CROSS-BORDER PENSION PROVISION IN EUROPE

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**A. MAIN POINTS**

**Current Position**

- At the moment there is no Europe-wide regulation of pension provision. Each country has its own rules in relation to the setting up and administering of pension schemes and also its own rules in relation to the tax treatment of pension contributions.

- At the moment each country tends to have restrictions on the extent to which schemes can have members who are employees of overseas companies.

- The UK provisions are outlined in the First Appendix.

- As can be seen, the UK rules in relation to overseas employers and employees are confusing, and this is the case Europe-wide. It is not always possible for EU nationals to receive cross-border pensions without running the risk of having contributions taxed in more than one country. In addition it is not always possible for employees to move overseas and take their existing pension rights with them.

- Pension arrangements of local subsidiaries are not likely to meet the needs of international staff posted there for a short time, as they will be set up to comply with local laws. Also, the employee may not qualify for membership of occupational schemes (because they are not there long enough, or for other reasons), or have time to build up sufficient contributions to provide a reasonable benefit. In addition, an employee working overseas may not want a pension building up in the currency of a developing country subject to currency fluctuations.

- At the moment, employers are unable to establish one single pension fund for all of their employees worldwide, or even Europe-wide. Each state has different regulatory requirements. Thus multinational companies have to set up different schemes for each country in which they operate which leads to duplication of administration and compliance costs, and a lack of investment efficiency.

- More crucially, each state taxes pensions in a different way. Broadly, there are three systems of taxation of pension schemes - some tax contributions, some tax returns on investments and others (like the UK) tax the retirement benefits when paid. Any employee moving to a country with a different type of tax regime is liable to double taxation.
• In addition, each state places different importance on occupational pensions in the scope of overall retirement provision. There is said to be a three pillar structure of pension provision in the EU and across the developed world. The three pillars are I- social security, II- occupational pension plans and III- individual savings. The UK has a small state pension system compared to, for example, France. In France the social security system plus the mandatory company sponsored plans provide individuals with an income close to the pre-retirement national average salary. France, Italy and Spain traditionally have generous state pensions. Belgium, the Netherlands, Switzerland and the UK are good models of pillar II retirement provision. Austria, France and Italy have termination indemnities (compulsory lump sums when employment ends).

• Each state also funds its retirement provision differently. The UK has a trust scheme allowing accumulation in a trust fund through tax free contributions and tax benefits on investment growth. In Germany and Austria close to half of pensions are typically held in book reserves on company accounts, so the responsibility for paying the pension remains with the company. Across Europe there are the beginnings of a move away from book reserve as the sole means of pension funding, with external vehicles such as trusts and foundations becoming more common. Also, in some countries, such as the Netherlands, insurance funds are the vehicle for some retirement benefit saving.

**Potential Solutions**

1. **Offshore Pensions**

• At the moment the only way to have a truly cross-border pension with no regulatory or tax problems or anomalies is to set up an offshore pension scheme. Usually set up in Bermuda, the Caymans, the Channel Islands, or the Isle of Man. The Isle of Man has a fairly comprehensive regulatory system for pensions based on the UK Pensions Act 1995.

   Most new offshore schemes are defined contribution (money purchase), although some existing schemes are defined benefit (final salary).

• Some advantages of an offshore scheme for international staff- they are flexible so can take account different social security benefits being accrued and varying career patterns, and can be used wherever staff are working in the world.

• Some disadvantages- employer will have to ensure compliance with whatever regulatory requirements exist in the offshore location, employee contributions are not usually tax deductible so schemes are usually non-contributory, employer contributions may also be taxable as a benefit in kind so the employer may have to bear the tax.

2. **Cross Border Pensions**

• Many multinational companies operating in Europe are in favour of the idea of pan-European pension schemes, which would enable them to set up one large scheme for their whole workforce rather than separate schemes for each country in which they operate.

• Advantages of pan-European pension schemes:
   - allows employees to move around freely without affecting their pension provision (between companies as well as between countries),
• allows employers to set up large schemes which are more economic to run and more efficient for investment purposes,
• allows employers to move staff around more freely,
• eliminates barriers for pension providers in that they will have freedom to provide pensions throughout EU, which creates greater choice for employees

Disadvantages of pan-European pension schemes:

• Difficulty of harmonisation: pension provision very different in EU at the moment, with different states relying to various degrees on the social security system,
• taxation of pensions also very different in different states, and it would be hard to assimilate this;
• surveys have shown that individuals in different member states have different understandings of investments and the risks involved. Individuals in countries with high social security pensions and low levels of occupational pensions tend to be less likely to understand the investment risks which can affect the value of pension funds, and tend to be more risk-adverse than individuals in a country such as the UK where most pension provision is through occupational and personal pensions subject to investment fluctuations.

