Section B – Costs to the Exchequer

Section B relates to one action in the Roadmap: 3.13. This action concerns reviewing the cost of supplementary pension to the Exchequer.

The State encourages individuals to save for retirement by offering tax incentives when saving for a pension. However, participation rates in supplementary pensions remain low among low and middle income earners, motivating the introduction of an automatic enrolment system (see Strand 2 of the *Roadmap for Pensions Reform 2018-2023*). In this context, it is important to review how well existing financial incentives for pension savings are working.

> ***Action 3.13 provides for a review of the cost of funded supplementary pensions to the Exchequer. To inform decisions relating to financial incentives for retirement savings and underpin the development of the automatic enrolment system (see Strand 2), this will include an assessment of the economic and social benefits delivered and an evaluation of equity in the distribution of tax expenditure on pensions.***

Background

Ireland's taxation treatment of pensions involves an 'EET' (exempt, exempt, taxation) system whereby (subject to various limitations, see below) contributions to pensions are tax exempt, pension fund growth is exempt from income or capital gains tax and pension fund benefits are taxed at an individual's marginal tax rate when they are drawn down.

By its nature, marginal tax relief on contributions has limited effectiveness at lower income levels. Having said that, Ireland's highly progressive income tax system results in, for example, a single individual entering the higher income tax bracket at €34,550, a level which is below average earnings. At these moderate income levels, marginal relief represents a significant financial incentive for pension savings.

According to the report on Tax Expenditures for the Tax Strategy Group, the cost of tax relief on private pensions is estimated to have been €2.4 billion in 2014[7]. These costs (i.e. tax forgone) include tax reliefs associated with employee and employer contributions, exemption of employers' contributions to occupational schemes from employee BIK taxation, the tax exemptions for contributions to RACs and PRSAs, and tentative figures for exemption of investment income and gains of approved superannuation funds and of tax free portions of retirement lump sums.

Despite existing tax incentives in place to encourage pension saving, supplementary pension coverage in Ireland remains at below 50% (reducing to circa 35% when the private sector is considered in isolation). To address this low coverage rate, the *Roadmap for Pensions Reform 2018-2023* proposes the introduction of a new Automatic Enrolment Supplementary Retirement Savings System, for workers without a workplace pension.

[7] http://www.budget.gov.ie/Budgets/2017/Documents/Tax_Expenditures_Report%202016_final.pdf

Contributions

Employee contributions to supplementary pensions are exempt from income tax, but are liable for PSRI and USC (since 2011). Tax relief is given at the individual's marginal income tax rate. Two main limitations apply in relation to tax relief on such contributions: employee contributions are subject to age-related limits restricting the proportion of remuneration that can be contributed to a pension scheme. In addition, there is an upper limit of €115,000 on the amount of earnings that may be taken into account for the tax relief purposes, which applies whether an employee is contributing to a single pension product or to multiple pension products.

Employer contributions to their employees' occupational scheme are not subject to the age-related percentage limits nor the overall earnings cap. Employees are not liable for Benefit in Kind (BIK) on employer contributions to an occupational pension scheme, but if an employer contributes to an employee's PRSA, these contributions are not exempt from BIK. The age limits and earnings cap apply to the combined value of employer and employee contributions to PRSAs, and it is only where the combined employer and employee contributions exceed the relevant age and earnings related limits that a BIK charge will arise.

Growth in Pension Funds

The investment income and capital gains of a pension scheme are exempt from income and capital gains tax.

Benefits

In simple terms, taxation rules allow scheme members or individuals, subject to certain conditions, to take a tax free retirement lump sum from their fund; and then further provides for the taxation of the remaining pension entitlements.

For Revenue approved schemes, the maximum lump sum benefit available at normal retirement age to an employee is one and a half times final remuneration (including retained benefits) i.e. 3/80ths of final remuneration for each year of service over a 40 year period.[8] Under RACs and PRSAs, or where a DC member wishes to avail of an Approved Retirement Fund, 25% of the fund can be taken as a retirement lump sum. In this case, the first €200,000 of a retirement lump sum is tax-free[9], the portion of a lump sum between €200,001 and €500,000 is taxed at the standard rate, and the balance is taxed at the individual's marginal tax rate and subject to USC.

All other income from supplementary pensions is taxable and subject to USC[10]. Current rules also prescribe a maximum benefit that an individual can receive from a Revenue approved

[8] Late entrants can commute part of their pension at a higher rate than this but, in that regard, the maximum lump sum commutation of one and a half times final remuneration can only be provided where the employee has 20 years' service with his or her current employer.

[9] As advised in Footnote 4, the tax-free amount of €200,000 is a lifetime limit and encompasses all retirement lump sums paid to an individual on or after 7 December 2005.

[10] ARF distributions are not treated as pension income but they are taxable and subject to USC.

occupational pension at normal retirement age as two-thirds of final remuneration. The rules envisage this accruing over a period of 40 years' service with the same employer at the rate of 1/60th of final remuneration for each year of service – this is known as "the strict 1/60th basis".[11] A maximum allowable pension fund at retirement for tax purposes (known as the Standard Fund Threshold – SFT) was introduced in Budget and Finance Act 2006. The SFT is €2 million and applies to both occupational pension funds and personal pension products. Its objective is to address the problem of pension overfunding and excessive pension accrual. Rather than applying restrictions to pension savings or accrual during the contribution phase, significant additional tax charges are imposed on the value of retirement benefits above set limits when they are drawn down.

As part of this review, and to inform the development of an automatic enrolment retirement savings system in Ireland, the IDPRTG would like to gain stakeholder perspectives on financial incentives for supplementary pensions and puts forward the following questions for consideration.

[11] However, it is possible to qualify for this maximum benefit over a shorter period under what is known as the "uplifted scale". Under this approach an individual can, starting not less than 10 years from normal retirement age, fund for the maximum benefit of two-thirds of final remuneration.

CONSULTATION QUESTIONS

B1. How should the economic and social benefits of tax relief on pension contributions and investment returns be considered/measured and how do you believe the system of tax relief performs in that context?

B2. To the extent that the State's tax expenditure on pensions has not resulted in high coverage rates, what in your view explains this?

B3. What adjustments, if any, could be made to marginal relief to best support the roll-out of automatic enrolment?

B4. What form of financial incentives for supplementary pensions, alternative to existing ones offered by the State, would better encourage lower and middle income earners to save for their retirement?

B5. In evaluating equity in the distribution of the economic and social benefits from this tax expenditure, what factors should be considered?

B6. Should changes be made to the existing tax treatment of pensions in any of the following stages?

- Tax treatment of employee contributions
- Tax treatment of employer contributions
- Tax treatment of growth in pension funds
- Tax treatment of drawdown of pension

If so, what kind of changes should be introduced and for what reasons?