheets of Irish corporates. This would result from the removal of the deferred tax asset attributable to pension contributions which sits on their balance sheets.

Placing further restrictions or levies on the tax free lump sum payments which are payable on retirement would have a number of significant consequences.

Firstly, there would be a significant, though perhaps unintended consequence, for defined benefit schemes where a fall off in the exercise by members of the option to commute their pensions in favour of a lump sum payment would result in additional deficits.

Secondly, the effect of such changes would have the most significant impact on middle income earners for whom a greater proportion of their pension savings are taken in lump sum form.

Thirdly, it would be necessary to consider the relationship between tax free redundancy payments and lump sum pension payments which are currently offset. In the event that pension lump sum payments were to become less attractive it is likely that those in a position to manipulate their benefits would take redundancy payments in lieu of pension lump sum payments while the majority of ordinary PAYE workers would suffer.

Finally, these changes would require equity in treatment as between public and private sector employees which may cause significant political difficulties on implementation as public servants have no choice regarding taking a lump sum.

The figures are out of date

Before relying on 2006 calculations, the Department of Finance would need to be satisfied that contributions in 2009 and 2010 will be in line with past experience.

IAPF is aware that contributions will not be anything like the levels experienced in 2006. There are already huge falls in the levels of contributions being made by individual savers for a variety of reasons including a loss of confidence in investment markets, the downturn in economic activity, business closures and a general squeeze on discretionary incomes.

Similarly, contributions from occupational pension schemes are falling sharply due to salary freezes and pay cuts, reduced bonus payments, large scale redundancies and business closures. Additional Voluntary Contributions are also being suspended for the reasons outlined above. In some cases, employers are cutting back on both employer and employee contributions to pension schemes as a means of preserving current employee head count and/or incomes or in addition to cuts in each. All of these are concrete examples of a disintegration of the pension system, even with the current incentives.

For these reasons, IAPF believes that it is inaccurate to suggest that reliefs of circa €3bn in 2006 will have a similar valuation in 2009 or 2010 or beyond or even that they can be readily converted into tax revenue to address current budget deficits.

The deemed cost of reliefs and what the Government might be able to raise as revenue are very different amounts. Being able to turn the cost of reliefs into revenue would only be possible if those reliefs are reasonably costed and behaviour would remain the same if the system of applying reliefs was changed.

At best the Government might be able to reduce reliefs (and alleviate current deficits) by perhaps €300m rather than the €3bn that has been suggested by some. However, in order to do this, the Government would essentially have to dismantle the current voluntary pensions framework and no-one has yet assessed the cost of replacing it or developing a better model.

The people who would be most hurt by this proposal are those middle income earners who would receive tax relief on their contributions at standard rate but have their benefits taxed at their marginal rate.

For those who have a choice, they are likely to simply choose not to save in this manner and find alternative means of saving. For this group, to continue saving in this way is effectively partaking in a system of double taxation. This is not a logical result for individuals who are attempting to be prudent and save for their futures. The result will be that they will save in vehicles that are unsuitable for long-term savings.

However many members of occupational pension schemes, including public servants, must be members of their pension scheme as a condition of employment. They will therefore see a reduction in their take-home pay for no extra benefit. This may diminish any advantage that employees see in the provision of a pension scheme as a benefit and employers may just decide to wind up schemes.

It would also provide particular difficulties for employers who are struggling to provide defined benefit schemes. As most of these schemes are currently in deficit employers and employees will currently be putting together proposals to restore solvency. IAPF is aware from its members that almost all funding proposals require significant increases in contributions. It would be much harder to get agreement on an employee contribution increase where employees have effectively already seen their contribution increase as a result in a change in the way tax relief on contributions is granted.

Such a reaction would be similar to that already seen by public servants to the introduction of the pensions levy. Indeed this group would see an increase in the effect of that levy as a result of any change to the system of tax relief. A public sector worker on €50,000 per annum is subject to a pension levy of 7.5% of salary. However, they are taxed at the marginal rate and will expect a 41% relief on this charge resulting in a net cost 4.4% of salary. The proposal to reduce relief to standard rate would increase the net cost of the pension levy to 6%. Instead of the levy costing €2,200 p.a. it would now cost €3,000 p.a.

What should be done?

In view of the current state of the country's finances, we understand the Government's need to explore all opportunities for additional short finance. However, changing the current tax relief for employees and employers will seriously threaten the future of private pensions in Ireland and at the end of the day could well be unworkable. It will also not raise anything like the revenue that has been suggested by many.

Looking at this as a short-term measure to raise revenue will destroy the future of pension provision in Ireland will not only not have the desired effect in raising revenue but will store up serious problems for current and future generations of retirees and tax-payers.

In the short term, it is necessary to ensure that any potential areas of abuse which have not yet been addressed are closed down. The utilisation of Approved Retirement Funds for wealth accumulation and inheritance planning should be subjected to further review.

In addition, the potential for Irish pension schemes to invest in Irish government bond issuances should be considered where such investments would provide the government with cheaper cost of borrowing than might otherwise be available.

As a short term measure, the establishment of a State Annuity Fund would provide additional working capital for the Government at this time with the corresponding liabilities being assumed into the very large provisions which must be made into the future for public service pensions.

The Commission on Taxation has already been tasked with considering how best the tax system can encourage long term savings to meet the needs of retirement. The Government's response to the Green Paper process is still awaited. It is important to consider pensions in the long-term framework and any action taken now could seriously undermine the work in these areas.