Society of Actuaries in Ireland

Submission to the Commission on Taxation

May 2008

Terms of reference

The terms of reference area of the Commission on Taxation review to which this submission relates is: "*consider how best the tax system can encourage long term savings to meet the needs of retirement*".

This submission is made by the Society of Actuaries in Ireland, which is the professional body for actuaries practising in Ireland. Actuaries provide advice and relevant solutions for financial, business and societal issues involving uncertain future events. Most of the Society's members work in the financial services industry and the profession has a statutory role relating to the supervision of pension schemes and insurance companies.

The Society seeks to make an impartial contribution to public debate on social policy and public interest matters where an actuarial perspective can add value.

The Society welcomes this opportunity to submit proposals to the Commission on Taxation.

Comments and Proposals

Tax relief on pension savings

1. Currently, there are significant tax incentives to pension saving in Ireland. Pension contributions are deductible at the marginal rate of income tax and PRSI contributions are calculated on earnings excluding pension contributions. Investment returns on pension investments are not taxed. Pensions are subject to income tax, but most retirees can convert part of their pension into a tax-free lump sum at the point of retirement.

2. It is important to note that, notwithstanding these generous tax incentives, many people are not saving for retirement and many more are not saving amounts that are adequate to provide an income in retirement in line with current Government policy objectives (i.e. that pensioners have an income of at least 50% of their pre-retirement income).

3. The Society's view is that the current system of tax relief is an effective approach to incentivising long-term saving. We believe that the system should be maintained, but that it needs to be communicated better. The provision of tax incentives, and effective communication of those incentives, is essential to encourage people to save for retirement.

4. The current system has been criticised for giving too much relief to high earners, but this ignores the income tax that will be payable on pensions in payment. In fact, our analysis shows that the current system gives the highest effective rate of relief (on a lifetime basis i.e. net of the discounted tax payable on pension income) to people whose earnings are not too far above the threshold for the higher rate of income tax and who are saving a moderate amount for retirement. We believe that this is a reasonable outcome (while acknowledging, of course, that high earners receive substantial benefits in absolute terms). Further detail in relation to our analysis is provided in paragraphs 5 to 11 below.

Value of tax relief on pension savings

5. The recent OECD Economic Survey of Ireland 2008 report has argued that our tax system, which aims for pension savings, returns and income to be subject to an "exempt-exempt-taxed" (EET) regime, is in fact fairly close to being an *"exempt-exempt-exempt" (EEE) system where income channelled through pensions is unlikely to be taxed at any point of the life-cycle."* The OECD report, and many others, have also argued that tax incentives to pension saving are poorly targeted and are of greatest benefit to higher earners who pay the higher rate of income tax of 41%.

6. However, the view that the current system of tax relief for pension savings is of maximum benefit to higher earners is not borne out by a quantitative analysis of the lifetime impact of the regime. The Society has estimated the overall effective rate of tax relief on lifetime pension savings, allowing for the tax relief on savings and the tax payable on pension income in retirement, taking account of the tax thresholds for persons aged over 65 and the impact of the tax-free lump sum that can be taken from overall retirement savings at the point of retirement. Details of the assumptions underlying this analysis are set out in paragraphs 8 and 10.

7. The results of our analysis are set out in Table 1 overleaf. The results indicate that the current system gives the highest rate of income tax relief to people whose earnings are not too far above the threshold for the higher rate of income tax and who are saving a moderate amount for retirement. Notes on the individual scenarios illustrated are set out in paragraph 9 overleaf.

Table 1

Annual salary €	Pension savings as % of salary	Overall effective rate of tax relief	Notes (see para. 9 overleaf)
25,000	20%	23%	(a)
45,000	20%	40%	(b)
100,000	20%	31%	(c)
200,000	20%	22%	(d)
45,000	25%	34%	(e)

8. The model is based on a 40 year old man who saves 20% of salary per annum until age 65[1]. It is assumed that, at age 65, he takes the maximum tax-free lump sum of 1.5 times salary and purchases an annuity with the balance. It is assumed that he survives until age 85. Our model calculates the present value of the tax relief on pension contributions and offsets against this the present value of income tax paid in retirement on the pension annuity. The model assumes that current exemption limits, tax-bands, etc. increase annually in line with wage inflation.

9. Notes on the projections are as follows:

   (a) An individual earning €25,000 per annum before retirement will pay no income tax in retirement.

   (b) The maximum effective rate of tax relief on pension savings applies to an individual with an annual salary of €45,000. Contributions benefit from relief of income tax at 41% and PRSI at 6%. In retirement, income tax will be paid at the standard rate on approximately 25% of the pension annuity, with no tax payable on the balance.

   (c) At higher salary levels, the effective rate of tax relief is lower. An individual earning €100,000 per annum obtains income tax relief at 41% and PRSI relief at 2%[2]. During retirement, he or she will be liable for income tax at the standard rate on most of the pension annuity and just starts to break into the marginal tax bracket.

---

[1] Broadly speaking, an individual starting to save for retirement at age 40 would need to make contributions at this level (or higher) in order to target a pension of 50% of salary inclusive of the State retirement pension.

