Supporting Retirement Saving (SRS) Incentives Scheme

Supplementary Paper Number 03 to the 2015 Pension Strategic Review

Technical Committee to the Minister of Finance on the Third Pension

December 2014

Contents

Appendices

01. Background

In the 2014 Budget Speech, on 4th November 2013, the Minister for Finance announced that during 2014 he would be establishing a regulatory framework for private pensions, which will be accompanied by effective fiscal incentives. This followed the work of a technical working group which reported its findings prior to the Budget (Appendix A). Subsequently the working group carried out a consultation exercise, where the main financial services' organisations, were asked to provide feedback on a number of proposals (Appendix E).

The purpose of these fiscal incentives is to help reinvigorate the culture of long term savings among the Maltese. Higher private saving can help address the possible pension adequacy gap that may evolve over the next decade due to the gradual weakening of the generosity of state pensions. It is also necessary to help generate the funds required to finance an improvement in Malta's investment ratio, and to further develop Malta's financial industry, generating high quality jobs and attracting more foreign direct investment. Moreover, one of the Country Specific Recommendations issued in June 2013, specified that amongst other measures, to ensure the long-term sustainability of public finances, the Government of Malta needs to encourage private pension savings.

02. Main Features of the Scheme

1. The Supporting Retirement Saving (SRS) incentives scheme will be composed of two components. The first component will be the provision of a tax refund on contributions to a personal retirement scheme (PRS) up to a maximum of €1,000 a year. Moreover, any investment income or gains made on these qualifying contributions will be exempt from income tax. The second component will be the ability to set up a special deposit account, known as an Individual Saving Account (ISA), and deposit in it up to a maximum of €1,000 a year. Any interest earned on ISA balances would be tax free.

2. The Scheme shall become operative in 2014, and a budget allocation of €1.5 million has been made. Initial projections indicate, that based on the experience of the UK and countries, with similar schemes, when demand for these types of savings, matures the cost of tax relief, under the conditions envisaged, could eventually rise to €5 million.

03. Key Recommended Features of Eligible Savings Products

1. For a saving product to be deemed a PRS, and be eligible for tax incentives, they need to fulfil set criteria. These can be summarised as:

   (i) Schemes need to operate under the Retirement Pensions Act or similar legislation like the Insurance Business Act;

   (ii) Benefit payments shall not start earlier than age 50 or later than 70;

   (iii) Only up to 30% of assets be given as a lump sum, the rest through annuity or drawdown in accordance to set regulations;

   (iv) Schemes to be subject to specified investment restrictions under the Retirement Pensions Act; and (v) schemes to have transparent charges and provide regular information to savers. While individuals will be free to contribute more than the maximum amount eligible for tax refunds, scheme operators will need to maintain separate records for qualifying and non-qualifying contributions. At any one point, individuals will have to hold all their qualifying contributions into one PRS.

2. At any one point, individuals will be allowed to have only one ISA, with a licensed banking institution. Accumulated deposits will be allowed to be transferred to an alternative provider once a year. This provision is meant to reduce administrative costs and induce banks to compete on the level of interest they offer. Once an amount is withdrawn from an ISA it cannot be deposited back, and unutilised deposit allowances will not be transferrable over successive years.

3. If individuals on middle income save the maximum amounts, based on conservative return assumptions, income from these savings would more than compensate for the projected decline in relative state pension generosity resulting from the reforms enacted by the previous administration (see Appendix F). Granting higher allowances than those envisaged here, would unduly benefit those on high incomes. However, allowances should be reviewed every five years and their relative value should be maintained.

04. Recommended Rate of Tax Relief

1. The objective of this scheme is to provide support for those on low to middle incomes, to save for their retirement and reduce their dependence on (declining) state pensions. Higher income individuals, are already saving, and therefore require no assistance. As a result, rather than providing for tax relief at effective marginal rate of tax, we propose using a single rate of tax, namely 15%. This would mean that all taxpayers would get the same amount of tax refund for the amount of saving they make. The maximum tax refund would be of €150 a year initially.

2. One of the added benefits of applying this rate of tax relief would be to effectively increase the minimum tax threshold by a maximum of €1,000, for those low-income individuals opting to save in a PRS. On the other hand, people on high incomes, who are already saving, will get very little material benefit, from carrying on with the same saving behaviour as before. Most of the benefits of the tax refunds would go to those who really need to be rewarded for saving more.

Appendices

Appendix A: Summary of the report submitted by the Advisory Group on Private Pensions

1. Given that the relative generosity of the state pension is declining, and in view of the drop in the saving rate since the mid-1990s, Government needs to help sustain a culture of savings so that individuals are better able to achieve their desired standard of living during retirement.

2. Economic literature and international practices (see Appendix B), suggest that the optimal way to provide tax incentives, in support of retirement savings, is to grant them at the contribution and the accumulation phase. Pension pay-outs would then be taxed.

3. Savings products eligible for tax incentives should fulfil set criteria (Appendix C and D set out the existing pensions regulation and investment taxation frameworks). The core set are: (i) schemes need to regulated by the Malta Financial Services Authority; (ii) benefit payment shall not start earlier than age 50 or later than 70; (iii) only up to 30% of assets be given as a lump sum, the rest through an annuity or drawdown in accordance to set regulations; (iv) schemes to be subject to specified investment restrictions; (v) schemes to have transparent charges and provide regular information to savers. Additional criteria at this stage appear unnecessary and would require additional, possibly onerous, legislation.

4. Initially, the pension contribution allowance, could be set at €1,000 a year (equivalent to around a third of current median household savings). For someone aged 25, who contributes till pension age, this could result in a pension equivalent to 9% of the average wage and offset the projected relative drop in state pension replacement rates between now and 2060 (see Appendix F).

5. Tax relief on earned income, should be granted using a single rate of relief, rather than effective tax rates. The latter, would cost much more, and the benefits would mostly accrue to those on higher incomes. The best solution would be to use the 15% as it is the lowest marginal tax rate. This would provide better incentives for those on low-to-median earnings (who tend to be younger), where the need to support savings is higher.

6. To supplement personal retirement schemes, tax-favoured accounts could be introduced. Interest earned on these accounts (to which an individual could deposit up to €1,000 a year) would be tax free.

Appendix B: Theoretical and International Tax Treatment of Voluntary Pensions

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Introduction

A number of EU member states, have introduced reforms aimed at increasing the role of voluntary savings, at times accompanied by reforms in the public pension, aimed towards increasing responsibility of households, to save privately through occupational and individual pension plans. Although such pension reforms share similar approaches, the institutional environments of the 'third pillar' of pension savings differ considerably across countries.

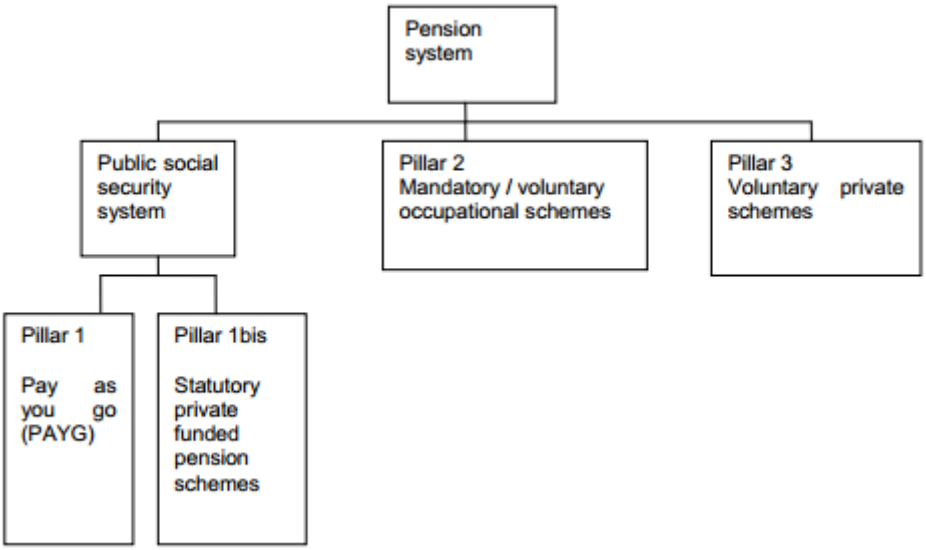
The primary purpose of this paper is to provide a comparison of different third-pillar systems, across EU Member States. In providing this comparison, it also gives an overview of four regimes of tax treatments (EET, ETT, TEE, and TEE).

This paper is organised as follows. The next section provides a brief discussion of the different types of pension systems. Section 3 underlines the need of tax incentives on pension savings. Section 4 deals with the effects of tax reliefs on savings. The fifth section discusses other factors affecting retirement saving rates, while section 6 outlines risks during the decumulation phase. Section 7 illustrates different tax retirement regimes and supplies a hypothetical example to report the net present value of tax, the pre- and post- tax rate of return. Consequently, the advantages and disadvantages of these treatments are presented in section 8. Section 9 gives an overview of actual pension systems and tax treatment of voluntary private pension across EU Member States. Section 10 presents the European Commission's view. Section 11 deals with the limitations on the extent to which third pillar pensions can classify to advantageous tax reliefs. The final section concludes giving some recommendations.

Retirement Income Systems

Income for retirement can be defined in different ways. The most commonly used typology is the 'third-pillar' approach underpinned by the World Bank (1994). Therefore, across the EU27 countries, a general classification of pension types can be divided in the following pillars, as shown in Figure 01 below.

Figure 01: The Structure of Retirement Income Arrangements



The Public Social Security System is characterised by a strong involvement of the public sector, which consists of pillar 1 and pillar 1 bis. Pillar 1 is based on a pay-as-you-go (PAYG) system while pillar 1 bis, is a regime in which its social security pension schemes are partly funded and are generally operated and managed by private institutions. By 2011 the European Parliament (2011), outlines that nine of the 27 EU Member States, switched part of their PAYG to statutory private funded pension schemes.

Savings within the second pillar aim to provide retirees with an adequate replacement rate (i.e. an adequate pension income relative to their previous earnings). Not all Member States have occupational pension schemes, with some States having both mandatory and voluntarily occupational schemes.

The third pillar consists of a voluntary pension in which an individual chooses to enroll in order to provide for himself or herself. It can also be a plan that an employer chooses to introduce for its employees, participation in which may be also voluntary. The third pillar includes private savings, mostly on a voluntary basis, supported by tax privileges in many countries. These systems perform best in combination with a dynamic labour market, which includes a low unemployment rate and high and increasing participation rate of older workers.

The development of the multi-pillar system will ease the burden on public finance associated with ageing. At the same time, it may be difficult for a country to switch from a PAYG system to a funded model as tax payers have to bear the expenditure associated with existing pensioners (transition costs), as well as to fund their own pensions. Having said that, this paper will be focusing on different models of third pillar pensions, and their respective tax regime.

Why the Need for Special Tax Treatments?

In theory, any form of taxation hurts economic efficiency by distorting behaviour. The typical explanations given for special tax treatments in retirement savings are explained below.

Insufficient Retirement Income

A primary argument raised by Whitehouse (1999) regarding the favourable tax treatment of pension savings, reflects the fact that retirement savings are more important than other forms of savings. Individuals may be myopic and fail to predict their needs in old age (Thaler and Shefrin, 1981), which typically translates into difficulty in saving sufficiently once retirement age has been reached. One factor that explains the lack of willpower is that individuals have large discount rates (Thaler, 1981; Laibson *et al*., 1998). Indeed, Thaler (1991) shows that the level of patience encountered by people is directly associated with the time-frame of decision making; such that *a priori* a high level of patience is manifested to long-term decisions. Consequently, the state should encourage individuals to save for retirement, during their working life, so as to ensure a sufficient standard of living in retirement. Hence, tax incentives may be required because in the absence of inducement lifetime savings will not be optimised.

However, this argument may not be valid since it is hard to measure the permanent income (Nyborn and Stuhler, 2011), and consequently, calculate the 'sufficient' level of income needed during retirement age. Moreover, tax incentives may fail to achieve the optimum level of saving, i.e. either render insufficient amount of savings relative to the minimum standard or are over-provided. Engen, Gale, and Scholz (1996), observe that households with tax incentives on saving have taken more debt than other households. Nevertheless, households that participate voluntarily in saving may have stronger tastes for saving than other households. For example Ameriks *et al.* (2003) and MacFarland *et al*. (2004), conclude that countries with strong 'propensity to plan' have a greater commitment to retirement savings. For these reasons, other means of ensuring sufficient retirement income, such as the introduction of the second pillar, is considered mandatory.