Moves towards Cross-Border Pension

Proposed EU Directive

• An EU directive has been drafted which aims to take the first steps towards harmonising pension provision across the EU.
• Deals with harmonising regulation of occupational pension provision, types of investment which such funds can make, and the minimum funding requirements for such schemes, allows for cross border pension funds to be set up.
• See Second Appendix for more detail on aims and provisions of draft directive and what stage it is at in the legislative process.
• See Third Appendix for draft directive as it was presented to the European Parliament for its Second Reading, and the amendments made by the European Parliament following that Second Reading.

UK Industry views on Directive

• Many of the regulatory requirements such as registration of schemes, communication with members and prudent investment, are already features of the UK system and the directive adds nothing new in these areas.

• The UK is used to qualitative approach to investments. UK pension providers can freely choose how much to invest in equities, bonds etc. The directive proposes that countries could impose limits on how much of the fund could be invested in various types of investment (the quantitative approach), although they would have to allow at least 70% to be invested in equities. In theory then, countries could place some restrictions on investment which would be different to what the UK pensions industry is used to.

• The directive allows pension schemes to be under funded as long as they have a recovery plan, which is similar to the current UK rules. In previous drafts it was proposed that cross border schemes would have had to be fully funded at all times. This would have been an onerous obligation and contrary to UK practice. However the latest draft of the directive, which has been approved by the European Parliament and has now gone to the Council of Europe for its second
reading, eliminates the need for full funding of cross border schemes. Instead such schemes will have to comply with the funding requirements in the scheme’s country of origin.

- The directive will not apply to public sector schemes, pay-as-you-go schemes, book reserve schemes, and may also not apply to schemes with less than 100 members, so a lot of schemes across Europe will not be affected by the measures, and to that extent will not be harmonised.

- The directive does not deal with the taxation of pension contributions, investment returns and emerging pensions benefits. Thus the taxation of pensions across the EU remains inconsistent. Many would say that the taxation of pensions is the biggest barrier to pan-European pensions and thus the fact that this biggest barrier has not been removed dilutes the effectiveness of the attempts to harmonise.

**European moves to harmonise the tax treatment of pensions**

1. **The April 2001 Communication**

   - In April 2001 the Commission prepared a Communication on the elimination of tax obstacles to cross-border pensions. The Communication proposed that:

     - The Commission would monitor each member states’ national rules on this and if necessary would take steps to ensure their compliance with the Treaty, especially in relation to non-discrimination.

     - An co-ordinated approach to the taxation of pensions be adopted across the EU, with member states switching to the EET system of taxation (exempt contributions, exempt investment income and capital gains, and taxation of pension benefits paid out) which 11 of the member states already use.

   - In January 2001 the Parliament adopted the communication and resolved that member states should develop a process of “open co-ordination” on the tax treatment of pensions. There have been no further legislative developments in this field. However the Commission has begun to bring cases before the ECJ where it considers that a country’s national tax rules are contrary to EU laws on equal treatment. The clearest example of this so far is the Danner case.

2. **The Danner case**

   - C-136/00 (Judgement issued on 3 October 2002)

   - Facts: Mr Danner was a doctor working in Germany. Began paying pensions contributions in 1976 to two compulsory German schemes. He moved to Finland in 1977. He was not required to do so but continued to pay contributions to the German schemes. These were tax-deductible in Finland until 1996. In 1996 Finnish law was amended to prohibit tax deduction of contributions to voluntary overseas pension schemes, although contributions to overseas compulsory and statutory schemes remained tax-deductible. Voluntary contributions to Finnish schemes were tax deductible. Mr Danner argued that this was contrary to Community law. The Finnish court referred the question to the ECJ.

   - Decision of the ECJ: The ECJ decided that such a national tax law was contrary to Community law - it was contrary to Article 49 (freedom to provide services). Further, it was not justified in terms of fiscal cohesion of the Finnish tax system as (a) Mr Danner would still be taxed on the pension he received so tax would still be paid and (b) there was a double taxation convention...
between Finland and Germany which meant that country A taxed the pensions received by residents in country A but waived the right to tax pensions paid by institutions in country A to residents in country B. The Finnish government also argued that if contributions paid to schemes run by foreign institutions were tax deductible, employees may then “fiscal forum shop” for pensions with institutions in member states with the lowest income tax levels. The Court acknowledged this but held that it could not be used to justify less favourable treatment in tax matters given to recipients of services established in a foreign state.

