Approved Retirement Fund Option for the "DC" PAYE Worker

Background

At present a situation exists where Proprietary Directors (directors who have more than 5% of the voting rights in a company) and Self Employed workers in defined contribution pension arrangements have a very important option in regard to how they can use their pension savings when they come to retirement that is not available to PAYE workers who are in employer sponsored defined contribution ("DC") pension arrangements.

(For some unfathomable reason this option is available to PAYE workers who take out PRSAs (Pension Retirement Savings Accounts) but is not available to PAYE workers whose employers include them in the company's sponsored occupational defined contribution pension arrangement.)

When a PAYE worker comes to retirement they may take part of their pension savings as a tax free lump sum. However, apart from any funds built up from AVCs (Additional Voluntary Contributions), the balance of their pension savings **must** be used to purchase an annuity from a life office.

In contrast to this proprietary directors and the self employed have a further valuable option. After taking their tax free lump sum they can either use the balance of their pension savings to buy a pension annuity or they can leave it invested in an investment product called an Approved Retirement Fund (an ARF). They can then withdraw income from their ARF Account when they wish and this income is then taxed as PAYE income when it is drawn down.

The IAPF considers that by not being allowed this important option PAYE workers in employer sponsored defined contribution pension arrangements are being significantly penalised compared to the Self Employed and company owners. This problem is compounded by the poor value available in annuity markets. In addition the ARF regime allows employees significant flexibility as to when they draw down money in that they can draw down higher or lower amounts as their personal circumstances change. For example an employee might decide to work part time from age 60 to 70 and initially draw down lower amounts of pension. For these reasons the IAPF has been lobbying the Minister of Finance in its annual budget submission to extend the Approved Retirement Fund option to all PAYE workers in occupational defined contribution schemes.

By giving this option government can support coverage objectives as this makes pensions more attractive to those reluctant to pass retirement savings to insurance companies.

Why is the ARF Option So Important?

In the current economic and regulatory environment buying an annuity means locking into a gross investment return less than the yield on medium to long term government fixed interest stock. Currently this means locking into a long term gross investment return of about +3.5%. This compares to the likely long term return which might be available from property or equity investments which experts suggest are likely to have a long term investment return of somewhere between +5% and +7%.

The reason why defined contribution pension funds invest pre-retirement savings predominantly in equities and property “real assets” rather than cash and fixed interest “monetary assets” is because in the past, over reasonably lengthy periods, “real assets” have significantly outperformed compared to “monetary assets”.

For example for the ten years to 31st December 2005, average returns from the main asset categories for Irish pension funds were:

Real Assets	**10 years % p.a.**
Irish Equity (ISEQ)	15.3
Irish Property *	17.0
UK Equity (FTSE)	9.6
N American Equity (FTSE N America)	10.2

Monetary Assets	**10 years % p.a.**
Fixed Interest *	8.4
Cash **	3.7

*Unitised Pension Property Fund and Fixed Interest average Mercer Market Insight
** Irish Life Pension Fund Cash

Longer term studies have shown that equities have returned at least 3.5% per annum greater than fixed interest. This demonstrates why all pension managed funds invest disproportionately in “real” assets.

However post retirement PAYE workers are required to purchase an annuity. Despite the fact that at age 65 workers now have a life expectancy of close to 20 years they are effectively required to lock virtually their entire pension savings into a long term investment return of +3.5%. This will in all probability lead to significantly lower retirement income for PAYE workers per euro of pensions savings compared to the self employed. It also limits the options available to those workers to exercise control over the retirement assets which they have accumulated.

A further disadvantage for PAYE workers is that by their very nature the value of the pension annuity dies with the member. In the case of members with ARFs the balance of the Approved Retirement Fund, if any, is available to provide benefits for the surviving family of the member.

Example

If a lady was a PAYE worker in a company sponsored DC pension scheme who retired at age 60 with €280,000 in pension savings she might take a tax free lump sum of €70,000 and use the balance of €210,000 to purchase an annuity. Currently €210,000 would purchase this lady a pension of €10,500 per annum with a residual pension of €10,500 per annum for her husband in the event of him surviving her. When this lady dies (and if her husband, who is of the same age, has pre-deceased her) there is no benefit available to pass on to her children. If this lady is survived by her husband, then he will receive an income of €10,500 per annum and when he dies there is no benefit available to pass on to his children.

If the same lady was a self employed female who retires at 60 with €280,000 in pension savings. She also takes a tax-free lump sum of €70,000 and leaves the balance of €210,000 in an ARF. Assume that the ARF earns a net investment return of 5.5% per annum and that life expectancy is the same as that assumed when pricing the annuity above. While either she or her husband, who is of the same age, are alive, an income of about €14,000 per annum could be drawn down monthly in advance from the ARF (subject to appropriate levels of tax). When both she and her husband die, the remainder of the ARF would be zero under the assumptions made. However, if anything did remain in the ARF, it is still available to provide benefits for her children.

Summary of example:

	Self Employed Person	**PAYE Person**
Tax free cash at age 60	€70,000	€70,000
ARF	€210,000	€0
Income to lady (could be more or less for self employed as needed)	€14,000 pa	€10,500 pa (annuity secured with insurer)
On death of lady (spouse previously deceased)	Balance of ARF, if any, available to children	€0 available to children
On death of lady (spouse not deceased)	Husband annual income of €14,000 pa. Balance of ARF, if any, available to children	Husband annual income of €10,500 pa. €0 to children on death

The Revenue Commissioners seem to fear that their tax take from pensioners will be significantly decreased if the ARF option is available to PAYE workers in employer

sponsored DC pension arrangements. On the assumptions used above the Revenue can expect to have a significantly higher tax take if the ARF option is available.

Action Required

IAPF, IBEC and ICTU should lobby the government to extend the ARF option to DC workers who are in company pension arrangements as part of the present partnership talks. There is absolutely no justification for giving this option to company owners, the self employed and standard PRSA contributors when it is not available to PAYE workers.