Capping Pensions Tax Relief

An Overview of Proposals Considered by the Taxation Policy (Pensions) Group

Patrick Burke

Background

- **Establishment and Composition of the Taxation Policy (Pensions) Group**
  - Requirement to deliver Exchequer savings from Pensions of €940m
  - Cost of reliefs estimated at €2.5bn as at 2010

- **Objectives**
  - To collect reliable and verifiable data from all sources and create a computational model
  - To analyse the savings and assess the impact of various policy options
  - To optimise social policy requirements for pensions coverage and adequacy

- **Principles**
  - Pensions are a long term contract of trust and critical to social and economic fabric
  - Avoid undermining the stability of 2nd pillar pensions given the strains in 1st pillar
  - Pensions should not be Wealth Management tools
  - Pensions relief amounts to deferral of taxation

Taxation Policy (Pensions) Group

5 primary goals:

1. To deliver total annual savings of €940m
2. To ensure fairness
    - As between low, middle and higher income earners
    - As between public and private sector
    - As between defined benefit and defined contribution systems
3. To minimise impact on employment and the economy
4. To protect coverage and adequacy in public and private sector pensions
5. Simplicity of Implementation and Communication

Two Policy Options

Memorandum of Understanding Approach

- Limit Tax Relief on Contributions to Standard Rate of Tax Relief

Programme for Government Proposal

- Limit incentives for retirement savings to €60,000 pension per annum

Requirement to find the lesser of two evils.

The Journey …

- **Budgetary Savings since 2010**

– Termination of Employee PRSI Relief	€120m
– Reduction of Employer PRSI exemption	€180m
– Reduction in Contribution Cap	€ 55m
– Reduction in SFT	€ 20m
– Increase in ARF Imputed Distribution	€ 38m
– Reduction in Maximum Tax Free Lump Sum	€ 5m
– Extension of ARF to DC	-€ 2m
Total	**€416m**

- **Sector Trends**

– Fall-off in contributions *	€ 111m

* Excludes savings due to increased early retirements in public sector

- **Total Reliefs saved to date** **€527m**

Plus: **Taxes Raised - Pensions Levy to date** **€1.5bn**

Analysis of €60,000 Option

Programme for Government Proposal

- **Saves c. €380m each budgetary year going forward (starting with €231m in 2013)**
- **Fairer as regards where the burden falls**
  - Impacts c. 27,000 taxpayers (primarily private sector) earning > €125k p.a.
  - Impacts high earners rather than middle Ireland
  - Accrual continues but rate of accrual reduces in public sector
- **Protects jobs and the economy**
  - Increases disposable income of high earners
  - Internationally competitive given that it follows capping approach in UK and US
  - Implemented by reduction in Standard Fund Threshold from €2.3m to €2m with 30:1 factor
  - Addresses multi-national employer (DC) concerns due to fairer 30:1 factor and net tax impact
- **Protects coverage and adequacy of private pensions**
  - Saving for retirement remains attractive for the majority (those earning < €125k)
- **Simple to implement and communicate**

** €72,000 for pre-'95 public servants*

Analysis of “Standard Rate” Option

Memorandum of Understanding approach

- **Saves c. €375m per annum (net of expected leakage)**
- **Unfair as regards where the burden falls**
  - Impacts c. 555,000 taxpayers earning > €35k p.a.
  - Disproportionate impact on low and middle income earners
  - Disproportionate impact on public sector due to operation of PRD
- **Negative impact on jobs and the economy**
  - On average reduces take home pay/disposable income by €830 per person
  - Reduces capacity for spending in the economy
  - Reduces attractiveness of Ireland for multi-national employers
- **Inflicts severe damage on private pension provision**
  - Saving for retirement makes no sense for those earning > €40k p.a.*
- **Simple to implement and communicate**
  - However, significant complexities if implementing intermediate rates of relief e.g. 30%

** 30% rate of relief has similar impact*

Policy Considerations

- **Pensions Policy will be impacted either way but:**
  - Standard Rate relief means that saving for retirement makes no sense for those earning > €40k p.a.
    - 30% rate of relief has similar impact
  - €60k "relieved pension" cap means that saving for retirement remains attractive for the majority (those earning < €125k)
- **Fairness as between Public and Private Sectors**
  - Public Sector employees are disproportionately impacted by movements to standard or 30% rate relief due to the operation of the Pensions Related Deduction
- **Fairness as between Defined Benefit and Defined Contribution Systems**
  - Defined Contribution system is treated more fairly using 30:1 multiplier
  - Standard Rate relief approach is biased towards private sector defined benefit system relative to the members of private sector defined contribution schemes