Moral Hazard

The second argument relates to moral hazard – individuals will under-provide savings given that they know that the state promises an adequate minimum income that serves as pension income of last resort (Börsch-Supan, 2004), especially for low-income earners. Therefore "by encouraging individual provision for retirement, the cost of social security benefits may be reduced, particularly when means-tested benefits are an important source of retirement income" (Whitehouse, 1999). In 'no tax-incentive' scenario, means-tested benefits act as a large disincentive to save for retirement, especially for low-income earners.

Savings

The third motive is one of capital stock. "The state should increase long-term savings to add to the level and/or stability of capital available for investment" (Whitehouse, 1999). This is further discussed in the following section.

Low Retirement Risks

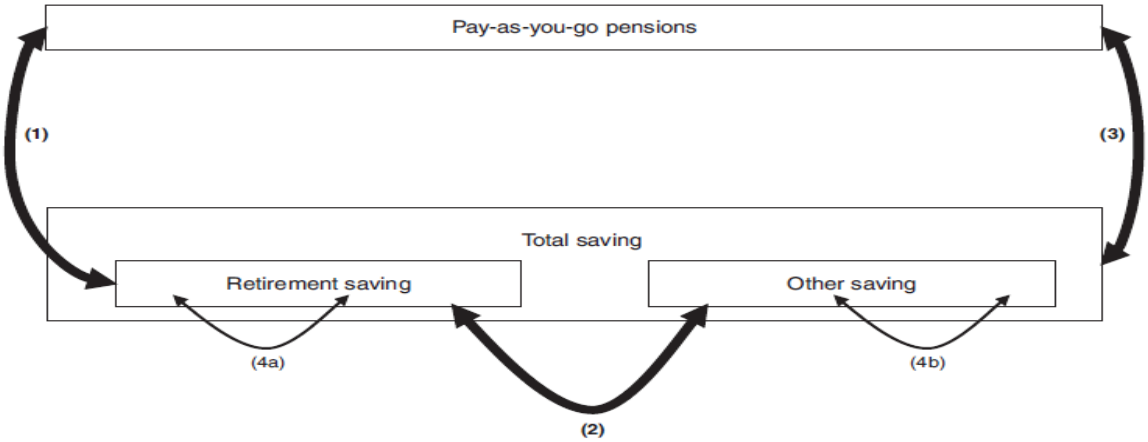
Decision-making is the result of two spheres: an emotional and cerebral dimension (Weber, 2004). The former bears a dread risk - the fear of catastrophe – while the latter holds an uncertainty risk – the fear of the unknown. Both risks are low in retirement, as there is neither sufficient degree of catastrophe nor a great deal of uncertainty to voluntarily prepare for retirement (Blake, 2006) due to rational ignorance. Therefore, behavioural economists argue that one needs to employ commitment devices that assist lasting changes in behaviour (Laibson, 1997; Laibson *et al.*, 1998), *inter alia* tax incentives.

Substitution between PAYG and Private Pensions

According to economic theory, models with consumption smoothing predict substitution between PAYG and funded pensions (both pillar 2 and pillar 3), and the effect of tax incentives to shift from unfunded to funded pension regimes depends on the dominance of the substitution over the income effect.

First, it is imperative to distinguish between two types of substitution, as illustrated by the arrows in Figure 02. The two types of substitution are (a) substitution between retirement wealth (future claims on PAYG pensions) and real wealth (claims on assets paid only for retirement, such as occupational or individual pensions) (see arrow 1), and;(b) substitution between retirement wealth (usually cannot be liquidised freely, such as no availability before retirement age) and other wealth that have no liquidity restrictions (see arrow 2).

Figure 02: Substitution among savings types



Source: Borsh-Supan (2004)

The two substitution mechanisms outlay interesting considerations, which render them important in the pension reform discussion. The first substitution mechanism implies that if the PAYG becomes less generous (i.e. reduced); people will accumulate more retirement savings. This is evident in economic models with consumption smoothing and overlapping generations - such as in Auerbach and Kotlikoff

(1987); Miles (1999); and Börsch-Supan, Ludwig and Winter (2003) – that include both PAYG and life-cycle motive for retirement saving. The second mechanism of substitution entails that when individuals are faced with an incentive to accumulate more retirement savings, they accumulate less assets for a smaller down payment, say by buying smaller houses.

These two effects are central to the argument of crowding out debate between Feldstein (1974) and Barro (1974). The general debate with regard to pensions is to what extent a push towards a funded pension design is superior to a PAYG system. New savings are created if the first substitution exceeds the second substitution mechanism. However, the contrary would happen if the second mechanism is strong, as it only shifts existing savings from one medium to another. This combination is shown in arrow 3 in Figure 02.

Theoretical Impact on Saving Rate

Following the discussion about the two types of substitution effects, it is important to assess the theoretical impact on the saving rate, if tax incentives are granted to voluntary retirement saving.

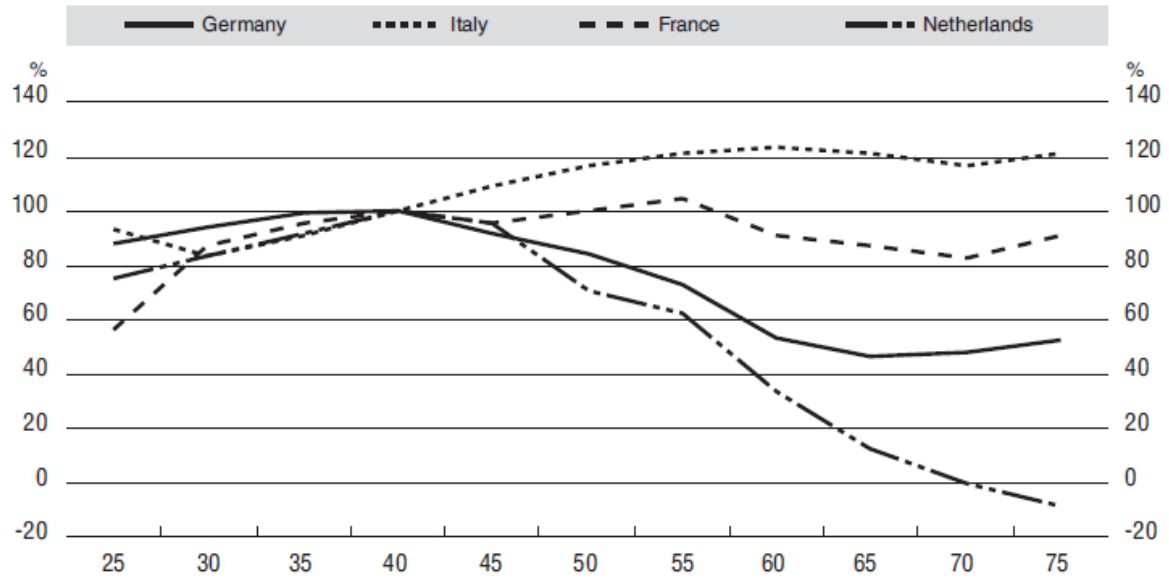
It is argued that tax incentives have two consequences on the individual private pension plans (Le Blanc, 2011). First, it is expected that the degree of tax incentives affects the willingness to save for pension retirement. By way of example, generous tax treatments will be compensated by an increase in private savings. However, this might not necessarily lead to an increase in total private saving because private saving for retirement and private saving for other purposes are substitutes. Therefore, the effect of tax incentives on private saving depends on the magnitude of the substitution effect and the income effect.

On the one hand, if individuals have a fixed target for retirement savings, tax incentives for pensions could induce them to save less during their working life since the level of retirement income would remain unchanged. On the other hand, a positive relationship is expected between tax incentives and pension savings because a higher level of incentive payments increases the opportunity cost of dissaving. This might not, however, necessarily lead to an increase in total private saving because private saving for retirement and private saving for other purposes are substitutes. Thus, the effect of tax incentives on private saving depends on the magnitude of the substitution effect and the income effect.

Cross-National Evidence

Cross-national evidence produced in Borsch-Supan (2004) shows that the extent of first substitution mechanism is stronger in countries where private retirement income is considered unnecessary due to high replacement rates of the public pension system.

Figure 03: Age-specific saving rates (cohort corrected)



Source: Borsch-Supan (2004)

Figure 3 shows the median saving rates in France, Germany, Italy, and the Netherlands by age cohort, to represent life-cycle saving. The life-cycle hypothesis states, that an individual's saving rate takes an inverted U-shaped curve, illustrating that a young age and elderly age dissavings take place, which are financed by saving rates in the working-age. Saving rates in France, Germany, and Italy are rather flat, indicating that there is no dissaving in old age. Indeed, in Jappelli and Modigliani (1998), private retirement saving was compared to a PAYG system, to explain that the observed phenomenon, as mainly due to over-preventive public pension systems. By contrast, the Netherlands has a more hump-shaped curve that agrees with the life-cycle postulation, possibly because of the low public pension provision at that time.

Substitution between retirement income and other saving

From Borsh-Supan (2004), one can also deduce that there is clear evidence on the partial effects of tax incentives (shown in arrow 3, 4a, and 4b). Several econometric studies using micro data sets - like Börsch-Supan and Stahl (1991), and Walliser and Winter (1999) - have shown that tax treatments measures for specific investment vehicles dedicated to retirement have had a positive impact on the relevant form of savings.

However, evidence on the total effects, i.e. the generation of new savings, is controversial. Conclusions from empirical literature are two-fold (Le Blanc, 2011); though inconclusive (Whitehouse, 1999). On one hand, several studies found that tax incentives lead to negative net savings and households shift their private savings from their taxable accounts to tax-deferred accounts in order to reap the benefits of the tax deferrals. By contrast, other studies conclude that tax-incentives bring about positive net savings. For instance, Antonlin, de Serres and de la Maisonneuve, (2004: 23) deduce from various studies that there is a strong relationship between tax-incentives and savings of low- and middle-income earners. In addition, tax incentives are likely to induce high-income earners to increase savings. Indeed, they state;

> "The existence of tax-favoured pension arrangements does not seem to be questioned even though these schemes appear to be costly from a public finance point of view. In fact, more and more countries are either introducing them or extending their coverage. A question that arises is whether tax-favoured arrangements can be justified even if they fail to rise private and national saving."

Hence, as argued above, a review of the literature indicates that there is no clear evidence that the level of tax generosity affects the level of saving. However, shifting the composition of saving towards long-term retirement products might at times be beneficial.

Other Factors Affecting Retirement Saving Rates

The preceding section showed that retirement savings rates are positively influenced by tax relief measures. However, it should be noted that savings for pensions are influenced by other factors, such as expectations about future pension reforms, and other behavioural and psychological factors, which may boost or reduce the effectiveness of savings incentives.

First of all, it is expected that anticipated future pension reforms, often related to reduction of generosity of the first pillar pension provision have a positive effect on retirement saving rates. By way of example, it is expected that a decline in the degree of generosity in the first pillar pension regime could be compensated by an increase in private savings.

Another factor that affects retirement saving, is uncertainty about saving incentives that inhibit the effectiveness of tax reliefs on retirement income. Engen, Gale and Scholz, (1996) postulate that poorly designed, low intertemporal elasticities of substitutions households, and lack of awareness about the need and opportunities for saving are the core reasons why retirement savings are relatively inelastic to tax incentives.

Other factors that influence actual retirement savings, are behavioural and psychological factors (ability of individuals to make and execute plans in accord with conventional optimising theory), procrastination and myopic behaviour. For example, Choi *et al.*, 2003, estimates that human decision making is often marked with inertia or procrastination. Generally, members tend not to alter their contribution rate or their chosen investment fund as they choose to take "the path of least resistance", implying that individuals makes the easiest choices with might not reflect optimality. In the same lines of thought, Mitchell and Utkus (2004), postulate that the initial conditions used to justify a decision, to engage in a particular investment pension fund, remain important over time, even though it might be irrational. The authors found significant anchoring effects on investment decision-making.

