

## The Commission on Taxation

### Submission by Irish Life Assurance 5<sup>th</sup> June 2009

#### Introduction

Irish Life would like to submit a number of observations on Term of Reference (b), to 'consider how best the tax system can encourage long term savings to meet the needs of retirement'.

We have noted a recent upsurge in media comment on the value and distribution of tax relief for retirement savings. We would like to make some observations to the Commission on Taxation about the fairness of the current system, based on our experience as Ireland's largest pension provider.

We are very conscious that the work of the Commission is at an advanced stage, and have kept this submission deliberately brief. We are grateful to the Commission for allowing the submission at this late stage.

#### Executive Summary

- ▶ Ireland has a very progressive income tax system where low paid workers benefit from low levels of income tax. Despite popular belief to the contrary, the pension system actually adds to the progressive nature of the income tax system. The pension system delivers most benefit to lower income and middle income workers.
- ▶ The two main reasons why the current pension system improves the progressiveness of the income tax system are:
  - ▶ The cost of the State Pension is higher than the income tax and social insurance paid by a very significant portion of the workforce and therefore the cost is effectively subsidised by the higher paid.
  - ▶ The tax relief for pension contributions, as a percentage of tax paid for lower and middle income workers is the same as, if not higher than, that for higher income workers.
- ▶ An analysis of contribution and benefit levels for Irish Life customers underlines the progressiveness of the system, with middle income customers being the most significant beneficiaries.
- ▶ Although there has been much media comment about abuses of pension tax reliefs, there are now controls in place to ensure that access to pension tax reliefs at high income levels is limited. However, there are opportunities to broaden the tax take from the pensions system.
- ▶ While SSIA type incentives for pensions do have merit, the complexity of integrating them with the existing tax system means that they are best considered as an additional opportunity to attract low coverage groups, and not a replacement for existing tax relief arrangements. Indeed, changing the pension system so fundamentally could introduce unhelpful uncertainty into pension planning, and result in individuals opting out of, or deferring, pension saving.
- ▶ Overall, we believe the current system of deferred tax for pensions is fair and equitable in that it adds to the progressive nature of the income tax system. We are cautious about changes to the current system for fear that it may undermine the confidence people need to have to commit to long term savings. It is important to remember that defined contribution is now the most common form of pension provision, and that people from all income groups will struggle to achieve adequate replacement incomes based on typical current savings levels.

**Observation 1:** The current income tax system is strongly progressive, with the effective overall tax rate increasing substantially as income increases. Pension tax reliefs do not change the progressive nature of the tax system.

Much debate has centred on the claim that higher earners can benefit substantially more than lower or middle income earners from the marginal tax relief system. It is true that higher earners can defer more tax through retirement provision in cash terms, however this is principally because they pay substantially more tax in the first instance – it does not significantly alter the level of progressiveness in the tax system.

A rigorous analysis of the equity within the tax system must look holistically at the net tax paid at various income levels when pension tax relief is availed of, rather than a narrow focus on the amount of tax saved through pension tax relief.

The tables below show a simple illustration of the impact of pension tax relief on the net amount of tax paid at various income levels. All figures are based on the tax rates that apply from 1<sup>st</sup> May 2009 and are based on a full 12 month basis. Rates applicable to a single PAYE employee were used. The first table shows the approximate total tax take (including PAYE, levies and PRSI) for PAYE workers on various levels of salary:

Salary	25,000	50,000	100,000	150,000
Income Tax	1,340	9,196	29,696	50,196
Income Levy	500	1,000	2,499	4,499
PRSI	735	1,735	2,736	2,736
Health Levy	0	2,000	4,250	6,750
Total Deductions	2,575	13,931	39,181	64,181
<b>Tax as % salary</b>	<b>10%</b>	<b>28%</b>	<b>39%</b>	<b>43%</b>

As the table shows, the current system is strongly progressive, with the effective overall tax rate increasing substantially as income increases. The effective tax rate for an individual earning €150,000 is over four times the rate paid by someone earning €25,000.

The next table shows the impact of making pension contributions at a rate of 10% of salary on the effective tax take at each income level:

Salary	25,000	50,000	100,000	150,000
Total Deductions	2,575	13,931	39,181	64,181
Tax as % salary	10%	28%	39%	43%
Employee Pen Cont %	10%	10%	10%	10%
Contribution Amount	2,500	5,000	10,000	15,000
Total Relief	-600	-2,450	-4,500	-6,900
Net tax	1,975	11,481	34,581	57,281
<b>Tax as % salary</b>	<b>8%</b>	<b>23%</b>	<b>35%</b>	<b>38%</b>

As the table shows, the progressive nature of the tax system remains strongly evident here – in fact the impact is to make the system slightly more progressive, with the effective rate paid at the €150,000 level now increased to 4.75 times the rate at €25,000. The factor increases to 4.75 because the tax relief, as a percentage of the tax paid, actually reduces as income increases.

