Commission on Taxation & Welfare
An Coimisiún um Chánachas ⁊ Leas

Briefing Paper

Pension Tax Expenditures

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Key points

- In Ireland the general tax treatment of supplementary pensions is one of exempting contributions to pensions, exempting investment income from pensions and taxing the decumulation phase of pension drawdown ('EET').
- As noted in previous papers the cost of tax expenditures in this area are considerable totalling over €1.7 billion in 2019 and are among the largest recorded. It is noted that the true costs of these expenditures is likely to be higher again owing to limitations in the costing methodology applied and due to limited availability of data particularly in the area of lump sums.
- This paper notes a number of areas where deviations exist in the application of the EET model in Ireland. Examples used include at the contributions stage where employer PRSI is not payable on pension contributions and also at drawdown where the treatment of tax free lump sums means that a portion of pension savings remain untaxed across the lifetime.
- In addition to these exceptions, the analysis of tax expenditures in this area gives rise to a number of other areas for consideration by Commission members including the equity of the current system of tax relief and existing contribution limits.
- The outcome of the ongoing policy formation on auto enrolment may also have implications for existing pension tax expenditures, which may require revisiting this topic.

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1 Introduction

At meeting 5 of the Commission a secretariat paper was presented which centred on the process of reviewing tax expenditures. It was agreed by Commission members that there were a number of key areas where the process for reviewing expenditures could be strengthened and that further data was required in order to agree an approach for consideration of the largest individual expenditures.

A follow up paper was presented at meeting 10 providing further data, including analysis of the 23 largest tax expenditures (by reference to calculated revenue foregone) along with detailed lists of tax expenditures which would be covered by the individual vertical work streams of the Commission work. This examination led to agreement that the scale and breath of supplementary pension related expenditures would be considered by the Commission on a standalone basis. Tax expenditures associated with pensions, had a combined cost of over €1.7billion in 2018 figures and represent some of the largest tax expenditures in the State. This paper aims to give an overview of the supports that the State pays for pensions, with a focus on the tax treatment.

The Commission is not alone in examining the tax implications of pensions. The Interdepartmental Pensions Reform & Taxation Group (‘IDPRTG’) was established in 2018 to examine, amongst other things, the tax treatment of pensions, along with assessing the economic and social benefits delivered and an evaluation of equity in the distribution of tax expenditure of pensions. The IDPRTG published its report in late 2020, along with recommendations focused on the reform and simplification of the existing supplementary pension system. These are detailed at section 4.2.

A common thread running through Commission on Taxation work in 2009 (COT 2009) and the more recent IDPRTG publication is around the appropriate targeting of Exchequer support for supplementary pensions. The IDPRTG note that despite generous tax incentives to save, large proportions of low and middle income cohorts continue to make little provision for retirement. Such reforms would require rebalancing of existing tax incentives in order to address coverage gaps and improve income adequacy in retirement.

Over the last 20 years there have been a number of commitments and proposals to reform the system of State support for supplementary pensions. These included proposals for a flat rate of contribution relief of 40% (COT 2009) or a standard rate of 33% to apply to all contributions(Pensions Framework, 2010), or simply to reduce overall levels of tax relief and pension related deductions (Troika, 2010)[1]. Further debate has also arisen on the equity of State support in this area. Furthermore, Ireland's pension taxation model offers three stages at which taxation could occur- at contribution stage, during investment or during drawdown) but the OECD notes that currently some pension savings never incur taxation. Other potential areas of reform could also include changes to the lifetime benefit that can be accrued under the €2m Standard Fund Threshold or alter the annual age related limits on contributions.

The Programme for Government also commits to introducing a **pension auto-enrolment** system which would be designed to address the low proportion of employees in Ireland with supplementary pension cover, which includes both occupational and personal pensions. Work currently underway on the proposal (expected to come to fruition over the coming 6-12 months) and decisions taken on the funding model for State support may impact the recommendations that the Commission ultimately make on appropriate levels of State support and tax expenditures in this area.

Any discussion of the area of pension taxation expenditures should be read in conjunction with previous papers dealing with demographic trends and fiscal sustainability.

2 Outline of pension landscape and developments in Ireland

The pension system in Ireland is structured around multiple pillars, as follows:

1. First pillar- State Pension system.
2. Second Pillar- designed to provide a standard of living related to pre-retirement income. These pensions are usually provided through occupational pensions which supplement the first pillar.
3. Third pillar- voluntary, enabling people to save if they wish to so. In Ireland savings can be made through Additional Voluntary Contribution (AVCs) to occupational pensions or through various individual pension products such as Pension Retirement Savings Accounts (PRSA).

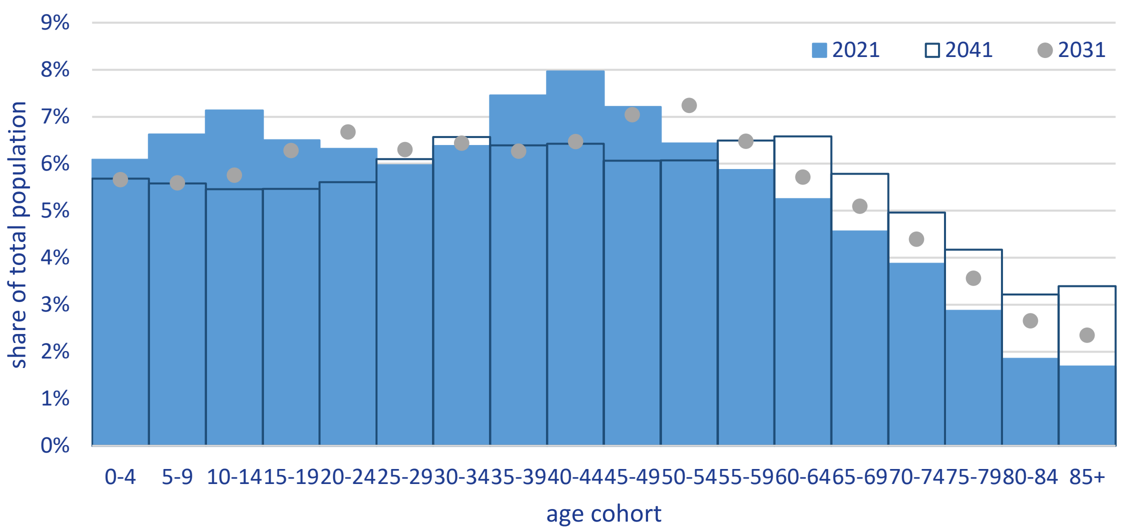
As indicated previously the purpose of this paper is to consider further the specific tax expenditures associated with supplementary pensions under pillar 2 and pillar 3. It does not deal with the pensions associated with the first pillar (including non-contributory state pension and contributory state pensions).

[1] IMF Memorandum of Understanding 2010

2.1 Demographic trends in Ireland

The Commission is reminded of the demographic changes that are forecast over the coming 30 years, detailed in the fiscal sustainability papers at meetings 2 and 8. Ireland's population is ageing and people are also living longer and therefore living an increasing proportion of their lives in retirement. Ireland is also experiencing a shift in age structure, which relates to legacy impacts of shifting migration patterns from as long ago as the 1950s.