A common behavioural constraint in voluntary pension economics is choice overload and herding. Standard economic theory states that people are better-off the more choices they have. However, with regard to the choice of investment fund for pension contributions there is a probability of choice overload (Sethi-Iyengar *et al*., 2004). Indeed, individuals may feel deluged and refrain from participating in any possible scheme. In addition, evidence produced by Duflo and Saez (2004), shows that saving decisions are often influenced by the behaviour of peers: a worker joins a private scheme if other fellow workers join. This is referred to as herding behaviour.

Moreover, behavioural economists, often state that individuals tend to be overconfident about their future and make significantly optimistic forecasts. Overconfidence in decision making may result into lack of diversification (De Bondt, 1998; Goetzmann and Kuman, 2001), such as owned portfolios from sectors that are highly correlated.

So far, the focus has been on factors affecting retirement saving during the accumulation phase. But maximisation of utility of consumption during retirement, is also relevant to this study. There is a range of risks, which can lead to lower consumption than anticipated in a rational lifecycle financial framework, say due to longevity risk, inflation risk, health risks and capital market risks (Blake, 2006).[1] These factors also condition the decisions related to consumption during retirement.

[1] For further discussion of factors affecting the decumulation phase see Blake (2006).

Approaches to Taxing Retirement Savings

There are three points on savings, at which taxation is possible:

i. when money is contributed to the fund, either by employees or employers;
ii. when investment income and capital gains accumulate to the fund; and
iii. when retired scheme members receive benefits.

Taxation can be levied at each of the stated points. At each of these three points, the cash flows can be taxed (T) or exempted (E). The presence of a 'T' indicates the imposition of taxation while 'E' reflects tax exemption at the respective point. However, 'T' does not reflect the overall burden of the tax but it is an indication of the incidence of taxation at that particular stage.

Theoretical taxation combinations render eight taxation models; of which four are of interest. These are shown in the Table below.

Table 01: Fiscal Incentive Framework Options

	Contributions	Returns	Benefits	Name
i.	T	T	E	Comprehensive Income Tax
ii.	E	T	T	Deferred Income Tax
iii.	E	E	T	Classical Expenditure Tax
iv.	T	E	E	Pre-paid Expenditure Tax

The simplest way to explain and illustrate differences between these regimes is through the aid of a hypothetical example. The following working assumptions are adopted:

i. 10 per cent annual real return
ii. 25 per cent tax rate
iii. Five-year investment term
iv. No inflation

The four hypothetical examples are presented in Table 1 above.

The first column shows the tax, tax, exempt (TTE) regime which corresponds to the comprehensive income tax. The amount of saving that reaches the pension fund is €75, implying that €25 out of €100 is taxed. This taxation approach also stipulates that investments returns are taxed, but not the benefits which are reaped out of the pension fund.

The exempt, tax, tax (ETT) model, known as deferred income tax, is shown in column two. Contributions are exempt, whereas both the earnings and the benefits are taxed. The amount of savings that reaches the fund is €100, from which the rendered post-tax investment return is equal to €43.56 and tax collected from benefits paid is equal to €35.89. Therefore the produced net pension is equal to €107.76.

Although the first two regimes (TTE and ETT) render the same net pension income, since the rate of taxation does not change, the effect on saving is different. Both TTE and ETT render a post-tax rate of return which is lower than the pre-tax rate of return. This implies a disincentive to saving, because consumption now is worth more than consumption in the future.

Table 02: Alternative Pension Taxation Regimes

	TTE	*ETT*	*EET*	*TEE*
	€	€	€	€
Pre-tax Contribution (A)	100.00	100.00	100.00	100.00
Tax (B)	25.00	-	-	25.00
Fund (C = A - B)	75.00	100.00	100.00	75.00
Net accrued income (D)	32.67	43.56	61.05	45.79
Fund at retirement (E = C + D)	107.67	143.56	161.05	120.79
Tax on pension withdrawal (F)	-	35.89	40.26	-
Net pension (G = E –F)	107.67	107.67	120.79	120.79
Memorandum item:				
Net present value of tax	33.14	33.14	25.00	25.00
Pre-tax rate of return	10.00	10.00	10.00	10.00
Post-tax rate of return	7.50	7.50	10.00	10.00

Source: Whitehouse (1999)

The third regime of exempt, exempt, tax (EET), known as classical expenditure tax, exempts contributions from tax and investment income or capital gains, however, taxes benefits from retired pension scheme. The amount of net pension is €120.79.

Tax, exempt, exempt (TEE) regime is produced in the forth column. The pre-paid expenditure tax involves taxed contributions, but not taxes are laid on the fund's investment return and tax-free withdrawal of pension benefits. The amount of saving that reaches the pension fund is €100, which after accumulation of investment return reaches a net pension sum of €120.79.

Both the third and forth taxation model are equivalent in effect and render a post-tax rate of return to saving equal to the pre-tax rate of return of 10 per cent of compound interest. This implies that people who save for future consumption, pay the same tax as those who consume now; meaning that these regimes are equitable in their treatment of different individuals.

Finally, it is pertinent to note that both EET and TEE have a net present value of tax revenue of €25 while TTE and ETT yield a higher value of €33.14. In other words, TTE and ETT yield a higher net present value of tax revenues to the government relative to EET and TEE.

However, in practice, EET and TEE systems may not have the same effect on saving because of the different stage at which the tax exemption occurs. The pre- and post-tax rates of return may no longer be equalised if the individual pays a different rates of taxation while in work when compared to the tax paid during retirement. The individual may benefit most from an EET regime given that the marginal rate during working period is generally higher.

In public finance literature, the first two regimes (TTE and ETT), are referred to as 'comprehensive income tax' because they tax citizens according to their ability to pay. By contrast, the last two regimes (EET and TEE) are equivalent to the 'expenditure tax' because they tax only consumption or expenditure and at the same rate whether consumption is undertaken now or in the future.

Advantages and Disadvantages of an Expenditure Tax Regime

The previous section indicates that an expenditure tax, preferably an EET system, has some desirable properties since it equalises consumption between the working life and retirement. However, the TEE system brings revenues forward from funded pensions. This helps to alleviate the transition pension deficit that arises in the cases of systemic reforms from a defined-benefit to a defined-contributory pension system.

In addition to this, an expenditure tax is simpler to administer than comprehensive income tax because investment returns are difficult to capture, especially those in the form of unrealised capital gains. Indeed, a TEE system limits tax avoidance and evasion as tax revenue, is collected up-front. In this

regard, revenue is also collected from individuals independent of their domiciliation and the intention to emigrate on retirement.

A pre-paid expenditure tax has also the benefit of raising more revenue from individuals during their working life, assuming that a progressive tax system captures higher income streams during their working life but pay at a standard rate during retirement.

Finally, another advantage of an expenditure taxation regime is that it maintains equal pre- and post-tax real returns whatever the mix of inflation and real returns in nominal interest rate. By contrast, the burden of the comprehensive income tax depends on the rate of inflation. Theoretically, a pure comprehensive income tax would only tax real returns; however, in practice one would tax nominal returns; implying that the burden of taxation increases with inflation. Consequently, the post-tax real return falls further still below the pre-tax real return. But with a comprehensive income tax more revenue is raised. As shown in Table 02 above, the net present value of tax is higher under the comprehensive tax base when compared to the expenditure tax base. This implies that under the first two regimes (TTE and ETT), the rate of taxation could be lower; meaning that it may improve labour-supply incentives and reduce work in the 'black' or 'shadow' economy. Nevertheless, this still means that savings choices are distorted.

Another disadvantage of an (classical) expenditure tax regime, is that it incentivises individuals to undertake riskier investments because pensions are taxed on withdrawal. The government becomes a co-investor sharing the risk of any losses in the pension fund. This implies a riskier portfolio choice.

Finally, pre-paid expenditure tax may suffer from a 'policy risk'. A TEE may confine future governments since it has to honour previous governments' commitments while revenues have already been absorbed at an early stage. On the contrary, future governments can argue that they are not bounded by commitments of previous governments and thus remove pension tax regimes in payment or investment returns.

Costs to Government

Different tax treatments have different public finance implications, mainly depending at which point retirement savings are taxed. This can be better explained by illustrating a hypothetical example. Suppose that an individual contributes €100 in a type tax regimes from one stipulated in Table . Assume, for simplicity, that the individual is subject to a 25% marginal income tax, and that investment earns a 10% annual return. Pension fund income is taxed at a 10% rate, when applicable. The discount rate is set to 10%. Finally, ordinary savings are taxed both on the initial amount and on the accrued income, similar to a TTE tax regime. A shift from ordinary savings to pension savings is generally more expensive for government, because the latter is more generous. Changes in costs to government after substituting funds from ordinary savings to pension savings are compared to ordinary savings, which is considered to be the baseline. This analysis was adapted from Yeol Yoo and de Serres (2004).

Table 03 below shows income flows of €100 pension fund for 5 consecutive years under an EET regime. At year end, the total gross pension fund accumulates to €161.05, from which €40.26 in taxes are deducted such that the net pension fund is equal to €120.79. Alternatively, the individual could have contributed the €100 fund in ordinary savings. The difference between taxes paid in ordinary savings (row 5) and the private pension (row 2) is the cost to the government in current price (row 7) resulted from a shift from ordinary savings to pension savings. The discount factor (row 8) was used to calculate the net present value term, such that the net tax cost to government per euro of pension savings in the present value term is equal to €0.08.

Table 03: Net Tax Cost of EET-Type Pension Savings

				Accumulated asset					With-drawal (year 5)	Net tax cost (pv)
		Row	Contribution (year 0)	1	2	3	4	5		
Private pension (EET)	Gross Balance	1	100.00	110.00	121.00	133.10	146.41	161.05	161.05	
	Tax paid	2	0.00	0.00	0.00	0.00	0.00	0.00	40.26	
	Net balance	3	100.00	110.00	121.00	133.10	146.41	161.05	120.79	
Ordinary savings (TTE)	Post-tax balance	4	75.00	82.50	90.75	99.83	109.81	120.79	118.04	
	Tax paid	5	25.00	1.88	2.06	2.27	2.50	2.75	0.00	
	Net balance	6	75.00	80.63	86.69	97.56	107.31	118.04	118.04	
Difference in taxes paid (TTE-EET)	Revenue Lost	7= 5-2	25.00	1.88	2.06	2.27	2.50	2.75	-40.26	
	Discount factor	8	1.00	1.10	1.21	1.33	1.46	1.61	1.61	
	NPV revenue loss	9 = 8/7	25.00	1.70	1.70	1.70	1.70	1.70	-25.00	8.52
Assumes a 10 per cent pre-tax rate of return and discount rate, 25 per cent marginal tax rate and five years of investment.										

If it is assumed that the government sets an ETT pension regime, then as illustrated by Table 04, the government can recover a part of lost revenue from implementing a 25 per cent tax on accrued income. Indeed, the overall net tax cost to the government is lower than an EET system by €0.04, implying that on each euro of pension savings, the government losses €0.03 in revenue in net present value terms.

Table 04: Net Cost of ETT-Type Pension Savings

				Accumulated asset					With-drawal (year 5)	Net tax cost (PV)
		Row	Contri-bution (year 0)	1	2	3	4	5		
Private Pension (ETT)	Gross Balance	1	100.00	110.00	121.00	133.10	146.41	161.05	159.59	
	Tax paid	2	0.00	1.00	1.10	1.21	1.33	1.46	39.90	
	Net balance	3	100.00	109.00	119.90	131.89	145.08	159.59	119.69	
Ordinary savings (TTE)	Post-tax balance	4	75.00	82.50	90.75	99.83	109.81	120.79	118.04	
	Tax paid	5	25.00	1.88	2.06	2.27	2.50	2.75	0.00	
	Net balance	6	75.00	80.63	86.69	97.56	107.31	118.04	118.04	

Difference in taxes paid (TTE-ETT)	Revenue Lost	5-2 -7	25.00	0.87	0.96	1.06	1.16	1.28	-39.90	
	Discount factor	8	1.00	1.10	1.21	1.33	1.46	1.61	1.61	
	NPV revenue loss	8/7 =9	25.00	0.80	0.80	0.80	0.80	0.80	-24.77	4.20
Assumes a 10 per cent pre-tax rate of return and discount rate, 25 per cent marginal tax rate and five years of investment, and a 10 per cent tax on pension fund income.										