Therefore, while the cash impact on the total tax paid by higher earners is clearly higher than for lower earners, the taxation burden remains very substantially weighted to higher earners.

**Observation 2:** An analysis of contribution levels for Irish Life customers reaffirms the progressive nature of the system, with middle income earners receiving the highest tax rebate as a percentage of tax paid.

In practice, pension contributions as a percentage of salary tend to be higher at higher income levels. The following tables are based on actual employee and AVC contributions to Group Defined Contribution Pension Schemes with Irish Life. In our experience, while higher earners make higher % pension contributions, the differences are not as marked as might be expected. (Employer pension contributions are paid in addition to these.)

Salary band	Employee Pen Cont %	% of Scheme Members
<25,000	5.0%	24.5%
> 25,000 and < 50,000	5.2%	51.7%
> 50,000 and < 100,000	6.8%	20.0%
> 100,000 and < 150,000	7.7%	2.8%
> 150,000	7.9%	1.0%

The table below demonstrates how the progressive nature of the tax system is retained in practice. The highest tax rebate, as a percentage of the tax paid, is to the €50k income group. The pension contributions of the €50k income group are only slightly lower than those for the higher income groups.

Salary	25,000	50,000	100,000	150,000
Total Deductions	2575	13,931	39,181	64,181
Tax as % salary	10%	28%	39%	43%
Employee Pen Cont %	5%	6.8%	7.7%	7.9%
Contribution Amount	1,250	3,400	7,700	11,850
Total Relief	-300	-1,666	-3,542	-5,451
Net tax	2,275	12,265	35,639	58,730
<b>Tax as % salary</b>	<b>9%</b>	<b>25%</b>	<b>36%</b>	<b>39%</b>

**Observation 3:** An analysis of 'net effective rates of relief' also demonstrates that the most significant beneficiaries of the current system of pension tax reliefs are middle-income earners.

Independent analysis, published by Life Strategies, looked at the equity of the current tax system in a different way. The Life Strategies analysis calculated the net tax saving achieved through retirement provision by calculating the present value of tax payable on future retirement benefits, less the amount of tax relief granted now, and used this calculation to derive 'net effective rates of relief'.

Table 5.1 in the Life Strategies Report (reproduced below) shows sample results for a single individual aged 40 contributing 5% to their pension with a further 10% contributed by their employer. As the table shows, the net effective rate of relief is highest for earners on salaries between €45,000 and €55,000. The net effective rate for someone earning €200,000 is 25.2%. This is less than 60% of the effective rate enjoyed by someone earning €50,000. This is because

the benefits of tax deferral are most marked for middle income earners, who can avail of marginal rate tax relief on their contributions, but will only pay tax at the standard rate on their retirement income. High income earners, on the other hand, will be taxed at the marginal rate on their retirement benefits.

Comparison of headline and effective rates of relief on pension contributions

Salary	Headline Rate of Relief	Net Effective Rate of Relief
25,000	22.0%	22.0%
25,000	22.0%	22.0%
35,000	22.0%	22.0%
40,000	38.1%	38.1%
45,000	43.0%	43.0%
50,000	43.0%	42.8%
55,000	41.7%	40.8%
75,000	41.7%	37.2%
100,000	41.7%	34.1%
125,000	41.7%	32.3%
150,000	41.7%	30.4%
175,000	41.7%	27.8%
200,000	41.7%	25.2%

*(Source: Life Strategies 2008. The tax system has changed somewhat since these figures were calculated, however the impact on the relativities between salary levels would be minimal.)*

We believe this is a rigorous illustration challenging the misperception that the benefits from pension tax relief increase consistently with income levels.

We would also make the observation that any policy change seeking to re-direct pension tax relief away from higher income earners towards middle income earners, as has been called for by some commentators, would not appear to make sense from a policy perspective – since this is the group that already gains most from the system.

An analysis of the benefits paid to Irish Life Defined Contribution Scheme members reinforces this point, with lower and middle income earners achieving the highest levels of replacement income.

Salary	Lump Sum	Private Pension	State Pension	Total Pension	% Income Replacement*
25,000	37,500	6,250	12,000	18,250	73%
50,000	75,000	12,500	12,000	24,500	49%
100,000	150,000	25,000	12,000	37,000	37%

The figures in the table above are based on the average saving rate of members contributing to Irish Life Group Defined Contribution schemes. The average saving rate across the whole portfolio means that people can expect to get a tax free lump of 1.5 times salary at retirement and a pension of 25% of salary at retirement. These projections assume people start saving at age 30 and earn 2% real investment returns. The average saving rate including employee, AVC and employer contributions is 10% for people in their 30s and this increases slowly to less than 15% as people approach retirement.