Economic Considerations

- **Economic impact is more favourable through Capping approach**
  - Capping "relieved pension" has a positive economic impact
    - High Earners likely to divert long term savings to current consumption
    - It will likely result in increased pay to higher earners (to replace lost benefits) thus increasing income tax receipts
  - Reducing the rate of relief to Standard Rate has a negative economic impact
    - It reduces take home pay for the majority who are obliged to contribute towards pension
    - Reduces capacity to spend
    - Applies equally if rate of relief reduced to 30%

- **Tax leakage would be significant if relief changed to Standard Rate**
  - Standard Rate relief would result in employer contributions replacing employee contributions
    - Applies equally if rate of relief reduced to 30%
  - Reasonable to assume c. €85m of leakage
    - Projected savings for those in the private sector earning > €200k p.a.
  - Capping of "relieved pension" has no similar issue

Political Considerations

- **Standard Rate Option**
  - The number of low and middle income earners impacted is severe (c. ***470,000 impacted***)
    - Represents 87% of all those affected
  - The impact on middle income (€50k – €100k p.a.) earners is significant at ***€659*** per person
    - Represents 50% of all those affected
  - The impact on low income workers is somewhat less severe at ***€188*** per person per annum
    - Represents 37% of all those affected
  - Of all those impacted only 13% are in the high income category

- **€60,000 Cap on "Relieved Pension" Option**
  - Impact restricted to those typically earning > €125,000 (c. 27,000 impacted)
  - Disproportionate impact in private sector
    - 88% of total affected by number
    - 80% of total affected by value
  - Disproportionate impact in private sector Defined Benefit system
    - 47% of total affected by number
    - 55% of total affected by value
  - Concerns of Multi-national Employers with DC plans recognised by 30:1 factor

Methodology of €60,000 Option

- **Methodologies for Implementation of Cap**
  - Reduce Standard Fund Threshold **"SFT"** to €2m which effectively caps "tax relieved pension" at €60k p.a. + €200k lump sum using 30:1 multiplier (down from c. €105k p.a. + €200k)
  - SFT would be future-proofed by annual CPI adjustment
  - Allowance must be made for pre '95 Public Servants not entitled to State pension
    - The model assumes a higher cap in such cases
  - Implementation measures addressed later
    - Collection and payment of tax on excess is straightforward
    - Legislative amendments are straightforward
    - Easily applicable across public and private sector and across DB and DC systems

- **Selecting the multiplier**
  - True multipliers vary from 20:1 to 45:1 depending on nature of benefits
  - Impractical to provide variable multipliers based on individual benefits
    - Pragmatic approach: use the multiplier which would apply to State Pension - currently c. 30:1
    - Can be reviewed every 5 years or so to reflect mortality and interest rate movements
    - The balance of impact, between DB and DC systems, shifts depending on multiplier used

Factor Approaches: 30:1 Multiplier

Option 1

- The multiplier would be applied at 30:1
  - » This factor is a reasonable representation of the current capital cost of the State pension
  - » This factor leads to a similar saving to the Exchequer as the 20:1 multiplier
  - » Exchequer savings are more proportionately balanced between Defined Benefit, Defined Contribution and Personal Pensions members
  - » This approach typically impacts more higher income families than 20:1
  - » This approach reflects the factor which would actually apply to the State pension and thus the logic for its application is straightforward

This approach balances the interests of multi-national employers, public servants and ordinary DC members.

It is the most balanced approach, is simple to administer and fairer in general.

Factor Approaches: Individual Multipliers

Option 2

- The multiplier would be determined on a case by case basis referencing:
  - » The recipients age at retirement
  - » Whether spouses or childrens pensions were attaching
  - » Whether inflation linked increases were attaching
  - » Current long term AAA EMU Government bond yields
  - » Appropriate gender and mortality assumptions

This approach would be extremely painful for public servants where 45:1 would typically apply in the current environment.

Assuming a Standard Fund Threshold reduction to €2.0m, public servants expecting to receive a pension of €60,000 would face penal tax on close to €1m at retirement.

It is probably the most accurate approach to take but would be very complex and difficult to administer.

Factor Approaches: 20:1 Multiplier

Option 3

- The multiplier would be maintained at 20:1
  - » This factor is a reasonable representation of the current capital cost of a male pension at age 65 with no spouses or childrens pensions attaching and no inflation protection
  - » This factor leads to a similar saving to the Exchequer as Option 3 (a 30:1 factor)
  - » Exchequer savings are disproportionately taken from Defined Contribution and Personal Pensions members
  - » This approach typically impacts more middle income families

This approach would be extremely difficult for multi-national employers where their DC pension schemes would be seen to be extremely unattractive in relative terms.