Table 05 and 06 measure the net tax cost of both TEE and TTE type of pension savings tax regimes. On each euro of pension savings, the net tax cost to government is €0.09 and €0.00 in present value terms respectively.

Table 05: Net Tax Cost of TEE-Type Pension Saving

				Accumulated asset					With-drawal (year 5)	Net tax cost (present value)
		Row	Contri-bution (year 0)	1	2	3	4	5		
Private pension (TEE)	Gross Balance	1	100.00	110.00	121.00	133.10	146.41	161.05	120.79	
	Tax paid	2	25.00	0.00	0.00	0.00	0.00	0.00	0.00	
	Net balance	3	75.00	82.50	90.75	99.83	109.81	120.79	120.79	
Ordinary savings (TTE)	Post-tax balance	4	75.00	82.50	90.75	99.83	109.81	120.79	118.04	
	Tax paid	5	25.00	1.88	2.06	2.27	2.50	2.75	0.00	
	Net balance	6	75.00	80.63	86.69	97.56	107.31	118.04	118.04	
Difference in taxes paid (TEE-ETT)	Revenue Lost	7 = 5-2	0.00	1.88	2.06	2.27	2.50	2.75	0.00	
	Discount factor	8	1.00	1.10	1.21	1.33	1.46	1.61	1.61	
	NPV revenue loss	9 = 8/7	0.00	1.70	1.70	1.70	1.70	1.70	0.00	8.52
Assumes a 10 per cent pre-tax rate of return and discount rate, 25 per cent marginal tax rate and five years of investment.										

Table 06: Net Tax Cost of TTE-Type Pension Savings

		Accumulated asset					With-drawal (year 5)	Net tax cost (pv)
Row	Contri-bution (year 0)	1	2	3	4	5		

Private pension (TTE)	Gross Balance	1	75.00	82.50	90.75	99.83	109.81	120.79	118.04	
	Tax paid	2	25.00	1.88	2.06	2.27	2.50	2.75	0.00	
	Net balance	3	75.00	80.63	88.69	97.56	107.31	118.04	118.04	
Ordinary savings (TTE)	Post-tax balance	4	75.00	82.50	90.75	99.83	109.81	120.79	118.04	
	Tax paid	5	25.00	1.88	2.06	2.27	2.50	2.75	0.00	
	Net balance	6	75.00	80.63	86.69	97.56	107.31	118.04	118.04	
Difference in taxes paid (TTE-ETT)	Revenue Lost	7 = 5-2	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
	Discount factor	8	1.00	1.10	1.21	1.33	1.46	1.61	1.61	
	NPV revenue loss	9 = 8*7	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Assumes a 10 per cent pre-tax rate of return and discount rate, 25 per cent marginal tax rate and five years of investment, and a 10 per cent tax on pension fund income.										

A European Comparison of the Tax Treatment of Pensions

Further to the explanation of the theory of taxation in relation to pensions, this section compares taxation regimes in practice, in a range of EU Member States. Table 07 summarises the tax treatment of pensions in EU Member States at three stages identified in the previous section: contributions, returns, and benefits.

Table 07: Tax Treatment of Personal Pension Plans

	Contributions	Returns	Benefits
Pillar III – EU Member States			
Austria	E	E	T
Bulgaria	E	E	E
Czech Republic	C	E	E
Denmark	E	T	T
Estonia	E	E	T
Germany	E	E	T
Ireland	E	E	T
Latvia	E	T	T
Lithuania	E	E	T
Slovenia	E	E	T
Slovakia	T	T	T
Spain	E	E	T
Sweden	E	T	T
United Kingdom	E	E	T

C = Tax Credit; E = Exempt; T = Taxed

Source: derived from country fiches

The majority of the EU Member States, adopted pension savings tax regimes, in accordance to the EET or ETT system. This means that the contributions are tax deductible, the investment results are usually exempt (with an exception to Denmark, Latvia, and Sweden), and the benefits are taxed.

The following sections provide some context in relation to each of the countries covered. Unless otherwise stated, all information was collected from the country's fiches on their pensions system as published by the website of Commission Services.

Austria

In Austria, the most important source for the provision of retirement income is the PAYG scheme, whereas other pillars are of de facto minor importance. Under the third pillar regime, there is a range of investment instruments that fulfill the purpose of old-age provision. Pension directed provisions are aided by the state in order to encourage the development of the third pension pillar.

The third pillar consists of private life insurance and private pension insurance. The most popular pension instrument is the "premium-aided pension savings scheme" (*Zukunftsvorsorge*). This was introduced in 2003, as a kind of life insurance (including a capital guarantee), subsidised by the state with a tax premium, which is currently 9% of the respective insurance premium. This is however, subject to a ceiling of insurance premium of €2,263.79 per year (Fink, 2010). The taxpayer can receive pension payments after a minimum investment period of 10 years. If benefits are received before the stipulated period, half of the allowed state bonuses must be refunded, coupled with a retroactive tax of 25% on the capital gains, and the capital guarantee is lost. If the entitlements are transferred or used for pension payments, no tax will be due. This scheme has been recording strong growth since its launch in 2003.

Bulgaria

The Bulgarian pension system has experienced considerable structural reforms since the late 1990s. The traditional PAYG system has shifted into a three-pillar system through the introduction of compulsory and voluntary fully funded pensions. The third pillar pension is capital-based. They involve voluntary contributions at the expense of insured persons or at the expense of insured persons, and the insurer or at the expense only of the insurer in order to provide life- or term pension for old age or disability, as well as survivor pensions. Licensed shareholding companies handle the organisation and administration of the supplementary voluntary pension schemes.

The occupation pension schemes were introduced into this pillar in 2007. Both the contributions paid by employers and insured persons are tax exempt, however, subject to a limit equal to 10 per cent of the taxable income. The benefits paid may be different between life-long, time-limited pension or lump sum. The same applies to employer contributions and investment income. Benefits were used to be taxed, however, they are now also exempted (Pension Funds Online, 2013). Hence, Bulgaria runs an EEE system.

Czech Republic

The Czech pension system is based on the first pillar and the third pillar. The third pillar is voluntarily, supplementary, fully funded and state-subsidised pension scheme based on defined contribution (DC) and available to those who participate in the first pillar or in public health insurance. In addition to the subsidies granted by the state, any employer can sustain his employees with additional contribution to employee's fund. Furthermore, both employers' and employees' contributions are subject to additional tax allowances. Members of the voluntary pension systems are allowed to switch between different pension fund providers. The third pillar pension system plays a minor role relative to the first pillar.

Pensions can be paid from a minimum age of 60, provided that a minimum number of contributory years are met, depending on the regulations of the pension fund. Otherwise, grants granted by the state during contributions have to be repaid with an additional tax (Pension Funds Online, 2013).

In addition, the state matches employees' contributions with the level of contributions. For contributions between CZK 100 and 199, the state adds CZK 50 plus 40% of the member contribution above CZK 100. If the pension plan member contributes between CZK 200 and 299, the allowance is CZK 90 plus 30% of the sum above CZK 200. If a member contributes more than CZK 500, the allowance increases gradually with the highest allowance being CZK 150 (Pension Funds Online, 2013).

Employers' contributions can be deducted from their tax base, up to 3 per cent of an employee's assessment base. Employer contributions of up to 5% of their wages are exempt from income tax for the employee (Pension Funds Online, 2013).

A number of reforms to the third pillar were valid as from 2013, with the aim of increasing the security of the capital of participants and of encouraging people to increase their contributions to the system. Capital accumulated from contributions was separated from assets of pension institutions, implying that there will be no longer the guarantee of at least zero returns as state regulation came to an end. Moreover, pension institutions are allowed to offer new investment products with higher rates of return, at the expense of higher risks. Another relevant change was an increase in the minimum and maximum state contributions in form of subsidies to encourage participants to save more, depending on the level of participant contribution.

Denmark

The Danish pension system is composed of three pillars. Of importance is the third pillar which consists of individual, voluntary pension schemes. The public voluntary early retirement pension (VERP) is also placed in this pillar.

The individual pension schemes generally consist of capital pension or annuity pension schemes, but may also be current life-long pensions. The amount of the pensions paid relies on the savings (including return) made by the individual.

All employees and self-employed persons, who are registered in the unemployment insurance fund and the VERP scheme, can apply for the VERP. This scheme is designed for members of age of 60 years, but who are not yet 65 years old. To be eligible for the VERP one needs to be a member of the unemployment insurance fund and paid the voluntary early retirement contributions for 30 years. Moreover, the membership and the contributions can start once one reaches the age of 30.

The basis benefit paid in the VERP is €24,300 annually, if retiring before the age of 62. This amount is further reduced based on the person's pension wealth. Concretely, this means that benefit paid is reduced by 3 per cent of pension wealth above a threshold of €37,000. If retiring at the age of 62 or later, the basis benefit is raised to €26,800 and the reduction based on the pension wealth is avoided. In 2010 the VERP expenditure amounted to 2.3 per cent of GDP.

As a general rule, Pillar 3 pensions, are taxed ETT. Once contributions are paid into the scheme they can be deducted from the ordinary income tax. But contributions are still taxed with the 8 per cent payroll tax. Furthermore, contributions to capital pensions are not deductible in the top tax rate. Pension savings are not taxed until the pensions are paid out.

When pensions are paid, they are subject to the personal income tax, but not the payroll tax. Benefits from capital pensions are taxed with a flat 40 per cent rate.

The Denmark's fiche projects that government's revenue is expected to increase, are resulting from increasing pension payments, despite the rising public debt due to tax deductions for pension contributions made today. This coincides with the European Commission's argument for deferred tax payments reviewed earlier in this paper.

Estonia

Estonian pension system is based on the three-pillar approach whereby the third pillar is supplementary individual voluntary pension scheme. The first possibilities for third pillar were created in 1998, when

the necessary legal framework was enacted. This was amended in 2011 which influenced the scheme in a number of ways.

Participation in the supplementary pension scheme can take two forms. Firstly, the purchase of pension insurance policies offered by licensed private life insurance companies (either with guaranteed interest rate or with investment risk). Secondly, the purchase of voluntary pension fund units managed by private fund managers (Estonia.eu).

The following tax incentives have been introduced to encourage participation in the supplementary pension scheme:

i. Contributions can be deducted from one's taxable income, however, limited to 15 per cent of the annual gross income.
ii. The Estonian Tax and Customs Board refunds 21% from the contributions made during the calendar year.
iii. During the decumulation phase, paid pensions are taxable at a lower rate (10 per cent) of income tax, instead of the normal rate of 21 per cent, but only if the collected money is taken as a lump-sum upon retirement. Payments of pensions made periodically, once a month or quarterly are not taxed.
iv. There is a minimum contractual age limit of 55 years to which tax exceptions can apply. The following changes with regard to voluntary pension schemes were ratified in 2011:

- shares could be exchanged easier and more flexible by abolishing the minimum amount of shares needed to be exchanged and time limit between consecutive exchanges;
- transfer between different pension insurance or pension fund is not taxed;
- exchange of different products were regulated by the law;
- there are no penalties if one withdraws pension savings before age 55;
- investment providers are obliged to assess the suitability of voluntary pension to each prospectus saver;
- a limit of €6,000 per annum is set to tax-free contributions, and employers can contribute to the fund of an employee up to 15 per cent of his salary or €6,000 without paying income and social tax (Segaert and Võrk, 2012).

Germany

The pension system in Germany is based on three pillars. Both the second and the third pillars are non-mandatory and cover occupational and private pension system. Both systems are tax-promoted and subsidised by government. One of the requirements to be eligible for tax treatments is that at least the nominal value of contribution payment should be guaranteed (zero rate of return). This type of pension is referred to as Riester pension (Augurzky, Mennicken, and Schmähl, 2012), which refers to the German Retirement Savings Act that was introduced in 2001 to provide saving incentives to boost retirement savings (ibid).

Subsidies can be categorised into two forms: a match of the participants' contribution and the deduction of all contributions from income for tax purposes. The regulations and subsidy methods were very complex; however these were simplified in 2005 (Börsch-Supan, Coppola, and Reil-Held, 2012).

The amount of subsidies on Riester pensions depends on individuals' income and number of children. In addition, every individual insured in Germany's public pension system and public officials, as well as other eligible spouses, are also allowed to get these subsidies. Subsidies could also be paid as lump-sum or tax deduction. The former is generous for low-income households with children, while the latter is advantageous for high-income households. The current regulation is summarised in Table, as produced in Bucher-Koenen (2011).