[2] The model ignores the slightly higher PRSA contribution rate applicable to salaries above €96,250.

(d) An individual earning €200,000 has a lower effective rate of tax relief than an individual earning €25,000.

(e) For an individual earning €45,000, the effective rate of tax relief falls from 40% to 34% if the level of pension contribution is 25% of salary rather than 20% of salary. Essentially, the higher the level of pension contribution, the lower the rate of relief, as the rate of tax payable on the marginal pension resulting from the extra savings is higher than the average rate of tax on the overall pension.

10. The model assumes a modest rate of investment return (5% per annum); this is also the rate used for discounting purposes. Wage inflation is assumed to be 3% per annum. If higher rates of investment return and wage inflation are used, the effective rate of tax relief is somewhat lower. This is because the resulting pension is higher and is therefore subject to a higher overall tax rate. Table 2 overleaf shows the effective rates of tax relief assuming investment return of 7% per annum and wage inflation of 5% per annum.

Table 2

Annual salary €	**Pension savings as % of salary**	**Overall effective rate of tax relief**
25,000	20%	22%
45,000	20%	38%
100,000	20%	27%
200,000	20%	22%
45,000	25%	33%

11. While our analysis belies the view that the current system is of most benefit to high earners (in terms of net tax relief as a percentage of earnings), it indicates that the current system does entail significant effective rates of tax relief. For example, the availability of a tax-free lump sum is an attractive feature in terms of encouraging people to save for retirement, but has a significant cost in terms of its contribution to the effective rate of tax relief, in particular for higher earners. To illustrate this, Table 3 below shows the estimated effective rates of tax relief if no tax-free lump sum is taken.

Table 3

Annual salary €	Pension savings as % of salary	Overall effective rate of tax relief (if no tax-free lump sum is taken)	Overall effective rate of tax relief (including tax-free lump sum -Table 1)
25,000	20%	22%	23%
45,000	20%	35%	40%
100,000	20%	22%	31%
200,000	20%	14%	22%
45,000	25%	30%	34%

This form of analysis could similarly be extended to consider the impact of other potential changes to the current tax system, including, for example, reducing the earnings cap for tax relief on pension contributions (currently €275,237) or removing the higher income tax exemption limits that apply to people over age 65 (currently €20,000 for a single person or €40,000 for a married couple compared with €5,210 and €10,420 respectively for people under age 65).

Capped matching contributions

12. Various parties have made the case for the provision of capped matching contributions for pension savings, similar in structure to those granted under Special Savings Incentive Accounts (SSIAs). The Society acknowledges that some people may find it difficult to understand the tax incentives for pension savings. We agree that the high take-up of SSIAs suggests that a similar system of matching contributions for pension savings could help to improve the level of pensions coverage, provided that any proposed product structure was practicable and economic to deliver. We note, however, that it is unlikely that the same take-up rate could be achieved for retirement accounts as for SSIAs for several reasons, including the fact that pension savings would have to be committed for much longer periods and should normally be invested in riskier assets than the cash-based assets that appealed to most SSIA-holders. We note also that dismantling the current system of tax reliefs in favour of capped matching contributions would present very significant logistical complications.

Pre-retirement access to funds

13. The Society believes that allowing the option of pre-retirement access to funds on a restricted basis would provide a major boost to long-term saving. The success of SSIAs supports this premise. A corresponding offset against tax-free cash at retirement could potentially be applied

Approved Retirement Funds (ARFs)

14. The Society's view is that the option to transfer pension savings to an Approved Retirement Fund at the point of retirement should be extended to all members of all defined contribution arrangements. It is inequitable to require some members of such plans to purchase an annuity at retirement, regardless of annuity costs at the time, while exempting others from the requirement. However, current tax anomalies should be addressed. In particular, as any money in an ARF has received income tax relief, we believe that such money should be subject to income tax when withdrawn from the ARF. ARFs should not be passed to estates as low-taxed inheritances.

15. The need for, or appropriateness of, ARFs under defined benefit schemes is less clear-cut, given that the primary *raison d'etre* of such schemes is to provide a specified level of retirement income. There may be an argument for extending ARFs to defined benefit schemes in the interests of a level playing field between defined benefit and defined contribution plans in terms of benefit options. However, if ARFs were to be extended to defined benefit schemes, a number of issues would need to be carefully considered first, such as the implications for funding strategies and investment strategies and the basis on which guaranteed pensions would be converted to lump sums.

16. At present, there is a requirement for an individual effecting an ARF to have a guaranteed income of at least €12,700 or to place €63,500 in an Approved Minimum Retirement Fund (AMRF). The Society recommends that the latter test should be abolished - the primary requirement is to ensure that the individual concerned has a minimum guaranteed income, and, in any event, an AMRF of €63,500 is of much lower value than a guaranteed income of €12,700 per annum. We also consider that the minimum income test should be indexed to ensure that it maintains its value relative to increases in earnings.

Phased retirement

17. Current Revenue rules do not permit the phased payment of retirement benefits. We suggest that the rules be amended with a view to facilitating phased retirement. Pension scheme members should be allowed the facility to draw a partial pension while continuing to work part-time.

END