Figure 1: Age cohorts – projections in 2021, 2031, 2041 (% of total population)



Source: Eurostat

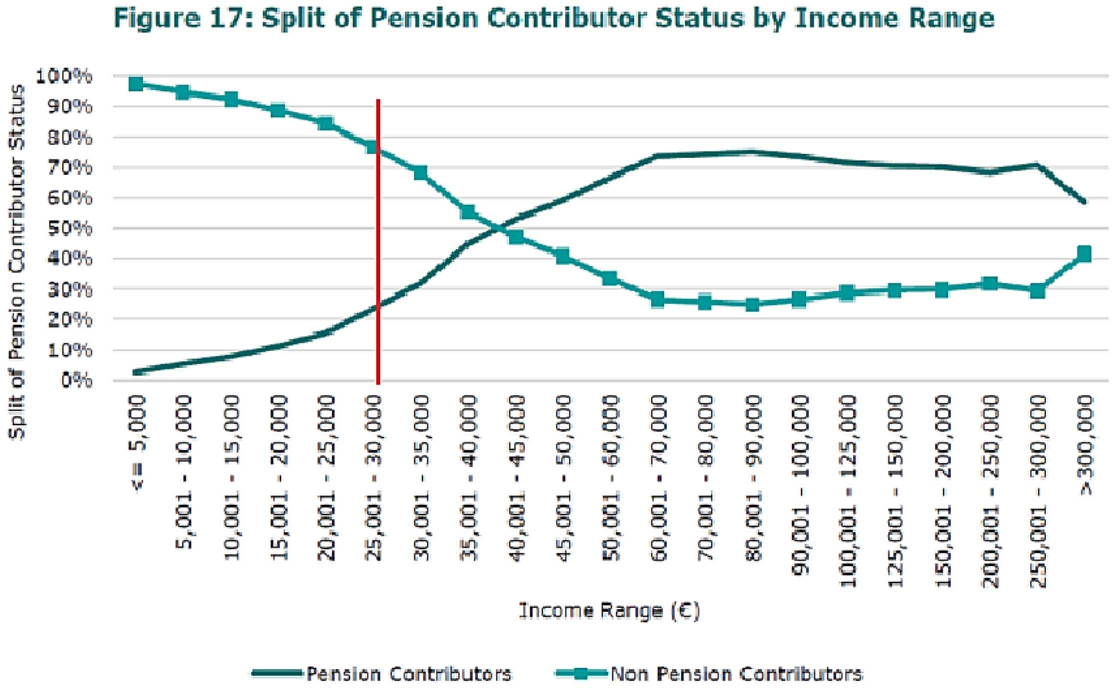
There is broad consensus on the magnitude of the scale of these changes in the near and longer term. It is estimated that the old-age dependency ratio, or the share of over 65 year olds as a proportion of the 20 to 64 age cohort, is to increase rapidly over the next ten to twenty years. There are currently four persons of working age for every one person aged over 65; by 2030, the equivalent will be closer to three and in 2040 it will be just over two and a half. In an international context, Ireland's old-age dependency ratio is projected to converge on the EU-27 average. The extent to which individuals have access to supplemental pensions which provide adequate levels of income in retirement will directly impact how the State responds to these demographic shifts.

2.2 Supplementary Pension coverage

Retirement income is likely to come from a variety of sources (for example, savings or investments), however for many the State pension will currently be their only or primary source of retirement income. ESRI research, using the Longitudinal Study on Ageing found that 55% of men and 28% of women were in receipt of supplementary pension income. CSO data indicates that about 56% of men and about 54% of women were contributing to a pension in Q3 2020. Looking at private sector alone, the *Roadmap for Pensions Reform* estimates that just 35% of workers have supplementary pension cover despite the availability of extensive tax reliefs. This analysis suggests that a high percentage of the working population is not saving enough, or is not saving at all, for retirement leaving large cohorts of people reliant on the State pension in future years. It is for these reasons that the Government announced the development and implementation of an Automatic Enrolment (AE) retirement savings system in the coming years.

The most recent data on pension coverage comes from the Revenue Commissioners PMOD (PAYE modernisation) data in 2019. This offers an insight into the proportion of each income cohort making pension contributions. Again, for scale the red line offers median income from the Revenue data at €25,421[2].

Figure 2: Distribution of pension contributor status by income range- taxpayer data



Source: Revenue Commissioners, PMOD analysis 2019

[2] Note this median figure takes into account part time and full time and seasonal workers. Data provided with Figure 7 in [Statistics and Insights from the first year of Real time Payroll reporting]

Unsurprisingly, younger workers and people on lower pay are less likely to be contributing to a pension, as they will have less income available to pay for future commitments, after paying for current commitments (housing, heat, light etc.). Research produced by the ESRI as part of the auto-enrolment process also indicates that employment type and work patterns, sector and employer size are key determinant factors in supplementary pension coverage. Furthermore part-time and self-employed workers tend to have much lower coverage rates compared to full-time and PAYE workers. In addition, the IDPRTG report points out that for incomes below €18,000 where effective tax rates are low, the State pension replaces over 70 per cent of pre-retirement income arguably reducing the need for a supplementary pension depending on the replacement rate policy goal.

The IDPRTG report found that while financial incentives play a role in pension coverage, it is difficult to determine the exact extent to which the tax treatment of pensions is a driver of coverage in Ireland. The report went on to point out that State financial incentives are not cited as a reason by those who do not have a private pension and to note that recent Irish evidence suggests that affordability, lack of an available occupational pension and inertia are the key reasons explaining low take-up of supplementary pensions.

The European Commission's Pension Adequacy Report 2018 discusses the relationship between home ownership and income protection in retirement and found that ownership is associated with lower levels of poverty. In Ireland the average age of first time buyers is increasing[3] and the rising number of people living in rented accommodation[4] has the potential to have negative implications for the income protection aspect of pension adequacy. These factors also feed into decisions around what individuals choose to do with discretionary income at lower income deciles, as saving for a home may displace saving for retirement.

The stated policy goal for pension tax expenditures was recently articulated in a Tax Strategy Group paper on pensions[5] as follows, *"It has been long established policy to encourage individuals on middle incomes to provide for some level of private pension which would (in addition to the basic State pension) help provide for an adequate replacement income in retirement"*. When considering the tax expenditures in this area it will be important to consider to what extent current tax reliefs are achieving this goal.

[3] Central Bank of Ireland, 2019. In 1991 the average age of first time buyers was 26, by 2016 it had reached 34.
[4] CSO 2016. Households renting from private landlords or a voluntary body has risen from 8% in 1991 to 20% in 2016.
[5] Department of Finance, TSG 12/21, p. 10

3 Outline of tax treatment of supplementary pension in Ireland (EET)

State support for supplemental pensions is neither new, nor unique to Ireland- most developed economies have fiscal supports for pension savings and such support usually takes the form of tax relief. In providing incentives, a state is assuming that workers require an incentive to lock-up savings until they retire, in order to achieve the desirable policy objective of increasing aggregate savings or encouraging citizens to pay for their retirement by deferring income and consumption today to provide for later years.