This table summarises the state subsidies for Riester products as applicable from 2008 onwards:

Table 08: Riester Subsidies

	Minimum percentage of income required to be saved to obtain full subsidies	**4%** **4%**
	Minimum own contribution in Euros per year	60

	Per capita subsidy in Euros per year	154
	Subsidies for children in Euros per year:	
-	**Children born before 1.1.2008**	185
-	**Children born on 1.1.2008 and after**	300
	One-time bonus if the subsidised individual is younger than 25 in Euros	200
	Maximum tax deductable amount in Euros per year	2100

Source: Bucher-Koenen, 2011

Ireland

The pensions system in Ireland is comprised of 3 main pillars. It is pertinent to note that both pillar II and pillar III are voluntary.

Under pillar II, pensions can be provided through a person's employment or directly through financial institutions acting as pension providers. A tax relief regime applies to contribution, returns, and benefits stages.

During the contribution stage tax relief, contributions are categorised into employee contributions and employer contributions. The former are relieved at the employee's marginal income tax rate, at which the maximum tax relievable contribution is subject to a cap as a percentage of remuneration. For example, for a pension plan of €100 at a tax rate of 41%, the real cost to the employee is €59 and tax relief is €41. Similarly, for the same pension plan of €100 at a tax rate of 20%, the real cost to the employee is €80 and the tax relief is €20. This implies, that with a progressive income tax rates, employee's tax relief is proportionally lower at higher levels of income. Furthermore, there are limits to the amount of tax relief available based on the age at the date of making the contribution. Employers also contribute to the retirement fund through a defined percentage of their employees' salary to their retirement fund. Employers also benefit from tax relief on any contributions to the employees' pension plan as these can normally be fully offset against Corporation Tax as a business expense (Society of Actuaries in Ireland, 2012).

During the accumulation stage, contributions are invested in pension funds, which are exempt from Irish Tax; though there is still some external tax leakage for pension fund investors as a result of dividend withholding taxes that are applied in some jurisdictions.

The third pillar pension in Ireland is compromised of the voluntary non-pension sources of income in retirement. It would typically include private savings, private investments and income from other sources. Other than capital gains tax of 30%, that is subject to a cap, there are few if any fiscal incentives that are targeted at the wider working population.

Latvia

Latvia has three-pillar type of pension system. The third pillar was in operation since 1998. Both DC and DB plans can be offered.

Workers can participate in the pillar 3 pension regime, directly or with involvement of their employer. Both the contributions amounts and timing are flexible, i.e. the participant can contribute in as much when s/he wished. Pensions can be received from accumulated pension capital from the age of 55, whilst one may opt to continue contributing and receive capital in parts (Bite, 2012).

Contributions that do not surpass 20% of a person's gross income in the tax year are not deducted. Investment income is taxed, while benefits are tax-exempt up to a certain limit. In contrast to the 2nd tier pension, a private pension is inheritable.

Lithuania

Since 2004, the Lithuanian pension system consists of three pillars of which there is a voluntary private funded pension scheme.

The DC pillar 3 pensions rests on the system of personal accounts. Contributions are exempted from social insurance pension contributions. This pillar offers certain tax advantages (Jankauskienė and Medaiskis, 2012).

The Lithuanian pension system grants third pillar pension savings in pension funds or life-insurance companies to have tax advantages. Income and corporate tax allowances are granted to contributions to the third pillar pension scheme if they do not exceed 25% of the person's annual earnings, and any amount above that level is taxed at a reduced rate of 15% rather than the regular rate of 27% (Pensions Fund Online, 2013). The investment returns on the contributions are not taxed while benefits received from contributions are partly taxed on the accumulated amount covering the contributions paid (Jankauskienė and Medaiskis, 2010).

In addition, there is a legal framework in pension accumulation that allows contracts to be terminated before reaching retirement age given that the maturity is not earlier than 10 years after the beginning of accumulation.

Slovenia

Slovenia's pension system rests on multi-pillar approach.

Two kinds of voluntary supplementary pension insurance exist. These are collective insurance in which workers can be included via their employer who fully or partly finances the pension scheme, and individual insurance where insured persons pay contributions for themselves

The supplementary pension fund has the following conditions:

- the contributor has at least 58 years of age;
- the contributor has right to the first tier pension;
- at least 120 months have elapsed since the inclusion into the voluntary supplementary pension insurance.

An insured person also has a right to transfer the funds to another approved pension scheme.

In addition, the contributor (employer or individual) is entitled to tax relief for the paid-in premium; however the pension plan needs the approval of the Ministry responsible for labour.

Slovakia

The Slovak pension system consists of three pillars.

The third pillar was introduced in 1996 as a supplementary part of the pension system. It is a voluntary, fully funded, contribution defined, privately managed pension scheme. As of 2011, the third pillar is no more supported by tax incentives in the form of tax allowance as part of the fiscal consolidation package (Vagac, 2012).

Spain

The pension regime is categorised under two groups: the public system and private pensions.

Private pensions are voluntary (non-mandatory), supplementary and includes both individual and occupational pension funds. Occupational pensions include occupational plans and collective pension insurance plans (with retirement benefit purposes). They are usually agreed in the wage bargaining process, and are both financed by employers and employees.

Contributions to private pension plans enjoy a favourable tax treatment (EET) with the exception of collective insurance that does not enjoy tax exemptions. Benefits received from pensions are taxed at labour income.

Sweden

The new Swedish public old-age pension system was fully implemented in 2003. The new earnings-related old-age pension system consists of a notionally defined contribution (NDC) PAYG component and a fully funded, defined contribution (DC) pension system.

Tax-deductions apply for voluntary private pension saving, something that is especially important for self-employed who not are covered by any occupational pension plans.

Since 2008, the capped yearly deduction allowed is €1,260, however, self-employed, who are not eligible to occupational saving plans, are granted higher deductions. The latest country fiche reports that in 2009 approximately 39% of the population 20-64 years made tax-deductions for private pension savings, in average €570 and in total €1,120 billion.

Private tax-deductible pension savings are taxed ETT.

The European Commission's View on Tax Regimes

The Commission supports the system of deferred income taxation (ETT) for three reasons:

i. "contributions to pension funds diminish a person's ability to pay taxes;
ii. encourages citizens to save for their old age;
iii. Helps Member States to deal with the demographic time-bomb, as they will be collecting more tax revenues at a time when more elderly people may call on the State for care." (European Commission, 2013).

However, the Commission notes that many Member States do not allow mobility of pensions, i.e. tax reliefs for pension contributions paid to pension funds in other Member States. This effectively is hindering competition in national pension markets and created major obstacles to free movement of labour.

Limitations on Deductibility

As highlighted in the countries' pillar III profile above, the majority of countries have a restriction on the extent to which pension contributions can classify to advantageous tax treatments. This is typically to control tax avoidance and\or because of distributional issues (Whitehouse, 1999). Generally higher-income earners have a larger pool of funds and are more able to make relatively larger pension contributions leading to a larger tax advantage.

Restrictions on pension contributions can take a number of forms:

i. absolute limits on the amount of contributions;
ii. limits on the proportion of contributions that can be deducted;
iii. limits on the proportion of income on which contributions can be made;
iv. limits on the deductibility of contributions at higher rates of income tax.

Hypothetical can be drawn to illustrate the implications for Government revenue of different tax treatment regimes, alongside the interaction with restrictions on contributions. The results drawn are sensitive to the assumptions adopted as shown below.[2] A similar framework used in Section 6 is to be adopted to analyse the implications of the last restriction on pension contributions for higher-rate taxpayer as shown in
Table 09 below shows - The first case assumes that an individual pays a higher tax rate of 40 per cent, during both his working life and retirement. By contrast, the second case depicts a situation whereby an individual pays the higher rate of tax in work, but pays a standard rate of tax during retirements, assumed to be 25 per cent.

Table 09: Alternative tax treatments for higher-rate taxpayers

	Case 1	***Case 2***

[2] Scenarios may need to be calibrated on the basis of actual policy parameters.

	Higher rate in work and retirement				Higher rate in work, basic rate in retirement			
	EET	*TEE*	*EET with limit*	*ETT*	*EET*	*TEE*	*EET with limit*	*ETT*
Contribution	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Tax	0	40.00	15.00	0	0	40.00	15.00	0
Fund	100.00	60.00	85.00	100.00	100.00	60.00	85.00	100.00
Net Investment Return	61.05	36.63	51.89	33.82	61.05	36.63	51.89	33.82
Fund at Retirement	161.05	96.63	136.89	133.82	161.05	96.63	136.89	133.82
Tax on Pension	64.42	0	54.76	53.53	40.26	0	34.22	33.46
Net Pension	96.63	96.63	82.14	80.29	120.79	96.63	102.67	100.37
Net present value of tax	40	40	49	50.14	25	40.00	36.25	37.68

The first column shows the classical expenditure tax. Contributions are deductable at the higher rate of 40 per cent when contributions are paid and investment returns accumulate. However, when pensions are paid, the annuity is taxed at the higher tax rate, so that net pension is equal to €96.63. As already explained earlier in the paper, EET tax treatment is equitable, i.e. people who save for future consumption pay the same tax as those who consume now.

The pre-paid expenditure tax is shown in the second column. Contributions are taxed at the higher rate of 40%, rendering a fund equal to €60. The net pension result is the same as the classical expenditure tax of €96.63.

The third column illustrates an example on limits imposed on the deductibility of contributions at higher rates of income tax of 40% for EET tax treatment. The deductibility of pension contributions is constrained to the standard rate of tax – assumed to be 25%. This implies a partial deductibility of €15 per €100, which is the difference between the higher and standard rates. Given that the pension fund is relatively lower, the generated net investment return is less than the unrestricted expenditure tax by €14.49 or 15 per cent, meaning that the net pension is less generous for EET tax treatment with limits. However, the net present value of tax is €9 higher, implying greater revenue for government. It is to be noted that since the fund at retirement is relatively smaller there is less to tax when the pension is paid.

The deferred income tax regime (ETT) is produced in column 4. In this example, the net investment return is taxed at the standard rate, 25%. Note that the net pension and the net present value of tax of EET and ETT are alike. This shows that if one restricts the deductibility of contributions the EET regime would be similar to the ETT tax treatment.

Similar to Case 1 under Case 2, the TEE regime renders a lower net pension but a higher net present value of tax relative to the EET. Again, limiting the deductibility of contributions to the basic rate (see column seven) reduces the value of net pension from €120.79 to €102.67 and the net present value of government revenue collected from taxes increases from €25 to €36.25. Just like Case 1, the net present value of tax under an EET tax regime with limit yields similar results to the ETT regime.

Conclusions

This paper provides a number of theoretical and policy insights on the application of different regimes of tax treatments and their implications in incentivising voluntary third pillar savings. Firstly, the literature indicates that an expenditure-tax system is considered as the best way to tax pensions, because, unlike the comprehensive income tax it does not distort intertemporal consumption, i.e. people's preferences in relation to consumption and saving over the course of their life. Furthermore, it is easier to administer and the tax burden does not change with inflation.

Secondly, preferential tax treatment to retirement savings should not be implemented with the aim to increase aggregate savings as this might not be the case. Rather, the scope of tax incentives is closely related to the level of retirement income deemed to be adequate by an individual contributor.

Thirdly, there is clear evidence which supports substitution between state PAYG pensions and private retirement savings in the long run. People tend to accumulate more private retirement savings, the less generous the state PAYG becomes. Further, tax reliefs entice people to accumulate retirement savings possibly at the expense of other assets.

Finally, this paper outlines the advantages and disadvantages of the expenditure tax regime. In this view, most countries adopt ad-hoc system close to EET. This is in spite of the European Commission's preference for an ETT tax regime. The TEE, however, is also desirable from a public finances point of view since it collects revenues up-front.

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The Special Funds (Regulation) Act, 2002 provides a regulatory framework to allow the establishment of pension schemes in the form of: [a] a trust; [b] by contract or [c] an Investment Company with Variable Share Capital established under the Companies Act.

