

GOVERNMENT POLICY DOCUMENT ON PENSIONS UNVEILED

At last, the National Pensions Framework has arrived. But what does it mean for hard pressed pension trustees, employers and employees?

In fact, the immediate practical implications are limited. There are several statements of good intention, which we applaud:

- Sustainability, affordability and adequacy of the State system;
- Review of defined benefit regime;
- A new pension scheme for the public service.

If followed through, these will hopefully have a beneficial effect on the overall health of pension provision.

The Framework proposes some practical changes which will have a more immediate impact on how we manage pension planning:

- Increasing age for eligibility for the State pension;
- Changing tax relief on contributions to a single rate of 33%;
- Extending draw down facilities for Defined Contribution schemes;
- Mandatory minimum pension provision.

We discuss each of these topics in brief.

There is also the stated intention to cap tax free lump sums at €200,000. The treatment of the excess and the rate of tax to apply have yet to be decided, so we hope to write further on this matter when the facts are known.

If you would like to discuss any of the issues raised or any matter relating to employee benefits, please contact your Willis consultant or Kirstie Flynn, kirstie.flynn@willis.ie



STATE PENSION DELAYED UNTIL AGE 68

Assuming that the Government proceeds with the proposals contained in the National Pensions Framework, people will have to work longer to get a State pension.

From January 2014 the State Pension (Transition) will be abolished, making the minimum age to qualify for a State pension 66.

People who reached age 65 in 2013 and who qualified for the transition pension should continue to receive it until age 66 when they qualify for the old age pension. Therefore the first people who will be faced with a void at age 65 are likely to be those born in 1949.

In 2021 the qualifying age will go up to 67, meaning that nobody will become entitled to commence State pension that year. This will impact those born in or after 1955. From 2028 the minimum age will be 68. Those born in or after 1961 will not receive a State pension until age 68.

This change is in line with what has been happening in many countries across Europe and reflects increasing life expectancy among people in retirement as well as the financial pressures being felt by governments.

However, a delay in the State pension has unwelcome consequences for working people and for private pension schemes.

For most people thinking ahead for retirement, the State pension forms an important part of our planning. If the State pension is not going to be available at the time of retirement, those plans have to be reviewed and changes made. Possible ways of coping with the delay in State pension might be:

- To draw down extra funds from a private/occupational pension in the early years of retirement (now that the ARF option is becoming more widely available) at the expense of diluting funds for later years;
- To defer retirement until eligible for the State pension, although this may not be possible depending on the terms of one's employment contract;
- To look for part time or temporary work during the intervening years before the State pension commences.

None of these options is very attractive for people who have spent years working and saving towards a secure retirement.

There will be issues for Defined Benefit schemes that will need to be addressed in the short term. In spite of the move towards Defined Contribution schemes in recent years there are still over a quarter of a million members of private sector Defined Benefit schemes. The majority of these schemes take account of the State pension in calculating benefits. An increasing number of public servants are now paying full PRSI contributions and similarly have the State pension factored into their benefit calculations.

- Will the State pension offset continue to be deducted from occupational Defined Benefit pensions from age 65, even though people will not start receiving it for up to a further three years?
- Will already struggling Defined Benefit schemes be asked to take on the increased financial burden of paying a bridging pension up to the point where the State pension comes on stream?

- Will members have to use AVCs to make up the new shortfall in income between age 65 and 68?
- Is it time to review retirement ages to coordinate State and occupational pensions?

We would have to wonder if the full implications of this change have been carefully thought out? If, as seems likely, the delay in the State pension causes more people to defer retirement, then there will be consequences for the unemployment rate. Except in periods of full employment, it is likely that the government will simply be trading off one cohort of people reluctantly having to work beyond age 65 for another group of younger people eager to work who cannot find jobs.

How to respond to these new challenges? The best approach will be tailored, depending on the circumstances of each case. There is a limited lead-in time, especially for people expecting to retire as early as 2014, so the issues will need to be tackled sooner rather than later.