Like most tax expenditures, the Revenue Commissioners use the tax forgone method of costing. This attempts to estimate how much tax would have been paid if contributions to pensions were treated under the benchmark tax system and it does not take account of the possible behavioural changes associated with the pension incentives. Reducing or eliminating pension incentives to save now could reduce or eliminate taxable drawdown from pensions in the future, creating future erosion of the tax base. Components of financial incentives should be viewed as interdependent and changing one aspect of pension taxation will have implications for pension savings and therefore levels of taxation[6].

3.1 EET system of tax reliefs

Ireland, along with many other OECD countries offers tax relief at certain points of the savings cycle (at deduction, at point of investment) and taxes at drawdown. This is referred to as 'EET' referring to the 'Exempt (Contributions), Exempt (Return on Investment), Taxed (Pension Income)'. According to the OECD, 'EET' is the most commonly used system for taxation of pension savings, in use in 20 of the 42 countries included in their 2018 study (including Ireland). Ireland's form of EET is not 'pure'. For example;

1. While pension contributions by individuals or employees are relieved for the purpose of income tax (within limits), employee PRSI and USC liabilities remain.
2. Pension income drawn down in retirement is subject to the USC and income tax, but not employee or employer PRSI.
3. Investment growth of pension funds is not taxed (no stamp duty, CGT, VAT, exit tax). There was a one off stamp duty levied on the total value of investments (assets) over the period 2011-2015 to fund the *Jobs Initiative*.

[6] Report of the Interdepartmental Pensions Review and Taxation Group (IDPRTG), p49

4. A significant proportion of the benefits taken at retirement are allowed as a tax-free capital payment (see section on tax-free lump sum).

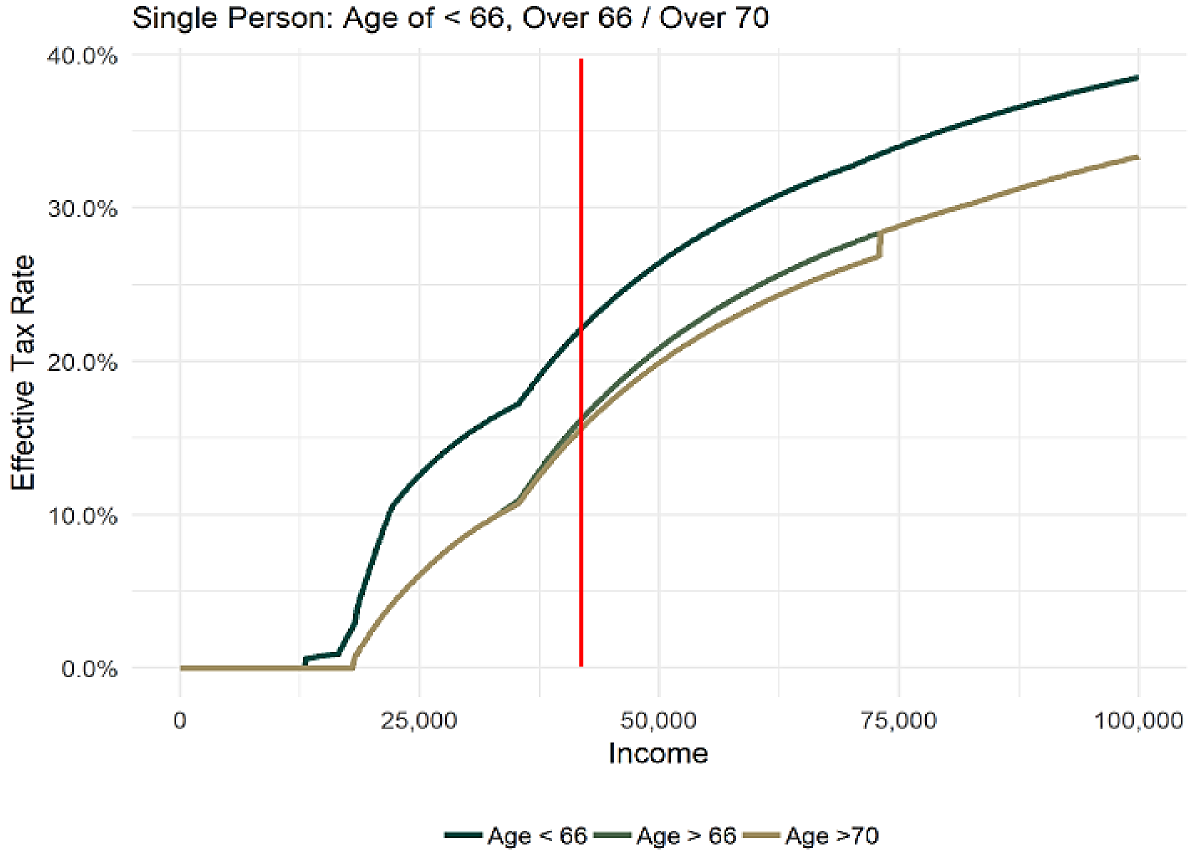
The OECD[7] noted in 2008 that Ireland's EET regime is close to being EEE (exempt, exempt, exempt) for many, 'where income channelled through pensions is unlikely to be taxed at any point in the life cycle. The IDPRTG noted in 2020 that 'as our EET system matures and our population ages, taxation on pension income could potentially increase'. The OECD also noted that even where there is a consistent rate of taxation, there is a net fiscal cost associated with an EET system, which increases when three additional factors are accounted for:

- The existence of a tax free lump sum;
- Under-funding and lower income replacement in retirement which leads, in a progressive taxation system, to a lower effective rate of taxation;
- Concessionary tax treatment for those over a certain age.

Effective tax rates are lower in retirement as workers typically earn more in their working life than they will in retirement. Effective tax rates are also lower due to specific elements of the tax code favouring retired citizens (e.g. Age Credit, specific USC treatment, PRSI exemption). This beneficial age-related tax treatment applies to income generally and not solely to pension income. The IDPRTG note that the combination of the three listed factors create effectively an EEE regime at lower income levels. An important point to note on the table below is that 70% of all tax payers earn less than €40,000[8] (making the most important part of the graph below, that section to the left of the red line)

[7] OECD, Economic Survey of Ireland, 2008, p. 90
[8] Section 7.1.1 of Employment paper from Meeting 4

Figure 3 Comparison of Effective Tax Rates at different ages



Source: IDPRTG report 2020, p54. Calculations use 2019 rates and bands/credits; incorporates Income Tax, USC and PRSI, assumes individual is entitled to full State Pension

3.1.1 Accumulation in working life- Contributions

Relieving contributions from taxation is the most common approach across the OECD and EU. However, the taxation of contributions to pension savings exists, in some form, in 32 per cent of EU Member States. In Ireland employee contributions are deductible for income tax purposes from taxation, and employer contributions is exempt from BIK for the employee. The Employer also receives a PRSI relief on contributions.

3.1.2 Return on pension fund assets

The most common approach internationally is to exempt the return on pension fund investments from taxation, with taxation applied to pension fund gains in just 6 out of the 42 countries studied by the OECD (e.g. Denmark and Sweden). Different approaches to taxation of investment returns include taxing nominal versus real returns, and varying when the taxation occurs (e.g. at withdrawal or as the returns accrue).

