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Cross-border pension funds: will IORP 2 help the take-off ?

The first pension fund directive (2003/41/EC), often called «IORP directive», sets out basic requirements for occupational pension funds that are allowed to operate on a cross-border basis.

It is probably not an exaggeration to claim that the 2003 directive was a complete failure as almost no cross-border pension funds have been launched over the last 11 years.

On 24 March 2014, the EU Commission published the draft directive on IORP 2 (COM 2014 final) which is aimed at reviewing IORP 1.

The major question is, whether IORP 2 will be more successful and enable the market for cross-border pensions to take off.

Will IORP 2 make cross-border pensions fly?

A first positive element in the draft directive is certainly the idea of a harmonised annual pension benefit statement, which should make cross-border pension schemes much easier to handle. The intention is to produce this statement according to a standard template of two pages.

In IORP 1, an opting out clause for pension schemes with less than 100 members was provided. This opting out clause is maintained in IORP 2.

The governance principles have been strengthened in IORP 2, in line with some of the requirements of the Solvency 2 directive applicable in the insurance sector.

- new requirements for key functions (risk management, internal audit and, where relevant, actuarial function) are introduced
- the role of custodians has been reinforced and has been made compulsory for DC schemes. This is not a new requirement for Luxembourg based ASSEPs, SEPCAVs and CAA funds.
- It is intended to better supervise outsourcing chains
- a self-assessment of the risk-management system is required

It is important to point out that IORP 2 is not dealing with solvency requirements of pension funds as it was announced already by EU Commissioner Michel Barnier before. This is to be dealt with at a later stage. Parts of the insurance industry see a discrimination of insurance companies in this exclusion. It is fair to mention however that many pension funds are not for profit organisations and just serve as a funding vehicle to finance pension promises for staff of a single employer or a group of employers. In many cases, the employer remains liable for the commitments of the pension fund.

In IORP 1, host countries were allowed to impose more stringent investment rules for foreign pension funds entering their market. This possibility has been removed and host countries cannot impose additional requirements anymore. Pension funds are deemed to be long-term investors andthe EU Commission takes this opportunity to broaden the scope of eligible assets. Pension funds should be allowed to invest in assets that are not negotiable on regulated markets; they may go into illiquid assets like for instance real estate or infrastructure projects to help funding growth in Europe.

Article 13 explicitly allows transfers of pension schemes from a pension fund in country A to a pension fund in country B. However, these transfers of pension schemes from country A to country B require prior approval by the scheme members or their representatives.

Globally speaking, there are a number of encouraging ideas in the draft directive. The fact that a political agreement could be reached on the watered-down "portability" directive in July 2013 on the other hand enhances the chances for the development of cross-border pensions.

Not all obstacles removed

Unfortunately, the draft directive does explicitely not deal with aspects of social and labour law, tax law or contract law, all of which we know are the major obstaclesto developing cross-border pension funds today.

Another rule which was very much criticised in the past in IORP 1 has been maintained: therequirement for pension funds operating on a cross-border basis to be fully funded at all times. Unfortunately, Article 16 of the draft directive confirms this discrimination. In DB schemes funding deficits can occur from time to time; they arise from several origins, like for instance the reduction of the discount rate (leading to an increase of pension liabilities), poor performance in the capital markets or actuarial losses (changes in life expectancy). In these circumstances, the funding deficits are mostly amortised over a period of time that needs to be discussed between the plan sponsor, the actuary, the pension regulator and the tax authorities. In some countries, tax authorities indeed might not allow an immediate amortisation of funding deficits for budgetary reasons. The maintenance of this requirement makes the operation of DB schemes on a cross border basis very difficult.

IORP 2 is certainly a step forward but it is still not the "grand cru". Fortunately, it is only a draft at this point. The discussions and the objections to be raised over the months to come may lead to improvements in the present draft and adoption of a more courageous text removing some remaining barriers to improve mobility of workers in Europe.

New tax circular on pensions (LIR N° A 03 from 25 march 2014) (Click here for more information)

On 25 March 2014, the tax administration issued a revised circular on the tax treatment of occupational pension schemes (OPS).

The circular confirms that expenses in OPS must be in accordance with the occupational pension scheme law of 8 december 1999 (1999 OPS law) to be tax deductible. Funding of an OPS is subject to a lump-sum tax of 20 % paid bythe employer. Furthermore, the funding for an individual employee cannot exceed 20 % of the annual pensionable salary. The 20 % limit does not need to be observed year by year, but is considered over a professional career. In case the funding exceeds the 20 % limit, the excedent part is not considered as a tax deductible expense. Special rules apply to defined benefit plans that were in place in 1999 when the law entered into force. The 20 % upfront tax applies on the entire funding, even on the portion above the tax deductible ceiling. Benefits payments remain tax –free in Luxembourg.

Benefits paid by OPS are tax free for Luxembourg residents.

OPS are dealing with retirement, survivors and disability benefits. Other benefits, like for instance accident insurance or healthcare, are not in the scope of the 1999 OPS law. This means that premiums for these type of benefits are subject to general tax principles. Individual pension promises do not fall under the scope of the 1999 OPS law and also follow a different tax treatment.

Special amortisation rules apply to funding deficits in defined benefit plans.

If shareholders are also employees in their company, special rules continue to apply: the expenses are only deductible if the OPS appliesto the whole staff.

Annual tax certificates (for deductibility purposes) do not need to be submitted to the IGSS on a yearly basis. A control every 5 years is sufficient. In principle, the certificates have to be established before 31st of March.

Personal contributions by staff remain tax deductible up to 1’200 EUR/year (Art 110 LIR). Employees can contribute more than 1’200 EUR but the excedent is not a tax deductible item, neither under art 110 LIR, nor on any other article of the tax code. Benefits in relation with contributions above 1’200 EUR are, however, tax exempt.

New double tax treaty with Germany reviews taxation of pensions

In the new double tax treaty between Luxembourg and Germany, the taxation of pensions has been substabtially modified As of 1January 2014, social security pensions are taxed in the country of source. This means in practice that the pension of German tax residents will be taxed in Luxembourg; these German tax residents need a Luxembourgish tax card.

For occupational pensions, the treaty provides for a taxation in the country of residence. If the pension is a benefit payout of a duly authorised occupational pension scheme in Luxembourg, and if the funding of the benefit was subject to the 20 % lump-sum tax in Luxembourg, the benefit is tax exempt in Germany. The reserve rule on the German tax rate however applies to this income. If the benefits are not derived from contributions that have been taxed in Luxembourg, the occupational pension benefits are taxable in Germany.

UK allows lump-sum payments on occupational pensions

On 19 March 2014, the UK Chancellor of the Exchequer suggested a series of radical reforms to the UK pension system. In future, retirees who have been members in defined contribution schemes will be allowed to withdraw their pensions as a lump-sum if they can prove that they have a retirement income of at least 12’000 £. 25 % of the lump-sum will be tax-free, the remaining part being taxable. Some observers in the UK point out that people are often ill-informed and make poor decisions about financial planning for old age.

As a reminder, occupational pensions in Luxembourg can be withdrawn as a lump-sum also. Private 3rd pillar pensions however can only be withdrawn as a lump-sum up to 50 % of the savings.