Assuming a Standard Fund Threshold reduction to €1.4m, a private sector DC employee would only expect to receive a €32,000 relieved pension (relative to a public service equivalent of €60,000) reflecting the unfairness of this approach.

It is probably the least accurate approach, is simple to administer but deeply unfair.

Factor Approaches: Individual Multipliers

Individualised Factors presents additional complications:

a. Many DB schemes have discretionary pension increases in retirement. How would the factor be calculated when it is not clear what increases if any will be granted? If increases are assumed but not paid an individual would be paying for benefits never received.

b. There could be a similar issue for public servants. The current scheme pays increases linked to earnings. The government is examining increases linked to prices which would logically be lower in the long term. Which should be used for calculating the factor?

c. Should the factor be gender specific? Are there issues of gender discretion here that might conflict with the EU Gender Directive?

d. Should the factor allow for spouses benefits? Again there may be issues of discrimination here. If the factors specifically allow for spouses benefits a married person retiring on the same day as an unmarried equivalent would pay higher taxes.

e. Some people may be forced to early retire from a pension scheme due to redundancy schemes. This early retirement may lead to a tax even if no tax would have been payable at retirement.

f. DC investors build up a fund rather than a pension. It would be difficult to determine an appropriate fund to target since the fund would continually change as interest rates (and hence annuity rates) change.

g. Some investors would receive a “sovereign annuity” on retirement. Would different factors apply here to reflect the lower level of security on these annuities?

Implementation Considerations

- **Certification by scheme administrators and providers that benefits remain within caps**
  - Self-certification follows current Revenue practice in most areas – PFT Notification also used as PFT Certificate
  - Benefit Crystallisation Event declaration would continue to be required
  - Electronic submission of PFT Certificate assists profiling of potential audit cases
- **€60k should be subject to automatic annual escalation to reflect inflation and 30:1 multiplier should be reviewed from time to time to reflect mortality tables and interest rates**
- **Implementation must ensure the "relieved pension" cap is not a cliff for public sector**
  - Pensions must continue to increase as senior civil servants are promoted through top end salary bands
- **Penal tax could be recovered:**
  - By the pension scheme/provider, at retirement, by lump sum with a consequent reduction in the pension payable
  - Impact on public sector 'excess' benefits should be dampened by extending 10 year deduction period to 15 years or alternative measures such as tax surcharge on excess if maintenance of lump sum value is preferred
- **Existing benefits and limits would be grandfathered as per previous practices**

Early Release Assumptions

- **Assumptions to estimate Drawdown:**
  - Estimated value of AVC assets in the system is €5.7bn
  - Assumed Government policy would be to tax AVC drawndowns at marginal rate
  - Assumed Government policy would be to restrict access to 25% of AVC assets
  - Assumed those with larger AVC assets are closer to retirement
  - Assumed those in most financial distress are < 50 years age
  - Assumed that 1 in 5 persons choose to drawdown all 25% of their AVC savings

- **Estimated Drawdown €285m**
  - Resulting in assumed tax recovered by Exchequer of c. €100m

- **Approach adopted in Budget 2013 was to allow 33% drawdown over 3 years**
  - Assumed recovery of €250m may prove to be too high

In Totality

Measures taken to date/to be taken	Quantum of Savings p.a.
Employee PRSI and USC	€60m
Employee PRSI and Health Levy relief – public sector	€60m
Employer PRSI on contrib'ns	€90m
Employer PRSI (Budget 2012)	€90m
Contribution Limit to €115k (Budget 2011)	€55m
SFT Reduction (Budget 2011)	€20m
ARF Imputed Distrib'n (Budget 2011)	€38m
Lump Sum Limitations	€5m
Impact on Contrib'ns of Tax Policy and Econ. Conditions	€111m
Impact of €60k pension cap and 30 times multiplier	€380m
Total Savings (per annum)	**€909m**
Pensions Levy (c. €1.8bn 2011 – 2014)	€460m
Total	**€1,369m**

Current Position

- **Government Policy has been determined but not yet implemented**
- **Pensions Levy is to cease in 2014**
- **Factor to be used is critical to fairness for DC**
- **Implementation and Grandfathering approaches have yet to be concluded**
- **Challenges to assumed savings do not reflect conservatism in model regarding accrued AVC's and deferred benefits**

THANK YOU
Patrick Burke