3.1.3 Withdrawal or decumulation in retirement

The majority of countries in the OECD tax (partially or fully) pension income on drawdown; 13 out of the 42 countries studied do not tax pension income (e.g. New Zealand and Australia). The tax treatment of the pension income also may depend on the type of pension savings product.

3.2 Brief overview of main tax expenditures and cost

As outlined in the Secretariat paper on Tax Expenditure data (Meeting 10), the tax treatment of pensions represents one of the larger Exchequer tax expenditures being worth at least €1.7billion (2018 figures). The IDPRTG notes that, in common with other countries operating an EET system, the exact cost of this is difficult to quantify due to the general nature of tax expenditures, data difficulties and specific pension-related challenges (see further information at 3.2.2 below).

3.2.1 List of tax expenditures

The official list of pensions tax expenditures, prepared by the Department of Finance has six reliefs, however the IDPRTG list a wider range of reliefs from tax offered in various ways and at various times. The more extensive list is given below

Table 1 Pension Tax Reliefs

Stage	Tax expenditure	Description	Beneficiaries	Cost €m
Contributions	Employees' contribution to approved superannuation schemes	Contributions are allowable as an expense in computing Schedule E income (Sections 774 & 776).	663,900 (2018)	€677.7 (2018)
	Exemption of employers' contributions from employee BIK	Sums paid by an employer into an approved, statutory or foreign government employee retirement scheme are not chargeable to tax in the hands of the employee (Section 778).	413,000 (2018)	€658.3 (2018)
	Pension Contribution (Retirement Annuity and PRSA)	Figures in this field are a total for RAC's and PRSA's which are not available individually.	98,300 (2018)	€241.3 (2018)
	Employers' contributions to approved	Contributions are allowable as an expense in computing Schedule D Case I or Case II income (Section 774).	431,000 (2018)	€173.2 (2018)

	superannuation schemes			
	VAT recovery	Employer value-added tax (VAT) recovery for pension fund management fees and set-up costs		
	Employer PRSI	Relief from Employer PRSI on employers contribution		
Return on Investments	Exemption of investment income and gains of approved superannuation funds. (includes Stamp Duty, CGT, Exit Taxes, VAT exemption etc.)	Exempts the investment income of a fund held or maintained for the purpose of a scheme (Section 774 – Approved Fund, Section 785 – RSA, Section 787I – PRSA)	No beneficiary or costing data available in the Tax expenditure report.	
Drawdown	Tax Relief on “tax free” lump sums	The first €200,000 of a retirement lump sum is tax-free, 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. Data is not available on the cost of this, as it is not possible to distinguish between redundancy related lump sums and retirement lump sums.	No beneficiary or costing data is available in the Tax expenditure report	
	Beneficial inheritance treatment	Beneficial inheritance treatment of ARF/AMRF (approved minimum retirement fund)		
Total				€1,750.5

Source: Department of Finance, Tax Expenditure Report October 2021 and IDPRTG report November 2020.

3.2.2 Data difficulties

Ireland, along with most OECD states, uses the revenue forgone method of estimating the costs of tax expenditures. As discussed in the Tax Expenditures paper, there are benefits and drawbacks of each of the main methods of estimating costs. In relation to pensions tax expenditures there are specifically called out by the IDPRTG report.

Firstly they consider data-related limitations and note that reliable and accurate data is needed in order to produce a tax expenditure estimate. Up-to-date data is currently not available for all categories of pension taxation. The group notes that the behavioural assumptions upon which calculations are made will have implications for the estimated costs. Usefully they give an example where estimating the cost of tax relief on pension fund returns in an EET or TET (Taxed, Exempt, Taxed) system is based on the assumption that the Exchequer will gain in the absence of the exemption, as saving would continue in some other taxable form of investment.

Within the revenue forgone method, a present-value or cash-flow approach can be taken. The Revenue Commissioners (who cost most of the tax expenditures in the State) use the latter methodology to estimate component costs to the Exchequer and bases calculations on contributions made in the same year. In contrast, a present-value approach applies on a life-cycle basis and accounts for relief and taxation throughout an individual's life.

The IDPRTG report asserts that the assumption of unchanged behaviour is the most significant shortcoming associated with a revenue forgone method in the area of pensions tax expenditures. They point to how interdependent components of financial incentives are and note that changing one aspect of pension taxation will have implications for pension savings and therefore levels of taxation. They offer an illustrative example where the level of tax relief on contributions is reduced, resulting in falling or cessation of contribution levels, thus reducing total gains on pension funds. This action could lead to future withdrawals and lump sum amounts likely being smaller, again impacting the deferral element of pension tax expenditure. Revenue forgone calculations do not account for this behavioural change.

3.3 Contributions

3.3.1 Employee contributions and income limitations

Employee contributions to supplementary pensions are deductible for income tax purposes, but are not deductible for employee PRSI and USC. Tax relief is given at the individual's marginal income tax rate, currently 20 per cent or 40 per cent. Two main limitations apply in relation to tax relief on such contributions.

- Employee contributions are subject to age-related limits (see table 2 below), restricting the proportion of remuneration that can be contributed free of income tax to a pension scheme. These limits are in place in order to encourage contributions throughout working life but are balanced against the need of some (often self-employed) people who may need to backload their pensions later in their careers.

- In addition, the maximum amount of earnings taken into account for calculating tax relief on contributions is €115,000 per year. This applies whether an employee is contributing to a single pension product or to multiple pension products.

Table 2 Age related percentage limits for tax relief on pension contributions

Maximum earnings taken account - €115,000		
Age	Percentage limit	Example
Under 30	15%	**Example 1:**An employee aged 42 earns €40,000 pa: €40,000 x 25% = €10,000 This employee can get tax relief on annual pension contributions up to €10,000. **Example 2:** An employee aged 42 earns €200,000 pa. As the net relevant earnings limit is €115,000 the percentage is calculated on €115,000rather than the actual income of €200,000. The employee can get tax relief on annual pension contributions up to €28,750.
30-39	20%	
40-49	25%	
50-54	30%	
55-59	35%	
60 or over	40%	

Source: IDPRTG Report

As indicated, tax relief on employee contributions is given at the individual's marginal income tax rate. It often suggested that one way of simplifying current taxation arrangements would be to standardise the rate of relief applicable to pension income, for example to the lower rate of 20% or to 30% as a midpoint between current standard and higher rates. It is notable that the agreement reached with EU/IMF in 2011 involved commitments to deliver savings in tax relief, including a gradual change from marginal rate to standard rate tax relief on pension contributions. However, in 2013 the Minister for Finance stated that such standardisation would disproportionately impact average earners and that marginal tax relief would not be changed. This position was adopted due to the relatively average levels of income that are subject to quite a high marginal tax rate in Ireland when compared internationally. This means that relatively average income earners get the higher rate of pension tax relief. In 2021 the higher rate of income tax applies to incomes over €35,300 for a single person or €44,300 for married couples with one earner (€36,800 and €45,800, respectively in 2022).

There are some idiosyncrasies in the pension system around funding rules and these are discussed in the next section.