CHANGE IN TAX RELIEF FOR PENSION CONTRIBUTIONS

At present contributions to an approved pension scheme, up to specified limits, qualify for relief from Income Tax at the individual's marginal rate (20% or 41%) and Social Insurance contributions (4%) and the Health Levy (4%)¹.

For a higher rate tax payer this relief can amount to 49% of the contribution paid. For a person on the lower tax band the relief is less, typically around 28%.

The National Pensions Framework proposes to replace tax relief with a Government contribution equivalent to tax relief at 33% regardless of the person's tax band.

There is no proposal to change tax relief on employer's contributions or to alter the age related limits for employee contributions.

The mechanism for delivering the Government contribution, which would have to be equal to 50% of the individual's contribution, is yet to be decided. It is unclear whether there will be an actual cash payment to the scheme, to be invested by the member or trustees alongside other assets, or if the Government contribution will consist of some other credit or

¹ Up to €75,036 earnings. At €75,036 employee's Social Insurance contribution goes to 0% and Health Levy goes to 5%.

security to be redeemed at a later date. If it is the latter case people will need to review their investment strategies, as a Government promise, presumably with interest, would be very similar to a Gilt, thus skewing the overall investment portfolio towards bonds.

While the new arrangement will be a boon to lower earners, who will get a higher subsidy for their pension contributions, anyone on the top rate of tax will inevitably lose out. Instead of 49% tax relief, the new regime will equate to a maximum relief of 41% (i.e., 33% + 8% Social Insurance and Health Levy saving).

For many taxpayers this will be a serious disincentive to making pension contributions. Consider the position of someone earning over €75,036, where the effective rate of relief will be 38% (33% tax and 5% Health Levy), who retires with a pension of more than €36,400 per annum – not exactly an excessive amount – who would then be subject to tax at 41% plus health contribution of 4%. The tax and levies payable on the pension would actually be more than the tax relief received on the contributions. Against a background of the Government hoping to encourage people to make adequate provision for retirement, this measure simply does not make sense.

Sadly, some people may cease making voluntary contributions. Other potential issues are:

Defined Contribution Schemes: It will be harder to encourage employees to join contributory schemes. New plans may have to be set up on a non-contributory basis in order to make them attractive to employees. For existing schemes, there is the obvious temptation of changing the rules to make them non-contributory. This leads to the increased risk of insufficient pension payable at retirement, unless the employer chooses to make up the shortfall.

Defined Benefit Schemes: Many employers and trustees whose schemes are underfunded are considering the various options available to return the scheme to a solvent position. One of the options that may be considered is an increase in employee contributions. This may prove difficult if employees on the higher rate of income tax are already feeling the increased cost of pension provision as a result of the tax relief change – and any proposed increase will have a larger impact on such employees' net income than at present.

None of this is a direction in which pension schemes should be heading, in the current environment of increased employee self management.

EXTENSION OF APPROVED RETIREMENT FUNDS TO ALL DEFINED CONTRIBUTION SCHEMES

On retirement a member of a Defined Contribution pension plan generally has a limited number of options regarding how to use their available pension fund. A portion of the fund can be taken as a tax free lump sum (an option which most people select) and the balance must be used to provide an annuity, or pension, for the person's life. There are further options as to the terms of the annuity, such as protection for surviving dependants and automatic annual increases.

For directors who own or control at least 5% of their company there is the alternative of taking a quarter of the accumulated fund as tax free cash and either taking the remainder as a taxed lump sum or investing the remainder in an Approved Retirement Fund (ARF).

To be eligible for this option, the person must have a separate guaranteed pension for life of at least €12,700 per annum, or alternatively must transfer a minimum of €63,500 into a special vehicle called an Approved Minimum Retirement Fund (AMRF) or use that amount to purchase an annuity.