\*excluding value of lump sum.

**Observation 4:** There have been very substantial increases to the State Pension over the last few years. This is a very significant benefit to recipients and the cost of this benefit is under-appreciated.

We estimate the cost of providing a pension equal to the current level of State Pension would be around €4,500 per year for someone beginning to save at age 30. The table below compares the cost of the State Pension to the total tax deductions calculated earlier.

Salary	25,000	50,000	100,000	150,000
Total Deductions	2,575	13,931	39,181	64,181
Tax as % salary	10%	28%	39%	43%
Cost of State Pension	4,500	4,500	4,500	4,500

Comparison of this cost with the amount of taxation at low to medium income levels shown in the earlier section illustrates the very substantial level of cross-subsidy within the system – higher earners shoulder a very substantial share of the cost of providing for the State Pension.

**Observation 5:** Any potential over-subsidisation at very high income levels has largely been curtailed.

It is difficult to see a rationale for the State incentivising pension provision at very high income levels through tax relief, and therefore we are supportive of the series of measures introduced to limit the access to pension tax relief at very high income levels.

The recent reduction of the earnings cap from €275,000 to €150,000 has greatly reduced the scope for using tax relief at very high salary levels. We note that the introduction of this cap has already resolved some of the more extreme situations that have led to public dissatisfaction. The standard fund threshold is another limiting measure which could be reviewed again in future.

Similarly, the introduction of deemed distribution rules for ARFs has ensured tax revenue generation where ARF income drawdown does not take place voluntarily. We believe there is scope here for further measures in relation to taxing inheritances.

This issue has been the subject of considerable media comment. Effective controls are now in place here, and more time should be given to allow these policy changes to filter through to public perceptions.

**Observation 6:** There are opportunities to broaden the tax take from the pensions system, while retaining the fairness and progressiveness of the system.

We are conscious that our submission is narrow, relative to the overall Terms of Reference of the Commission. Our focus has been to address the popular misconception that the current pension system distorts the progressive nature of the income tax system. We accept that the Commission has a very onerous task in that it needs to identify new sources of revenue that broaden the existing tax bases, while maintaining fairness among taxpayers.

In respect of pensions, we suggest that the Commission could consider the following areas:

- Reducing the lifetime pension cap below the current limit of €5.4m.

- Taxing undistributed income from ARFs at the full marginal income tax rate on the death of the main holder and his or her spouse.
- Increasing the 4% PRSI rate to reflect the significant increases in the level of the State Pension over the last number of years.
- Removing the current income tax exemption limits for people over age 65 and taxing everyone under the PAYE regime instead.

We believe these measures have significant potential to increase revenue while maintaining the fairness of the existing pension system.

**Observation 7:** While SSIA type incentives do have merit, the complexity of integrating them with existing pensions and tax systems mean that they are best considered as an additional opportunity to attract low coverage groups, and not a replacement for existing tax relief arrangements.

In its submission on the Green Paper on Pensions, Irish Life argued that the most effective way of tackling pension coverage is through an auto-enrolment system, whereby employees would automatically be enrolled in a suitable pension arrangement.

However, the concept of a simple pension plan offering SSIA style tax credits also has merit (even if it is unproven). In particular, it could support coverage to particular demographic groups, which currently have low coverage, e.g. the self-employed, low income earners (not paying income tax), and female and part-time workers who may have breaks in their careers.

We see the concept of a simple pension plan offering SSIA style tax credits as complementary to, but in no way a replacement for, the current tax incentives for pensions operating in the public and private sectors. Replacing the current system wholly with an SSIA system would be incredibly complex, and unnecessary in our view.

The greatest difficulty with an SSIA type incentive is integrating it with the existing contribution and benefit limits for pensions. The existing pension incentives integrate well with the rest of the tax system. We believe careful consideration would need to be given to how an SSIA type pension incentive would work for employer sponsored pension schemes, in particular for defined benefit schemes, and in the public service. There are a range of complex issues that would need to be resolved in order to wholly replace the existing system of tax relief with SSIA type incentives.

There are also risks to pension coverage in embarking on such a fundamental change. Pensions are clearly a very long term financial planning vehicle, and individuals saving into pensions do so in the understanding that while taxation rates and limits may vary over time, the basic constructs for the treatment of pension contributions and benefits will remain constant. Changing these basic constructs could introduce an unhelpful level of uncertainty into pension planning, resulting in individuals opting out of or deferring pensions saving.

Many of these issues would be more easily resolved in the case of an SSIA scheme that sat alongside the existing system of pension tax relief, e.g. if it were only to be available to consumers who were not contributing to a traditional pension arrangement; or if contribution levels were to be capped at a similar level to SSIA's.