3.3.2 Employer Contributions

Employer contributions to their employees' occupational scheme are not subject to the age-related percentage limits or to the overall percentage of earnings cap that apply. Employees are not liable for

Benefit-in-Kind (BIK) on employer contributions to an occupational pension scheme. However, where an employer contributes to an employee's PRSA, those contributions are chargeable to BIK, though it is only where the combined employer and employee contributions exceed relevant age and earnings related limits that a BIK charge arises.

The reasons for the beneficial tax treatment of employer contributions to occupational pension schemes stem from the historic limits on the proportion of final salary benefit that a scheme could grant to a retiring member. Personal pension products do not feature this traditional benefit limit. Large occupational pension schemes are better regulated than single member schemes and from a risk perspective these are more desirable for the State to encourage a worker to invest in. The differential treatment of employer contributions to occupational schemes as compared, for example, to PRSAs is likely to be a primary reason for the establishment of so many occupational schemes in Ireland, the vast bulk of which are single member schemes[9].

The absence of any BIK charge on employees in respect of employer contributions to occupational pension schemes on their behalf, when coupled with the fact that employer contributions to such schemes are not included in the age-related percentage limits that apply to tax relieved employee pension contributions, represents a significant benefit. This is particularly the case for individuals, such as proprietary directors, who can influence their remuneration packages in a way that allows them to maximise their pension savings through employer-based pension contributions. However, this tax treatment should be seen in the context of a regime where limits are applied at the point where benefits are drawn. In addition, as drawdown is taxed at the marginal rate, applying BIK would involve taxing the same income twice.

In 2011 Employer Pay Related Social Insurance relief on employee pension contributions was reduced by 50%. The following year (2012) relief of employer PRSI for employee contribution was removed.

The Interdepartmental group on Pension Reform and Taxation (IDGPRT) recently concluded that '*The differential treatment of the PRSA for funding purposes should be abolished and employer contributions to PRSAs should not be subject to BIK'*[10]. The report acknowledges that there will be a fiscal impact, though they do not cost it.

[9] IDPRTG Report, S. 3.67 p. 32
[10] IDPRTG Report, p45

3.3.3 Standard Fund threshold

The Standard Fund Threshold (SFT) is the limit or ceiling on the total capital value of tax-relieved pension benefits that an individual can draw down in his or her lifetime from all of that individual's pension arrangements. The SFT was introduced in December, 2005 and is currently €2 million (at inception in 2005 it was set at €5million). Its objective is to limit State support for pension accrual for reasons of equity in line with Government policy to only provide fiscal support for pension saving be capped at a certain level of income. 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, to claw back a portion of the relief previously accrued.

The 2009 Commission on Taxation took the view that there should be a correlation between the annual earnings limit and the standard fund threshold and that any movement in the annual earnings limit should be accompanied by a corresponding movement in the level of the standard fund threshold. The annual earnings limit is currently €115,000.

The system works as follows. On each occasion that an individual becomes entitled to receive a benefit under a pension arrangement for the first time (called a "benefit crystallisation event" (BCE)) they use up part of their SFT. At each BCE a capital value is attributed to the benefits that crystallise and the value is then tested against the SFT, by the pension scheme administrator. When the capital value of a BCE, either on its own or when aggregated with prior BCEs, exceeds an individual's appropriate fund threshold a "chargeable excess" arises and a tax charge at 40% is immediately applied on the amount of the excess. In addition, when the remainder of the excess is subsequently drawn down as a pension (or, for example, by way of a distribution from an ARF or vested PRSA), it is subject to tax at the individual's marginal rate.

Calculations of the level of income the current cap of €2million provides depend upon the annuities market at point of drawdown. As annuity rates have fallen in line with interest rates over recent years so too has the level of income. The Department of Finance estimate that it would buy €60,000 per annum for 30 years after retirement[11] however any estimates are highly dependent on assumptions around lump sums and market pension annuity rates. It is important to note again that 70% of Irish workers earn less than €40,000 per annum during their working life and are likely to have retirement income far below this sum.

[11] Department of Finance statement to The Journal in response to ISME legal action challenging the SFT cap.

3.3.4 Calculation of the SFT evolving over time

The taxation treatment of the different supplementary pension savings arrangements has evolved in an *ad hoc* manner over time. At its root is the changing nature of pension funds. Historically, pension products were predominantly defined benefit (DB), schemes but today the predominant new scheme type is Defined Contributions (DC)[12] and the tax treatment of pensions retains a DB focus, leading to anomalies.

DB arrangements have specific rules setting out benefit entitlements under various circumstances (retirement, death etc.). Benefits are usually expressed in terms of 'pensionable salary' and years of service. The risk relating to returns on investment and longevity lie with the employer operated scheme. Almost all public service schemes and some funded occupational schemes are defined benefit. In DC arrangements, the benefits at retirement or leaving service depend on the value of the investment fund accumulated for the member and there is no guarantee of any minimum benefit, moving many of the risks onto the employee. Many funded private sector occupational schemes and all personal pensions (PRSAs, Buy out bonds, and RACs) are DC.

The IDPRTG report notes that achieving full harmonisation of the supplementary pension system would involve fundamental changes to pension savings models (DB, DC and other products). Instead they have focused on making recommendations that offer the possibility of ease of introduction and which go some way towards harmonisation and simplify the supplementary pension system.

3.4 Lump sum

Ireland is somewhat unusual in Europe in having substantial pension tax free lump sums. The table in Appendix C to this report gives some examples from other countries around Europe of the tax treatment of lump sum payments. In some countries lump sums are not permitted (Netherlands and Sweden, for example) while in others the amount of lump sum is linked to a proportion of the total pensions savings pot and it is taxed (UK, France and Belgium). Only Portugal, Malta and Ireland have some lump sum tax free and Ireland is alone in having a monetary limit (€200,000 lifetime limit) rather than a percentage of overall savings.

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

[12] Note, according to the Pensions Authority Report 2020 DC schemes greatly outnumber DB schemes (82,211 vs 701) but the number of members attaching to the DB schemes remains larger (500,810 vs 411,044 in DC schemes). Many of the DB schemes are closed to new members.

final remuneration for each year of service over a 40 year period. Under RACs and PRSAs, or where a Defined Contribution fund member wishes to avail of an ARF, up to 25 per cent 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, 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. No beneficiary or costing data is available in the tax expenditure reports for this relief as it is not currently possible to disaggregate data on lump sums (this will also include redundancy lump sums).

Different rules apply to the calculation of a lump sum entitlement depending on the savings vehicle, subject to an overall lifetime limit of €200,000 which encompasses all retirement lump sums paid to an individual on or after 7 December 2005. The Commission on Taxation Report in 2009 noted that: 'Although the tax-free status of this lump sum is an arrangement of long standing, it is not possible to identify an objective rationale for it'[13]. As indicated earlier, exemption of significant elements of pension income from tax at the point of drawdown raises questions around the legitimacy of an EET system of tax reliefs in an Irish context.

All other income from supplementary pensions is taxable and subject to USC. Current rules also prescribe a maximum benefit that an individual can receive from a Revenue approved occupational pension at normal retirement age, as two-thirds of final remuneration[14].

It is worth noting here that there are scenarios where some individuals may also benefit from an additional tax free lump sum on redundancy/ex-gratia termination payments of up to €200,000.