Revision of the Legislation

The Retirement Pensions Act (Chapter 514 of the Laws of Malta) was published by means of Act No. XVI of 2011, in the Government Gazette on the 5th August 2011. This Act will repeal and replace the Special Funds (Regulation) Act (Chapter 450 of the Laws of Malta), regulations and directives issued thereunder, once it comes into effect when the Pension Rules to be issued thereunder are published. **The scope of the Retirement Pensions Act is to create a more flexible and user friendly piece of legislation, rather than undertaking a complete overhaul or making drastic changes to the current legislation.**

The Retirement Pensions Act ("RPA") provides the legal framework for the licensing and regulation of retirement schemes, retirement funds and service providers related thereto as well as the requirement of recognition for persons carrying on back-office administrative activities. The detailed requirements and conditions for licensing or recognition as well as on-going obligations of persons licensed or recognised under the Retirement Pensions Act are stipulated in the law itself, in secondary legislation and Pension Rules which may be issued from time to time under the said Act. The Retirement Pensions Act, secondary legislation and Pension Rules, also transpose the provisions of Directive 2003/41/EC of the European Parliament and of the Council of the 3rd June 2003 on the activities and supervision of the institutions for occupational retirement provision (the IORP Directive).The draft Pension Rules have been issued for consultation and feedback received is currently being mapped.

Pursuant to Article 38(1), the administration of the RPA is vested in the Malta Financial Services Authority as the Competent Authority for the purposes of the Act.

A retirement scheme means a scheme or arrangement with the principal purpose of providing retirement benefits. A Retirement Scheme may take the form of Defined Benefit Schemes and Defined Contribution Schemes. A Retirement Scheme established under the RPA, is open to occupational and personal schemes. Any operator can establish such a Retirement Scheme and sell it to Maltese Residents as there are no prohibitions in this regard at law.

In terms of the RPA, an "occupational retirement scheme" is a retirement scheme established for, or by, an employer/s or an association representing employers, jointly or separately, for the benefit of employees. A "personal retirement scheme" means a retirement scheme which is not an occupational retirement scheme and to which contributions are made for the benefit of an individual.

A scheme/arrangement shall not constitute a retirement scheme under the RPA if it provides for:

(a) the payment of retirement benefits to five or fewer members; or

(*b*) the commencement of payment of retirement benefits to a member on a date that is earlier than that on which such member has attained the age of **fifty**, **or later than the age of seventy**, except in those cases where the scheme or arrangement provides that:

(i) the payment is made by reason of the disability or death of a member; or

(ii) the payment, in the case of an occupational retirement scheme, is made to the member without the necessity of the member's consent in line with any Pension Rules, in the event that the member is no longer employed by the employer and other Schemes providing cover against investment or biometric risk.

No retirement scheme shall carry on any activity for the provision of retirement benefits in or from within Malta, unless such retirement scheme is situated in Malta and is duly licensed under the RPA.

The Pensions Regulatory Framework provides for the authorisation and regulation of service providers providing the following licensable activities:

1. Retirement Scheme Administration - administering the operation of a retirement scheme.

2. Custodian or Trustee Services
   - acting as custodian or trustee of a retirement scheme
   - acting as custodian or trustee of a retirement fund.

3. Investment Management
   - management of the assets of a retirement scheme
   - management of the assets of a retirement fund

Points to take out from Pensions Framework in relation to Third Pillar Pensions

1. Operations of the Scheme

The contributions to the Scheme will be invested in accordance with the Scheme investment objectives and shall respect the following **investment restrictions**:

i. The Retirement Scheme Administrator shall arrange for the Scheme assets to be invested in a prudent manner and in the best interest of Members and Beneficiaries. In the case of a potential conflict of interest, the Scheme Administrator, or the Asset Manager that may be appointed to manage the Scheme's assets, shall ensure that investment activity is carried out in the sole interest of members and beneficiaries;

ii. The Retirement Scheme Administrator shall ensure that the assets of a Scheme, are properly diversified in such a way as to avoid accumulations of risk in the portfolio as a whole.

iii. A Retirement Scheme should not engage in transactions with any of its members or connected persons thereto.

iv. A Retirement Scheme should not grant any loans to any of its members or connected persons thereto.

v. A Retirement Scheme should not engage in borrowing in connection with property purchases, on behalf of any of its members or connected persons thereto, provided that the Scheme may borrow only on a short term basis in relation to the management of its assets and should not engage in any leverage.

vi. The investment policy should be clearly specified or agreed, as the case may be, with the Member and there should be clear disclosure awareness by client of applicable risks.

2. Programmed Withdrawal Arrangements

Retirement Benefits shall be **paid out in a stream of income payments**, other than benefits paid on death or permanent invalidity of the member.

i. On retirement, 30% of the assets of a member in a Retirement Scheme or Retirement Fund, as the case may be, may be paid as a cash lump sum. The remaining assets shall be used to provide a retirement income.

ii. The Retirement Scheme shall, at the request of the Malta Financial Services Authority, demonstrate that any remaining assets of a member which are not paid in the form of a cash lump sum as outlined in para. (i) above, generate sufficient income to the retiree. The Retirement Scheme shall in making its calculations, use annuity/drawdown rates applicable in law in the country of residence of the retiree or of no such rates exist, annuity/drawdown rates applicable in the country of residence of the transferor scheme. It annuity/drawdown rates do

not exist in either jurisdiction, the Retirement Scheme Administrator shall base its calculation of a retiree's stream of income on publicly available annuity/drawdown rates.

iii. Where subsequent to a valuation of a retiree's assets, it is established that the retiree's value of assets is more than sufficient to provide the retirement benefit determined in accordance with para. (i) above, then 50% of the excess value of such assets as determined by the valuation may be withdrawn as a lump sum.

iv. The valuation shall be performed not more than once every financial year, and not within the first three years, from commencement of retirement benefits.

v. The above shall be without prejudice to any other limitations on withdrawal of retirement assets as specified by any other pensions or taxation legislation to which a retiree is subject to.

vi. In the case where a retiree is domiciled in Malta the conditions in para. (iii), shall only apply where the annual retirement benefit from an annuity exceeds €50,000.

vii. This value shall be adjusted annually to take account of changes in the index of inflation, as published by the National Statistics Office in the Government Gazette of Malta.

1. Income chargeable to tax under the Income Tax Acts:

(a) dividends, premiums, interest or discounts;

(b) any pension, charge, annuity or annual payment;

(c) rents, royalties, premiums and any other profits arising from property;

(d) capital gains arising from any transfer of:

- immovable property or any rights over such property.
- shares and stocks and such like instrument that participate in any way in the profits of the company and whose return is not limited to a fixed rate of return.
- units in a collective investment scheme as defined in article 2 of the Investment Services Act, including any redemption, liquidation or cancellation of such units or shares.
- units and such like instruments relating to linked long term business of insurance, including maturity or surrender of linked long term policies of insurance.

(f) capital gains arising from a transfer of the beneficial interest in a trust.

(g) capital gains arising from the transfer of the ownership or usufruct of or from the assignment or cession of any rights over any interest in a partnership.

A transfer causa mortis is not chargeable to tax.

2. Investment Income Provisions:

The tax rate is 15%, which is the lowest tax rate applicable to individuals other than the zero rate. Three cumulative conditions have to be satisfied for the application of the investment income provisions, i.e.:

- the nature of the income has to fall within the definition of investment income.
- there must be a 'payor' of investment income as defined by the relative provisions.
- there must be a 'recipient' of investment income as defined by the relative provisions.

Investment income means only the following categories of income:

- bank interest payable by a Maltese bank;
- interest, discounts or premiums payable by the Government of Malta;
- interest, discounts or premiums payable by a corporation or authority established by law interest, discount or premiums payable in respect of a public issue by a company, entity or other legal person howsoever constituted and whether resident in Malta or otherwise;
- interest, discounts or premiums payable in respect of a private issue by a company, entity or other legal person howsoever constituted and resident in Malta paid to a CIS: extension of previous provision to private placements but this is only applicable when the income is payable to a CIS – not to any other person. Really just 'plugging' a loophole, because otherwise 'prescribed funds' would not be subject to tax thereon;

- capital gains arising on the disposal of units in collective investment schemes upon the redemption, liquidation or cancellation of units held in a resident non-prescribed fund or a non-resident non-prescribed fund: in the latter case the disposal has to be made through the services of an authorized financial intermediary;

- capital gains arising on the surrender or maturity of units and such like instruments related to linked long term business of insurance where the benefits are at least 85% determined by reference to the value of units in collective investment schemes (Maltese licensed funds or foreign UCITS). For the purposes of the calculation of the capital gain: no account is taken of any part of the benefits that is determined by reference to the value of units in prescribed funds subject to the condition that such underlying investments were not acquired within 3 years from the surrender or maturity of the policy. The cost of acquisition is equal to the total premiums paid in relation to the linked portion of the contract of insurance;

- capital gains on redemption, liquidation or cancellation of securities (other than CIS units or units in LLTCIs) and not being company shares;

- Profits distributed by a non-resident CIS where such dividends are paid through the services of an authorised financial intermediary (AFI);

- interest payable by a foreign bank where it is made through the services of an AFI;

- profits distributed by a non-resident company (other than a CIS) which are paid through the services of an AFI to a Maltese-resident individual for whom the distributed profits constitute income derived from shares each of which is a qualifying asset as defined in article 9B – but WHT rate of 35%.

A recipient is defined as:

(a) a person (whether corporate or non-corporate) who is resident in Malta during the year in which the investment income is paid, other than:

- a bank carrying on the business of banking in Malta;

- a person carrying on the business of insurance;

- any other company which is owned and controlled, directly or indirectly, by any of the above (excluding listed companies s.t.c);

(b) a receiver, guardian, tutor, curator, judicial sequestrator or committee acting on behalf of a person referred to above;

(c) a trustee or foundation by virtue of which money is paid to or for the benefit of a person referred to above.

Tax deduction amounts to 15%, except that profits distributed by a non-resident company, (other than a CIS) to a Maltese-resident individual through an AFI, is subject to tax at 35% and payments, (other than local bank interest income) to a prescribed fund at 10%.

The recipient has an option to receive the investment income gross where:

- an election in writing has to be submitted to the payor;

- election is effective as from 14 days following the receipt of such notice by the payor; however an election made on the opening of a bank a/c or on the purchase of bonds, loan stock or other instrument has immediate effect (because A/c must be regulated in some way from the beginning).

Such an election may be revoked for any subsequent transactions, and the 14 day period also applies for a revocation. Option is flexible and can be applied on the basis of the particular circumstances.

Where an election has been made to receive the investment income gross, the resident investor is required to declare such investment income in his tax return and be charged to tax on such income under normal rates.

Where no election has been effected, a resident individual is not obliged to disclose the relative investment income in the tax return. Maltese resident companies must include reference to the income in their audited accounts and consequent tax returns.

However, no resident person (whether individuals, companies or other) would be charged to further tax on investment income which has been subject to withholding tax – for companies, the particular profits are allocated to the FTA and no further tax thereon should be imposed on distribution to shareholders.

Persons Exempt from Income Tax are:

(a) The Income of the University of Malta;

(b) The income of any trade union registered under the Employment and Industrial Relations Act in so far as such income is not derived from a trade or business carried on by such trade union;

(c) The income of a non-profit making organisation so long as such non-profit making organisation does not carry out a business;

(d) The income of bona fide band clubs;

(e) The income of any pension fund, provident fund or other fund approved by the Minister responsible for finance;

(f) The income of any institution, trust, bequest or foundation, of a public character, which is engaged in philanthropic work;

(g) The income of any political party including the income of clubs adhering to political parties;

(h) The income of bona fide sports clubs;

Income Exempt from Income Tax is:

(a) Social Security Benefits specified by the Minister. As of date, the Minister specified the following benefits as being exempt:

(i) Disability Pension and Pension for the Visually Impaired;

(ii) Social Assistance;

(iii) Age Pension;

(iv) Marriage Grant;

(v) Maternity Benefit;

(vi) Children's Allowance;
(vii) Foster Care Allowance;

(viii) Disabled Child Allowance from the payment of tax.

(b) Any interest, discount, premium or royalties accruing to or derived by any person not resident in Malta. The exemption applies provided such income is not attributable to a permanent establishment the non-resident has in Malta.

(c) Wound and disability pensions granted in respect of wounds or disabilities caused by war and any pensions granted to dependent relatives of members of the armed forces of the Commonwealth killed on war service.