The individual retains control over how the Approved Retirement Fund is invested and can draw on it at any time or leave it invested indefinitely. Withdrawals of funds from the ARF are taxed at the individual's marginal rate in the year of receipt. Tax is charged on 3% of the fund value every year even if the person does not draw on it, provided the owner is aged at least 60².

For employees who are not 5% directors, the ARF option is also available, but only in respect of that portion of the accumulated fund referable to Additional Voluntary Contributions. The option is also subject to having a minimum pension of €12,700 per annum or transferring €63,500 to an AMRF or an annuity.

The National Pensions Framework proposes to extend the ARF option to all Defined Contribution schemes, subject to the individual having a prescribed minimum guaranteed pension. The AMRF alternative is not expected to apply and the minimum income is likely to be set at €18,000. An individual will be able to use a portion of the available fund to top up any other pension (e.g., the State pension) to meet the minimum requirement.

² Although any moneys actually withdrawn in any year are written off against the 3% tax in that year.

There are obvious advantages to freeing up Defined Contribution funds in this way, which can be summarised as follows:

- Not forcing people into buying annuities, particularly in times when interest rates are low and annuities are expensive;
- People will retain control of how the funds are invested after their retirement;
- People will have access to their capital in case they need it in retirement.

These advantages have to be weighed up against the 'risk' of longevity – if you purchase an annuity the life office will continue to pay it no matter how long you live, whereas a pensioner who lives longer than expected may run out of ARF funds.

It is intended that this change will come into effect from 2011. People retiring since December 2008 have had the option to defer purchasing an annuity until the end of 2010. It is to be hoped that those people will qualify under the new provisions and have the freedom to invest in an Approved Retirement Fund.

NEW MANDATORY PENSION SCHEME

Employers in Ireland are not obliged to provide any retirement benefits for employees, other than mandatory Social Insurance contributions.

Where a company does not have an occupational pension scheme for all its employees with at least six months service, it must offer excluded employees access to a Personal Retirement Savings Account (PRSA). This involves selecting a PRSA provider and giving employees the opportunity, on company time, to get advice about retirement planning. The employer does not have to contribute to a PRSA, but some do, using PRSAs as an alternative to traditional pension schemes.

Under a new proposal announced in the National Pensions Framework, to begin in 2014, employers will have to make contributions on behalf of employees, either in a conventional pension scheme or through a minimum mandatory arrangement operated by the Government (yet to be named or given an acronym).

Where employees are not included in a Defined Contribution scheme with contributions at least equal to those set out below, or in any Defined Benefit scheme, the employer will be obliged to enrol them in the new mandatory arrangement.

Contributions to the mandatory arrangement will be 4% of salary from the employee, 2% from the employer and 2% from the Government (equivalent to 33% tax relief on the employee's contributions, as announced elsewhere in the Framework). It is envisaged that contributions will be payable on salary between €6,604 and €51,740 per annum, with only employees with an income over €18,304 per annum being eligible.

Employees will be automatically enrolled on hire, or on the commencement of the new rules. A person can choose to opt out after three months, but will be automatically re-enrolled every two years. There will be a bonus paid by the Government into the fund after five years' continuous contributions.

This will be a Defined Contribution scheme. There will be a range of investment choices, through low, medium and high risk options, with a life stages version probably as the default option. Funds will be managed by independent investment managers, to be selected on a competition basis.

Compulsory minimum pensions have been discussed for some years now. This is a 'soft-mandatory' (opt-out) approach, which the Government clearly hope will provide a basic level of retirement benefit for those who would otherwise not get anything. In this formula lies the risk of a 'race to the bottom' – where employers and employees will be tempted to do just the minimum and to gravitate towards the lowest common denominator.

Inevitably, this proposal will be criticised from all sides. Employee groups will say that it is not adequate; employers will object to what looks like another tax on employment. It has already been criticised as a 'gift to the pensions industry' – despite the fact that submissions by industry bodies to the consultation process on the Green Paper on Pensions were universally against the introduction of mandatory pensions. Perhaps the Government will console themselves with the thought that, if everybody is unhappy, they must have it about right.