3.5 Investment Returns

Tax is generally not charged on the investment income or capital gains earned by pension funds, including stamp duty, CGT, exit taxes, all income taxes (including passive) and they are also VAT exempt. This is in line with the 'EET' model discussed above which allows contributions and investment returns to grow without being taxed, until the point of drawdown, when they are expected to be taxed.

However, it should be noted that the Minister for Finance introduced a temporary Pension Levy of 0.6% of the market value of pension fund assets, payable for each of the 4 years 2011 - 2014 and an additional levy of 0.15% for 2014 and 2015. The levy was abolished in 2016.

[13] P. 410.

[14] 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'

3.6 Fund structures

3.6.1 ARF

ARFs can be described as funds with earmarked assets with a particular tax status. They are a personal investment account into which individuals can (in certain circumstances) transfer part of their retirement fund, at retirement instead of using those funds to purchase an annuity. The performance of an ARF depends on the performance of the assets it is invested in. The key differences between an ARF and its main competitor, an annuity, is that an ARF does not guarantee a stable and predictable income for life, exposing savers to continued market risk, income volatility and longevity risk (i.e. running out of money before they die). Also, unlike an annuity, the ARF option allows an individual to pass on any unused capital as an inheritance without any clawback of pension tax relief.

The IDPRTG report notes that 'From a tax perspective, an ARF operates as a destination into which pension fund assets can be transferred at the point of retirement without incurring a charge to income tax'. ARF returns are not taxed but any amount drawn down is subject to income tax, USC and PRSI (where the individual is below the age of 66). There is also an annual imputed or notional distribution in place against which any actual drawdowns are off-set. Tax may also apply where an ARF is inherited.

ARFs are not regulated by the Pensions Authority (as they are not an occupational pension, nor a PRSA). They are not regulated under the Pensions Act (1990) but instead are defined under tax law.

3.6.2 Imputed distribution

Ireland's tax incentive model (EET) relies on taxing pension drawdown (albeit at lower effective rates than income at working age). This tax deferral model relies on individuals having taxable income in retirement.

To ensure that the ARF was being used as intended, and in an effort to limit its attractiveness as a vehicle for indefinite deferment of tax, the imputed distribution regime was introduced. It came into effect from 2007 and applies to ARF owners who are 60 years or over for the whole of a tax year. It was phased in between 2007-2009: 1 per cent in 2007; 2 per cent in 2008; and 3 per cent from 2009. The rate applicable in 2010 and 2011 was 5 per cent. The notional amount is taxed at the ARF owner's marginal income tax rate. Funds actually drawn down by an ARF owner are credited against the imputed distribution in that year to arrive at a net imputed amount, if any, for the year. In respect of ARFs with values of over €2 million, Finance Acts 2011 and 2012 increased the rate of the notional distribution to 5 per cent, and 6 per cent respectively. Finance Act 2014 reduced the 5 per cent rate to 4 per cent for ARF owners under the age of 70, where the value of assets in their ARF is €2 million or less. This was done to reduce the risk that individuals in the age group of 60 to 70 years might outlive their ARF funds. ARF owners are taxed on an imputed distribution, and therefore are not under any obligation to actually draw down funds (anecdotally, it is understood that individuals generally draw down an actual amount at least equal to the level of the imputed distribution, as otherwise they would effectively be paying tax twice on the same amount when eventually drawn down).

3.6.3 Tax of Funds on death

The amount payable to the deceased individual's estate is treated as income of the deceased for the year of the assessment in which he or she dies, with the following exceptions:

- Benefits from an AMRF/ARF can be transferred to the deceased's spouse or civil partner, without paying capital acquisition tax or income tax.
- A transfer to a child of the individual under 21 is exempt from income tax, but chargeable to capital acquisitions tax. A transfer to a child of the individual over 21 is taxed at 30 percent.
- Otherwise AMRF/ARFs are treated as if they had been drawn down on death and are subject to marginal rate income tax (or 30% if inherited by a child over age 21) and also Capital Acquisitions Tax if inherited by strangers.

Note in the above fund inheritance scenario, there is no clawback of the pension tax relief which was given during the accumulation/contribution stage, specifically to fund income in retirement, as the fund will not now be used to fund retirement. This acts as a disincentive to drawdown in retirement and, in doing so, potentially undermines the integrity of the EET tax regime. The IDPRTG recommends that this CAT treatment should be amended to ensure that both IT and CAT apply to ARFs where ARF proceeds are inherited by a child in order to encourage the deployment of tax incentivised pension savings as originally intended.

3.7 ARF/AMRF Expenditure Data

There is limited data on ARFs and AMRFs (Approved Minimum Retirement Funds). Although qualified financial managers are required to make tax returns in relation to imputed distributions, there is no consolidated information available on the estimated 70,000 ARFs and 40,000 (2019 estimate). The assets estimated in these vehicles at that time were of the region of €12.5billion and €2.5 billion respectively. In addition to this are the tens of billions in pension savings in DC schemes and products. Evidence suggests that the majority of the ARFs and AMRFs are low value.

These data gaps are expected to be somewhat addressed by a recommendation of the IDPRTG that ARF providers and PRSA providers should be required to make annual data returns to the relevant regulatory authorities, including ARF numbers, drawdown levels and distribution, asset allocation and fees. The IDPRTG expect to commence work on their recommendations shortly. (Q1 2022)

4 Previous recommendations on Pensions Tax Expenditures

There have been a number of pension reform initiatives over the last 20 years but the two most pertinent to an examination of pensions tax expenditures are what the Commission on Taxation had to say in 2009 and the Interdepartmental Pensions Tax Review Group which published a report in November 2020.

4.1 Commission on Taxation, 2009

The 2009 Commission on Taxation was specifically asked to consider tax incentives for retirement savings and in doing so they closely considered what reform initiatives were necessary to encourage long term savings and to review existing tax expenditures at the time with a view to assessing the economic and social benefits they deliver and make associated recommendations in that context. The relevant recommendations made by the Commission are set out in the table below:

Table 3 2009 Commission on Taxation – Pension related recommendations

#	Recommendation	Secretariat commentary
10.1	The regime for non-funded pensions should be examined to identify the implicit tax cost to the Exchequer in the context of an equitable distribution of the tax expenditure on pensions.	This formed part of the work of the IDPRTG, who have concluded that better data is required.
10.2	The current tax relief for personal retirement provision should in the medium to long-term be replaced by a matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer.	This work is directly linked to auto-enrolment proposals (currently underway).
10.3	The matching contribution approach should be accompanied by a kick-start provision involving a contribution of €1 for each €1 contributed by the taxpayer in the first, say, five years of pension provision by an individual.	See auto enrolment comment above.
10.4	The matching contribution should apply where an individual has relevant earnings including where, because of the level of his or her earnings, the individual is not liable to tax.	See auto enrolment comment above.