(d) Any capital sum received by way of commutation of pension, retiring or death gratuity or received as consolidated compensation for death or injuries.

An introduction to the taxation of collective investment schemes in Malta

Collective Investment Schemes ("CISs"), are vehicles that enable potential investors the possibility to entrust their funds with a licensed entity, to carry out collective investment activities. The advantages of investing in a CIS include the spreading of investment risk, and the possibility of participating in investment opportunities that would otherwise not have been feasible to the sole investor.

Funds are typically set-up as separate legal entities in their own right, and operate locally in terms of the provisions of the Investment Service Act. Funds may take up the corporate form under the provisions of the Maltese Companies Act 1995, including the setting-up of an investment company with variable share capital (SICAV), an investment company with fixed share capital (INVCO) and a partnership 'en commandite', having its share capital divided into shares. Furthermore, CISs may be set-up by way of trust (Unit Trust) and by way of contract (Mutual Fund).

The taxation of Collective Investment Schemes, is governed by the applicable provisions of the Income Tax Act, the Collective Investment Scheme (Investment Income) Regulations, and the Collective Investment Schemes Inland Revenue Guidelines.

Taxation at the fund level

The tax regime applicable to CISs is generally based on the classification of funds into prescribed and non-prescribed funds. A CIS may be composed of a number of sub-funds and the classification between prescribed and non-prescribed applies to each sub-fund within the CIS.

A prescribed fund is broadly a fund formed in accordance with the laws of Malta, that has declared that the value of its assets, situated in Malta, represents at least 85% of the value of the fund's total assets.

A non-prescribed fund is that fund which is not classified as a prescribed fund and would typically be an overseas based fund, a foreign UCITS, registered under the laws of a foreign country or a local CIS, registered under the laws of Malta, that has declared that the value of its assets situated outside Malta, represent more than 15% of the value of its total assets.

Prescribed Funds

The income received by a prescribed fund is subject to tax at source when such income is "investment income", as defined by the 'investment income provisions' of the Income Tax Act.

Investment income includes (refer to full list under Article 41 of the Income Tax Act):

- Local bank interest and certain foreign bank interest;
- Interest, discounts or premiums payable by the Government of Malta, by a corporation/authority established by law, or payable in respect of a public issue by a company resident in Malta or otherwise.

The tax withheld at source in Malta, by the respective payors, when making payments of investment income to a CIS, is at the rate of 15%, in the case of local bank interest and 10% in the case of any other investment income listed above.

Income from immovable property situated in Malta, is subject to the normal corporate tax rate of 35%, while any other income and gains, not being investment income, received by a prescribed fund, will not be subject to tax in Malta.

Non-prescribed funds

The income and gains received by a non-prescribed fund based in Malta are exempt from tax in Malta, unless such income is income from immovable property situated in Malta.

A non-prescribed fund not based in Malta, licensed as a UCITS, would not be taxable on its foreign source income and capital gains on the basis that the fund would not be resident and not domiciled in Malta. Local source income would also be exempt in the hands of the non-resident fund insofar that such income relates to interest, dividends, premiums, discounts, royalties and capital gains derived from the transfer of shares, subject to the satisfaction of certain conditions.

Credit for tax at source

A CIS, whether prescribed or non-prescribed, is not entitled to a credit or refund of any tax at source or withholding tax from income received by the CIS. Capital gains, dividends, interest and any other income derived from overseas investments, may be subject to tax imposed by the overseas jurisdictions, and such taxes may not be recoverable by the CIS or its shareholders.

Taxation at the level of the investor

The CIS's investment policy would typically set out the terms under which profits will be distributed, and would designate the fund or sub-fund as either an accumulator fund or a distributor fund. An accumulator fund is a fund that invests in longer-term investments aimed at capital accretion while a distributor fund's investment objective would be to provide a regular income, to its investors. In this respect, the fund's investors may consist of either accumulator unit holders or distributor unit holders. It is also possible for the same fund to consist of both types of unit holders.

(a) Dividends

Dividends distributed by a local CIS

Profits allocated to the Maltese Taxed Account, which are distributed by a local CIS (whether the funds are prescribed or non-prescribed), will not be subject to a withholding tax or any further tax in the hands of the investor, whether the investor is a resident or a non-resident person. The tax element allocated to the Maltese Taxed Account, suffered by the local CIS, will be available as a credit against the investor's tax liability by way of the full-imputation system.

As from year of assessment 2010, investment income (as defined) of a prescribed fund which has been subject to the withholding tax, under the investment income provisions of the Income Tax Act, will be allocated to the Final Tax Account. Distributions by the CIS from the Final Tax Account will not trigger any further tax in the hands of the shareholder and will also not entitle the shareholder to any credit or refund of the withholding tax incurred on such profits.

A CIS may also as from year of assessment 2010 have profits which may be allocated to the Immovable Property Account. An allocation to the Immovable Property Account of a CIS (excluding CISs which may be dealing in Maltese immovable property), should primarily entail dividends from the Immovable Property Account of other Maltese companies.
Foreign source profits are allocated to the Untaxed Account, unless the foreign source profits include income received by the fund that has suffered a withholding tax (under the investment income provisions) deducted by a local authorized financial intermediary. Dividends distributed by a local CIS, from the untaxed account to a resident investor, which is not a company, are subject to a withholding tax of 15%. The withholding tax would, however, be available as a credit against the investor's tax liability.

Dividends distributed by a foreign fund

Dividends distributed by a foreign fund, being a non-prescribed fund, to a resident investor, are taxable in the hands of the investor. The investor may however request a local authorized financial

intermediary to deduct a final withholding tax at the rate of 15% from the dividend received from the foreign fund. In which case, the investor will not be subject to further tax. Those investors that do not request an authorized financial intermediary to withhold such tax, would be required to disclose the income in their tax return and will be subject to the normal rates of income tax.

(b) Capital Gains

Capital gains arising on the transfer of units in a CIS, may be subject to Maltese tax. The chargeability to tax or otherwise of capital gains in the hands of the investor depends on:

- The type of transfer i.e. redemption, liquidation, cancellation or straight transfer;
- The type of fund in which the units are held i.e. prescribed or non-prescribed; and
- The tax residence of the investor.

Transfers of units in a local non-prescribed fund and non-resident non-prescribed funds

Capital gains arising on a transfer of units in a resident or non-resident non-prescribed fund by resident investors will be subject to tax in the hands of the investor.

In the event that the transfer involves the redemption, liquidation or cancellation of units in a resident non-prescribed fund, the gain may be subject to a 15% final withholding tax; which tax would be deducted at source by the local non-prescribed fund. The investor has however the option not to have such tax deducted at source, in which case the capital gain would have to be declared in the investor's income tax return and the normal rates of tax would apply.

A resident investor deriving capital gains on the redemption, liquidation or cancellation of units in a non-resident non-prescribed fund may also opt to have tax deducted at source at the rate of 15%. However the investor must request a local authorized financial intermediary to deduct the tax. Again, the investor could opt not to have such tax deducted by an authorized financial intermediary and would consequently be required to declare the gain in his income tax return and be subject to tax at the normal investor's rates.

The cost of acquisition for the purposes of calculating any chargeable capital gains/allowable capital losses on transfers of securities, in quoted non-prescribed funds is, determined on an average cost basis. The average cost of acquisition per unit/share is calculated by dividing the total cost of acquisition of all units/shares, held by the transferor on the date of transfer, by the total number of such units/shares. In the case of units/shares, held prior to 1 March 2001, the cost of acquisition will be the higher of:

- The quoted price on the date of acquisition, and
- The last quoted price before 1 March 2001.

The 15% final withholding tax would not apply to capital gains arising on the direct transfers of units by resident investor to third parties. Gains arising on transfers not constituting a redemption, liquidation or cancellation would need to be declared by the investor in his tax return and the normal rates of tax would apply.

Non-resident investors realizing gains on the transfer of units in a local or foreign non-prescribed fund would not be subject to tax in Malta, whether such transfer is made through a redemption or otherwise. The non-resident must, however, be the beneficial owner of the units being disposed of and should not be owned and controlled by, directly or indirectly, nor act on behalf of a person ordinarily resident and domiciled in Malta for such an exemption to apply.

Transfers of units in a prescribed fund

Capital gains arising on the transfer (including the redemption, liquidation or cancellation) of units in a prescribed fund by a resident investor would not be subject to tax, insofar that, the local CIS is listed on a stock exchange recognised under the Maltese Financial Markets Act (the Malta Stock Exchange is a recognised exchange).

The realization of capital gains by non-resident investors on the transfer (including the redemption, liquidation or cancellation) of units in a prescribed fund would be exempt from tax also in the event that the CIS is not listed on a stock exchange. The exemption would apply as long as the non-resident investor is the beneficial owner of the units, being disposed of, and is not owned and controlled by, directly or indirectly, nor acts on behalf of a person ordinarily resident and domiciled in Malta.

Transfers of units in a foreign fund not licensed as a UCITS and not licensed in Malta

Capital gains derived by a resident investor on the redemption, liquidation or cancellation of securities in a foreign fund, not licensed as a UCITS, and not licensed in Malta, may constitute investment income in terms of the investment income provisions only to the extent that the securities being redeemed, liquidated, or cancelled, do not consist of shares in a company. Capital gains derived in such a case, may at the option of the investor be subject to tax at the rate of 15%. In the event that such an option is exercised, an authorized financial intermediary would be required to calculate and withhold the tax due on the gain.

Other miscellaneous provisions for CISs:

Tax implications of the reclassification of a fund

The reclassification of a fund from a non-prescribed to a prescribed status, may attract tax on the eventual disposal of the units/shares held in the fund. For the purposes of calculating the capital gain/loss on the transfer of the units held in the reclassified fund, a disposal will be deemed to have been made on the date of the reclassification. The disposal value will be the last quoted price prior to the reclassification date of the fund and the tax on any capital gain will be due once the units are all eventually disposed of.

Units disposed of in a fund that was reclassified from a prescribed to a non-prescribed fund, will be treated as units in a non-prescribed for the whole holding period, regardless that gains may have accrued during the period that the fund was classified as a prescribed fund. Tax will therefore be charged on the gains, if any, accruing during the full holding period without any relief being given for the gains accruing during the period in which the fund was classified as a prescribed fund.

Switching of securities in a CIS

An investor may choose to switch securities from one sub-fund to another sub-fund within the same CIS (and also within different CISs subject to certain conditions). In terms of the CIS Rules, a switch will constitute a transfer for capital gains purposes, and may eventually be subject to tax, on the eventual final disposal of the securities.

Upon a switch, no gain or loss is deemed to arise for income tax purposes, and therefore any gains derived on a switch will not be subject to tax at the time of the switch. It is only upon the eventual final disposal of the securities in a CIS that the gains or losses derived by switching may be subject to tax.

In the case of a final disposal of securities held in a non-prescribed fund, the capital gain or loss derived on the disposal will be calculated by reference to the disposal value and the original acquisition cost of the securities ignoring any gains or losses arising on switching, insofar that, such switching did not involve a switch of securities from a prescribed fund.

In any other case, the capital gain or loss, arising on a disposal of securities in a CIS, will be calculated by aggregating any chargeable gains and allowable losses, arising on the switches and the final disposal.

Duty on transfers

An exemption from duty applies to any transfers of securities by a local CIS or transfers by investors of securities in a local CIS. The exemption in terms of the Duty on Documents and Transfers Act, only applies when the CIS is licensed under the Investment Services Act.

An exemption from duty would also apply in the case of transfers of securities by foreign UCITS (not licensed under the Investment Services Act), or transfers by investors of securities in foreign UCITS where:

- The foreign UCITS is a company;
- More than 50% of its ordinary share capital (including voting rights and rights to profits), is held by persons that are not owned and controlled directly or indirectly by persons resident in Malta; and
- None of the assets held by the foreign UCITS are situated in Malta (except for any assets held by the UCITS for the purposes of carrying on its business).

Value Added Tax

The services of a CIS should be considered to be exempt without credit supplies on the basis that the CIS is licensed, in terms of the Investment Services Act, and the supplies consist of the arrangement of a scheme. The supplies of a CIS consisting of transactions in shares, debentures and other securities, should also qualify as exempt without credit supplies.

CISs providing solely exempt without credit supplies, will not have the right to claim any input VAT suffered on expenses and overheads incurred. Consequently, a CIS providing exclusively exempt without credit supplies, would not be required to register for VAT purposes.