#	Recommendation	Secretariat commentary
10.5	A soft-mandatory approach could make a significant contribution to increasing pension coverage and should be considered.	See auto enrolment comment above.
10.6	An employee's payslip should show the amounts contributed by the Exchequer to the employee's retirement savings.	See auto enrolment comment above.
10.7	A retirement savings scheme along the lines of the former SSIA scheme, that is easily understood and which involves an Exchequer contribution, should be introduced – the scheme is outlined in Box 10.16 of Part 10.	See auto enrolment comment above.
	• As the annual earnings limit does not apply to employer contributions, there is a need to retain the standard fund threshold.	SFT has been maintained.
	• There should be a correlation between the annual earnings limit and the standard fund threshold, and the reduction in the annual earnings limit suggests that there should be a corresponding reduction in the standard fund threshold.	Since the 2009 Commission the SFT has reduced to €2 million (from €5,418.085 in 2009) and the earnings limit to €115,000 (from €150,000 in 2009).
10.8	A lump sum taken on retirement should be liable to tax as follows:	
	• An amount of up to €200,000 should be tax free.	Retained
	• The balance of the lump sum should be subject to tax at the standard rate of income tax.	Sums between €200,001 and €500,000 are taxed at 20% with the remainder at a beneficiary's marginal tax rate and subject to USC.
10.9	The current tax relief rules should be reviewed to ensure that contributions and remuneration levels cannot be manipulated close to retirement to allow individuals to take advantage of unintended and inappropriate benefits.	
10.10	Age-related limits on the amount of an individual's relevant earnings should continue.	These have continued.

#	Recommendation	Secretariat commentary
10.11	The flexibility of an ARF should be extended to defined contribution occupational pension schemes.	The IDPRTG concluded that the 'ARF option' should be replaced by a combination of in-scheme drawdown and a re-designed PRSA product that operates as a whole-of-life product
10.12	Anomalies in the treatment of different retirement arrangements should be eliminated as far as possible.	In progress. This was a core direction given to the IDPRTG. Action 3.18 'The IDPRTG will identify and progress measures to improve the harmonisation of rules to eliminate anomalies in the treatment of different retirement arrangements including taxation treatment.'
10.13	The various ages specified in the legislation governing the time at which benefits may commence should be reviewed and conformed.	Legislation not changed, but the IDPRTG concluded that • The lower age limit at which savers can access retirement benefits should be increased to 55. • The upper bound of 'normal retirement age' should be increased to age 75.

Source: CoT report 2009

4.2 IDPRTG report

The Interdepartmental Pensions Reform & Taxation Group (IDPRTG) is made up of representatives at official level of the Department of Finance, Public Expenditure and Reform, Social Protection, the Revenue Commissioners and the Pensions Authority. It was established to examine, amongst other things

- Identify and progress measures to improve the harmonisation of rules to eliminate anomalies in the treatment of different retirement arrangements including taxation treatment' and
- Review 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.

The IDPRTG published a report, along with recommendations in November 2020. That report contained a number of conclusions about pensions tax expenditures which are pertinent to the Commission's work in this area. These are set out below:

Reforming & Simplifying the Existing Supplementary Pension Landscape

1. The differential treatment of the Personal Retirement Savings Account[15] (PRSA) for funding purposes should be abolished, employer contributions to PRSAs should not be subject to BIK.

State Support for Supplementary Pension Saving

1. Adequate and timely data is a pre-requisite for policy analysis. Supplementary pension policy, and pension provision more generally, is a key area of policy both in terms of Exchequer-impact and the well-being of the population. Further consideration is required in the area of pensions to specify and collect the necessary data to support policy analysis.
2. Like the majority of OECD and EU countries, Ireland has adopted an EET system[16] of pension taxation. Such systems involve a long-run net cost which varies as a regime matures. The objective of this system of pension taxation is to encourage individuals to provide for later life and secure adequacy of income in retirement. Combining the scope and success of the State pension with a recognition that fiscal support for pension saving should be capped at a certain level of income, the focus of tax incentives for supplementary pension saving is on encouraging those on low-to-middle incomes to save for their retirement.
3. Due to limited data availability on some features of the pension regime in Ireland, accurately calculating the total cost of all tax reliefs is a challenge. However, it is clear that a net tax advantage exists for pension savers, as pension savings accumulate on a tax-free basis and effective tax rates are lower in retirement than pre-retirement. This benefit is highest, on a proportionate basis, at middle income levels with those on higher incomes also benefiting.

[15] A PRSA is an account that one can use to save for your retirement. It is an investment account accepting either lump sum or regular savings. Payments made to a PRSA are often tax deductible.
[16] EET refers to a pension taxation model which sees contributions being exempt, investment returns being exempt but drawdown of pension is taxed. More information on this is available at section 3.

Measuring Success: Coverage & Adequacy

1. Evaluating equity in the distribution of tax expenditures on pensions depends on how broadly or narrowly equity is defined. In a narrow sense, tax relief is regressive by nature - only those who pay tax qualify. Given the particular design of the Irish pension tax regime, including recent changes to limit reliefs at the higher end, middle income earners are the main beneficiaries of the current system of pension tax relief while a lower incentive is offered to lower income groups.

Review of the Approved Retirement Fund

1. Approved Retirement Funds[17] (ARF) assets should be treated for inheritance tax purposes in the same way as other assets where inherited by anyone other than the individual's spouse. Both Income Tax and Capital Acquisitions Tax should apply. (Currently, ARFs can be inherited by spouses without CAT or income tax and without a clawback of the pensions tax reliefs[18]).

5 Automatic Enrolment

As part of the Roadmap for Pension Reform 2018- 2023[19] the Government has proposed the introduction of an Automatic Enrolment (AE) retirement policy. Following publication of a draft 'Strawman' proposal and completion of a public consultation in 2018/2019 the Government approved a number of elements of the design of the AE policy. Decisions have now been made in relation to the target group, the contribution rates, the policies in relation to opting-out and re-enrolment, the administrative arrangements and organisational approach and the investment options.

In relation to the target group, employees aged between 23 and 60, who earn more than €20,000 a year (across all employments) and are not already contributing to a workplace pension, will be automatically enrolled. Employees who are existing members of a pension scheme/contract that meets prescribed minimum standards and contribution levels will not be automatically enrolled for the employment to which that pension relates. Provisions for opting out have also been included. However key decisions, including in relation to the exact form of State incentive for auto-enrolment have not yet been confirmed. The AE 'strawman' indicated that the State contribution to AE could be in the region of €1 for every €3 saved by members.

[17] An ARF is a personal tax-efficient investment fund into which an owner can transfer all or part of the balance of a pension fund after receiving a retirement lump sum. They are regulated under the Tax Consolidation Act, and are not considered a Pension product, so are not regulated by the Pensions Authority.
[18] This is discussed in more detail in section 3.6
[19] A Roadmap for Pensions Reform (2018 – 2021) – Department of Social Protection

While the funding of the State contribution has not yet been agreed it is likely that the form of the State incentive will have implications for tax relief as it applies to the current regime for supplementary pensions (i.e. either a direct contribution with no associated tax relief on contributions or some hybrid approach retaining tax relief). As the details of the configuration of the auto-enrolment scheme are not yet available, it is not possible to be definitive about how current pensions tax expenditures will interact with and be affected by auto enrolment. It may be necessary to return to this topic in the future. For now it is enough to understand that this is a complex area that will be discussed further.

While the Pensions Roadmap provided for the implementation of AE by 2022 it has been confirmed that the Government will now seek to gradually deliver AE over a longer timeframe. Options on structure and funding are expected to be considered by Government in the very near future.

6 Proposals for the Commission – forward looking

As illustrated throughout this briefing note, planning and saving for retirement in Ireland is highly complex and the behaviour of individuals is often driven by taxation rather than pension adequacy requirements at an individual level. According to Revenue the overall cost of tax expenditures in this area is estimated at €1.7bn and is likely to be higher due to data gaps.

In relation to vertical equity, there is clear evidence to suggest that the current system of exchequer support is not achieving its aims with pension coverage for low and middle income earners remaining low despite the availability of generous supports. There are many reasons why this is the case but it results in a system where higher tax payers contribute more of their income to their pensions and benefit more than standard rate payers.

On the question of horizontal equity, a number of inconsistencies have been highlighted in relation to treatment of contributions depending which may or may not be subject to age related restrictions depending on legal forms of employment.

Efficiency and equity questions also arise when we consider the implementation of the EET model in Ireland and the exceptions that exist.

A number of questions therefore arise for the work of the Commission in this area;

- Is the Commission satisfied that the current system of Exchequer support for supplementary pension provision is appropriately targeted? If not, what changes might better encourage lower and middle income earners to save for retirement?

- Does the Commission support the reform of tax expenditures at pension drawdown in order to improve the proper implementation of the 'EET' model? E.g. reform of tax free lump sum.
- Does the Commission support changes to the €2m Standard Fund Threshold and/or changes to the annual age related limits of contributions to supplementary pensions?
- Is marginal tax relief on pension contributions equitable? Should relief be limited to the standard rate of 20% or fully replaced with matching exchequer contributions?
- Should ARF (Approved Retirement fund) assets be treated for inheritance tax purposes in the same way as other assets where inherited by anyone other than the individual's spouse. This suggests that both Income Tax and Capital Acquisitions Tax should apply.
- Does the Commission endorse a recommendation to specify and collect more adequate and timely data in the area of pensions tax expenditures to support future policy analysis?

Appendix A: Bibliography

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Appendix B: Abbreviations and Glossary

ARF- Approved Retirement Fund. An ARF is a post-retirement investment contract into which the proceeds of any defined contribution scheme, additional voluntary contributions, PRSA, RAC, buy-out bond (where the benefits from a defined benefit or defined contribution scheme were transferred into a buy-out bond) or in the case of a 5% Director other retirement benefits that are not taken in the form of a lump sum or pension on retirement. Certain qualifying conditions must be met to be eligible to take out an ARF.

AMRF- Approved Minimum Retirement Fund- This is a post retirement contract where an individual re-invests a minimum of €63,500 of their pension fund until they reach 75 years. An AMRF must be taken out where, on retirement, an individual does not have a guaranteed annual income for life of €12,700.

DC- Defined Contribution. A DC pension arrangement operates such that the benefits at retirement or leaving service depend on the value of the investment fund accumulated for the member. There is no guarantee of any minimum benefit. Many funded private sector occupational schemes and all personal pensions (PRSAs, BOBs, and RACs) are defined contribution.

DB- Defined Benefit. A DB pension arrangement has specific rules setting out benefit entitlements under various circumstances (retirement, death etc.). Benefits are usually expressed in terms of 'pensionable salary' and years of service. Almost all public service schemes and some funded occupational schemes are defined benefit.

EET- Exempt, Exempt, Taxed- This refers to the tax treatment of pensions savings in Ireland - contributions are exempt from income tax (subject to age and income limits), investment gains are exempt from capital gains tax, and pension income is taxable on drawdown.

IDPRTG- Interdepartmental Pensions Reform and Taxation Group. The Interdepartmental Pensions Reform and Taxation Group (IDPRGT) was established under the Roadmap for Pensions Reform: 2018 – 2023. The Group is chaired by the Department of Finance and comprises representatives from the Revenue Commissioners, Department of Public Expenditure and Reform, Department of Social Protection, and the Pensions Authority. The Group was tasked with a number of actions in the Roadmap.

Occupational Pension Schemes. Occupational Pension Schemes are the basis of the Second Pillar. They are employer-provided and exist in both the public and private sectors. They can be either defined benefit (DB) or defined contribution (DC).

PRSA- Personal Retirement Savings Account. A Personal Retirement Savings Account is a contract between an individual and an authorised PRSA provider (such as an insurer, credit institution or investment firm) in the form of an investment account. It is a long-term personal retirement account designed to enable an individual to save for retirement in a flexible manner. It is structured as an individual contract-based DC product. There are two types of PRSAs – a Standard and Non-Standard PRSA. The difference between the two is that Standard PRSA charges are capped at 5 per cent of PRSA contributions paid and 1 per cent per annum of PRSA assets. Non-Standard PRSAs have no such caps on charges. The other main difference is that standard PRSAs can only invest in pooled funds (also known as managed funds), whereas non-standard products have a wider investment choice. A vested PRSA is a PRSA from which retirement benefits have commenced.

RAC- Retirement Annuity Contract. Retirement Annuity Contract (also known as a personal pension) is a Third Pillar product. They are specifically Revenue approved insurance policies taken out by an individual with an insurance company.

SFT- Standard Fund Threshold. The SFT is the limit or ceiling on the total capital value of tax-relieved pension benefits that an individual can draw down in his or her lifetime from all of that individual's pension arrangements. The SFT was introduced in December, 2005 and is currently €2 million.

Supplementary Pension System. The supplementary pension system is comprised of Second Pillar trust-based occupational schemes and Third Pillar contract-based personal pension products. It is considered supplementary as it is additional to the State pension system

Appendix C Tax Treatment of Lump sums across OECD countries

Table 4 Tax Treatment of lump sums in selected countries in Europe

Country	General Treatment	Tax Treatment of Lump Sums
IE	EET	Lump sum <€200,000 is 0% income tax rate €200,001-€500,000 is 20% income tax rate €500,001 is marginal income tax rate
MT	TET (individual contributions) EET (employer contributions)	Lump sums are tax-free up to 30% of the accumulated assets. Above they are taxed at the marginal rate of income tax.
PT	TET (individual contributions) EET (employer contributions)	If contributions were taxed, then one third of the pension benefit may be a tax free lump sum, otherwise it is taxed.
BE	TET (individual contributions) EET (employer contributions)	Employer's contribution capital is taxed on a decreasing scale, from 20% (at 60 years old, non-retired) to 16.5% at 65 years old, or 10% if the employee remained active until that age; Otherwise it is viewed as income and is taxed at the individuals marginal tax rate. Employees contributions capital is taxed at 10% if withdrawn following death, retirement and at age 60 at the earliest. Otherwise at 33%.
FR	TTT (individual contributions) TET (employer contributions)	Lump sums or programmed withdrawals are allowed in very limited cases, up to 20% lump sum is permitted. Lump Sums are taxed.
UK	EET	Lump sums are taxed as income eat the marginal rate of income tax.
NL	EET	Lump sum payments are not permitted and all pension benefits are taken as annuities.
SE	ETT for most plans EET for mandatory personal pensions	Lump sums are not permitted.

Source: OECD, 'The tax treatment of funded private pension plans' 2015