Appendix F: Consultation on tax incentives for Personal Retirement Schemes

An initial consultation meeting was held in November 2013, with representatives of the main financial services providers, namely the Malta Insurance Association (MIA), Malta Bankers' Association (MBA), Malta Association of Retirement Practitioners (MARSP), Malta Funds Industry Association (MFIA) and the College of Stockbroking Firms (COS). These were given a set of consultation questions, and subsequent meetings resulted in important changes in the proposed legislation. The initial feedback of these organisations is presented below.

- There was not considerable support to the initial proposal that **only products that fulfil the Retirement Pensions Act (RPA) eligibility criteria should be granted incentives**, with only one organisation (MFIA) accepting this unconditionally. RPA criteria were deemed fit for personal pensions, but could also be revised (COS & MBA). In particular, there is a need to have incentives reconciled with both the RPA as well as the insurance business regime (MARSP & MIA).

- No detailed specifications were suggested for **the type of product that would work best for Maltese savers,** as long as such investment products are duly approved by the MFSA, are of a long-term nature and financially strong to cater even for investors with limited education (MBA). A suggestion was made for retirement schemes to be set up as trusts (MARSP). A few simple revisions to the Insurance Business Act should make the linked long term contracts of insurance under its framework eligible for fiscal incentives (MIA). Savers should also be able to invest in both direct securities as well as other investment funds that are UCITS compliant (COS).

- Adherence to specified eligibility requirements remains important for the **granting of fiscal incentives for new saving in existing products not regulated by the RPA**. Respondents suggested that incentives should be given to products if they either fulfil all the RPA requirements, are lined in or plugged into RPA regulated pensions schemes, or at least, are invested in a new, approved/authorised product. Lumps sums should be allowed to be transferred into pension schemes, enabling these lump sums to become exempt after a ten-year tie down period (COS).

- Only one organisation (MARSP) **deemed the RPA criteria to be sufficient to make the launch of personal retirement schemes successful with Maltese savers**. The RPA could also reflect the UCITS Directive in terms of investor protections measures (MFIA). The need for clarity, flexibility and regular performance reporting was emphasised, with provisions enabling the availability of a default investment, a cap on charges and simple investment choices (MIA and MBA). Third pillar pensions should be designed to help the introduction of a second pillar whilst requiring an investment of 30% in Malta listed/registered securities (COS).

- Organisations were not in favour of imposing a **capital preservation guarantee**, arguing that it would limit the ability to introduce an array of investment products, offset potential gains and would not normally function in longer-term horizons. Also, in the current low interest rate environment, the cost of a guarantee could erode a significant portion of the return (COS and MBA). Products and their features should be left in the hands of providers and not made mandatory through legislative/regulatory requirements (MFIA). Rather, the approach should be towards 'cautious' risk profiling and regulation (MARSP). Investment life-styling also offers the benefit of predictability without the high costs/charges of guarantees (MIA).

- More important than **imposing a cap on management fees in the absence of regulations on capital guarantees or minimum rates of return**, respondents argued for transparency and full disclosure of fees. Capping management fees may restrict the choice/availability of funds (MIA). Market participants should compete on management fees and be competitive without intervention and instead the objective should be to pitch the fee and tax incentives at a level where the market size can grow sufficiently quickly to ensure economies of scale (COS and MBA). However, suggestions for the total expense ratio to be capped at 1.5% per annum (MFIA) and for net returns to exceed inflation over the longer term (MIA) were put forward.
- In terms of **the scope for investment choice/advice**, the importance of not having any imposition on the asset class or asset allocations within investment portfolios was stressed. Service providers

should ensure that products meet the risk profile and risk tolerance of their clients. Although the customer's risk profile may change on approaching the payout phase (MIA), the Government should not be responsible for identifying and determining investment strategies. Investment restrictions should possibly reflect those under the UCITS IV Directive (MFIA), though the new investment restrictions with respect to private pensions should suffice (MARSP). Offering a default investment choice should be mandated (MBA).

- Organisations agreed to have **transfer of personal retirement schemes regulated**. While rigid restrictions were deemed not in the consumer's interest, the need for regulation was felt to (a) prevent excessive sale and reinvestments (MIA and MBA); (b) provide a restriction on transfers of schemes outside the EU (MARSP); and (c) limit transfers of personal retirement schemes to changes from one trustee to another or transfer of assets from one regulated scheme to another (MARSP). Although no limits on transfers should be allowed, providers should be allowed to charge a transfer or early exit fee to cover administration costs (COS). These however, should be clearly communicated, kept to a minimum and not paid to intermediaries (MIA and MBA).

- Organisations were generally not in favour of **stricter regulations on marketing/selling practices**, arguing that the current and proposed pension rules should provide adequate regulation. While sales commissions should be permitted (MFIA), greater attention should be given to fee disclosure (MARSP). Indeed, sales commissions on initial sales must be allowed as in the absence of marketing, fiscal incentives would not be enough to encourage savers (MIA).

- **The provisions in the RPA were deemed to be sufficient for early access** in the case of permanent invalidity or death. Guidelines however, may be introduced to ensure permanent invalidity and to reflect the proposed Civil Union Act (MARSP). While early access should not be encouraged, given the high incidence of persons taking on early retirement, phased withdrawals may be useful, for instance 15% of investment may be withdrawn at 55 and again at 60 (MFIA). In case of death, inheritance rules should apply. Individuals should be allowed to withdraw a fixed amount or a percentage of the fund for certain events, such as marriage, first home (MIA).

- The Government, in joint initiative with the MFSA, NGOs and the private sector should launch a **financial education campaign to accompany the scheme**, with the main message highlighting the importance of saving for the future. Suggestions were made for a fully-fledged campaign, making use of billboards, information material, website, a call centre and the use of local councils.

- **The size of the personal retirement scheme market in terms of annual contributions** will depend on the level of disposable income, fiscal incentives and the attractiveness of the investment products (MBA). Estimates that third pillar pensions could attract €40 million are ambitious and would require a number of years to achieve, with further incentives (COS). Other estimates were made of a market generating around €30 million per annum (MIA). Respondents warned that Government faces a balance between the attractiveness of such schemes and the tax leakage that results from incentives. The maturity of the market will depend on the degree of awareness and education and may take a decade to reach from the year the scheme is launched (MIA).

- Respondents agreed that **the EET is the regime most likely to make the market attractive**. Suggestions were made to limit the tax burden post-retirement (MIA) or introduce other preferential post-retirement tax rates for people who invest more than the allowance (MARSP). Government could also provide an added contribution equivalent to the individual's tax savings, making such a contribution more identifiable and easier to market the scheme (COS).

- There is no consensus on the **size of the pension contribution allowance**. Capping at €1,000 annually may be unlikely to create enough savings (MIA and MBA) - amount could be raised to €1,200 (COS), €2,400 (MARSP) and up to €2,500 per annum (MIA). Allowances should increase over time on the basis of mechanisms such as growth in RPI, pensionable income, median income or a combination of factors (MIA).
- In order to **ensure that maturing long-term savings products are drawn down gradually rather than taken as a lump sum**, only the 30% lump sum should be tax free, with the remainder withdrawn through a phased drawdown approach. The current withdrawal rules, may also be

modified, to ensure that prior to the 30% withdrawal lump sum, an assessment is carried out to ascertain that the individual has sufficient income to ensure gradual drawdown (MARSP).

- The **single rate tax relief is not considered as the most effective form of tax credit**. Respondents tended to argue for a progressive rate, giving higher savers greater tax benefits.

- Respondents argued strongly in favour of the **retention of tax exemptions of lump sums**.

- **Tax relief should be linked to any income earned**, with the highest rate of relief limited to the marginal rate of tax (MIA). Most argued in favour of **allowances for dependants** (except COS).

- Whilst some argued that **employers who contribute to their employees' retirement scheme should be given tax relief** (MBA), given that this may pave the way for second pillar pensions (MFIA). Conversely, limiting it to individuals would keep message clearer (COS and MIA).

- Respondents argued that **having a two-tier tax relief system would create confusion**.

Appendix G: Justifying the choice of the initial level of the pension contribution allowance

Forecasts made in the *Strategic Review on the Adequacy, Sustainability and Social Solidarity of the Pensions System* (Pensions Working Group, 2010), indicate that the average replacement rate of state pensions in Malta will decline from 54.7% to 45% in 2060. To make good for this drop, the Pensions Working Group had proposed a carve-out of NI contributions of about 4% of wages. This was deemed to result in a replacement rate of 9.2% by 2050, offsetting the drop in relative state pension generosity.

The Central Bank of Malta's Household Finance and Consumption Survey indicates that, on average, the saving rate in Malta is 4% with median annual household savings of €3,000.

When choosing the initial level of the pension contribution allowance, the Advisory Group was driven by these two considerations; i.e. the projected drop in relative state pension generosity and the currently available pool of savings. Government should provide incentives to individuals in proportion to the projected decline in state pension generosity.

The amount of the pension contribution allowance should not be set too high, as this would only serve to reduce the tax burden of high income individuals who already do not rely on the state pension (due to the cap on maximum pensionable income) and who are saving. Rather, it should enable the average person to save enough to make up for the projected decline in relative state pension generosity. The amount should also be in line with average household saving, rather than with the (higher) saving rates observed among higher income individuals.

Assuming that the individual contributes always the same amount (and that charges remain relatively speaking stable over time), the generosity of the pension payout will depend crucially on the difference between the rate of return earned on savings and the growth in average wages. In the long run, growth in real average wages has to equal growth in labour productivity. Otherwise, the share of labour in total output would not stabilise. Assuming labour participation remains unchanged, growth in labour productivity is equal to real GDP growth less working age population growth.

Given that working age population growth is either close to zero or negative, this would imply that growth in labour productivity should be equal to GDP growth. In turn, if the economy is dynamically efficient, the real interest rate must exceed the growth rate. In fact, OECD long-term forecasts suggest that there is a gap of more than one percentage point between real GDP growth and the real interest rate in the Euro area.

On this basis, and assuming a long-run inflation rate of 2.5% (the average inflation rate in Malta over recent years), we modelled the return from a constant saving of €1,000 from someone aged 25. The €1,000 is equivalent to 5% of current gross wages (similar to the average saving rate). Someone aged 25 today has a life expectancy at age 65 of 22 years (according to latest Eurostat projections). The real rate of return was set at 2.5% and real wage growth at 1.5%. Upon reaching 65, the individual's accumulated pension pot would be converted into a fixed-sum annuity or drawdown arrangement (also earning a 2.5% real interest rate). This fixed-sum annuity or drawdown would be equivalent to a replacement rate of 9% (of the contemporary wage in 40-years' time) if one assumes that no lump sum is taken. In conjunction with the projected replacement rate from state pension, the average individual would thus have the same relative retirement income as someone retiring today just on the state pension.

Note, however, that if the full 30% lump sum is taken, then the replacement rate would fall to just 5.6%. Similarly, if the rate of return was to be just 1.5% (the lowest possible rate, unless one allows for dynamic inefficiency), the replacement rate with no lump sum taken would fall to 6.4%. Higher returns would, of course, result in higher replacement rates. If contributions are not made throughout one's career, replacement rates drop, particularly if saving occurs just in the later years (as investment returns would be less). Investing effort to ensure the young save makes much more sense than trying to raise savings among the older part of the working age population. Finally, someone on high income who opts to save the tax-favoured amount, would end up with a lower return (4.5%), than someone on average wages or someone on the minimum wage who saves a fifth of the allowance. This shows how the way the scheme is planned, should result in much better incentives for those on low-to-medium incomes.

Replacement rates under a number of different scenarios

	No lump sum	*30% lump sum*
Someone on average wage contributing full with 2.5% real return	9.0%	5.6%
Someone on average wage contributing full with 1.5% real return	6.4%	4.4%
Someone on average wage contributing full with 3.5% real return	12.7%	7.3%
Someone on average wage contributing full between age 45 to 64 with 2.5% real return	2.6%	1.7%
Someone on average wage contributing full between age 25 to 44 with 2.5% real return	6.3%	4.0%
Someone on double average wage contributing full with 2.5% real return	4.5%	2.8%
Someone on the minimum wage contributing €200 with 2.5% real return	8.1%	5.1%