- Result of *Danner* is that EU member states will have to treat pensions contributions to schemes in other states on the same tax basis as if they had been made in the same state. In theory this means that individuals could potentially invest their retirement savings in whichever member state offers the most attractive financial options.

- It has been suggested that *Danner* may allow UK companies to set up their pension schemes in the countries with the least regulation to avoid excessive UK supervision.

- The decision has been broadly welcomed, as it has been seen as a further step to encourage EU countries to dismantle the tax barriers which exist to establishing pan-European pension schemes.

- However *Danner* does not facilitate harmonisation in the way that legislation would.

**Further Developments**

- The Commission has written to all Member States to ask if their tax rules in relation to pensions are in conformity with Community law.

- The Commission has written to Denmark to request that it amends its legislation under which contributions to domestic schemes are tax deductible and contributions to foreign schemes are not. If it does not amend its legislation, it will be taken to court.

- Infringement proceedings have also been opened against Belgium, Spain, France, Italy and Portugal. The Commission alleges that these countries have discriminatory rules in relation to the taxation of pensions.

- The insurance company Skandia has challenged Swedish tax legislation which provides that contributions to insurance backed pension funds are only tax exempt if made to Swedish insurance companies. The Advocate-General’s (“the A-G”) opinion has been published. The A-G has stated that in his view there should be no restrictions as to where a company can pay contributions. The Court’s decision will follow in a few months. The ECJ is expected to follow the A-G. This would mean that employers could pay contributions into funds located outwith the employers’ “home” country and would represent a further step towards the creation of pan-European pension funds.

- An international IT consultancy, AMS Management Systems, has applied to the Inland Revenue in the UK asking for permission to enable its UK staff to join its Dutch pension scheme. If the Inland Revenue refuses, AMS plan to seek a judicial review in the UK courts. AMS is backed by Pepgo (the Pan-European Pensions Group, made up of 20 multinational companies).
B. FIRST APPENDIX

UK provisions in relation to overseas employees and employment

- In the UK, schemes need to be approved by the Inland Revenue in order to get the tax breaks afforded to pensions contributions in the UK. An overseas employer’s scheme which only has members chargeable to UK tax can be approved. If a scheme has some UK members, the part of the scheme relating to the UK employees can be approved but it has to have its assets segregated, or at least apportioned.

- Employees of a UK company who work abroad on a temporary basis can be members of an approved scheme if (a) they are still chargeable to UK income tax; or (b) there is an expectation that they will come to work in the UK or to retire in the UK. The UK employer has to make the contributions, and be reimbursed by the overseas employer. The period of service abroad should not exceed ten years.

- If an employee is permanently transferred to work for an overseas employer and his or her earnings cease to be chargeable to UK tax, they should be treated as having ceased pensionable employment. In some circumstances their accrued pension benefits may be transferred overseas, but not in all circumstances.

- Overseas employees of UK employers can be members of unapproved schemes, but there may be some tax liability for them if they are resident in the UK when benefits are paid to them.

- An employee can accrue benefits under an approved scheme while temporarily abroad, but if they also accrue benefits in an overseas scheme as well, they cannot transfer these into the UK scheme.

- Employees who are domiciled elsewhere and employed by an overseas firm in the UK can choose to remain a member of the overseas scheme. If it meets various IR conditions then it can be classed as corresponding and the employer and employee contributions will enjoy UK tax breaks.

- In addition the UK has various Double Taxation Agreements with all other EU countries. Under these, overseas employees may receive tax breaks.
C. SECOND APPENDIX

European Pensions Directive- detail on proposals and legislative process

Legislative Process

The directive is subject to the co-decision procedure. The directive has had its second reading in the European Parliament (“the Parliament”), and the common position has been approved, with some amendments. A version of the directive incorporating these amendments has not yet been published. However the most up to date version of the draft Directive, and a note on the amendments by Parliament are attached as the Third Appendix. In addition, the notes below which summarise the Directive incorporate the amendments.

The Commission will now have to deliver an opinion on the amendments adopted by Parliament. Following this, the Council will then have to consider the opinion (this will be the Council’s second reading of the proposal). The Council can either

(1) accept all of the amendments proposed by the Parliament in which case the directive will be adopted; or

(2) if it does not approve all of the amendments, the Council and Parliament will convene a Conciliation Committee (comprised of representatives from the Parliament and the Council, with the Commission also having an input). It will have six weeks to reach agreement on a joint text. The joint text then has to be approved by the Council and Parliament. If a joint text is not agreed, or if the Council and Parliament do not approve it, the Directive is not adopted. However, the institutions are hopeful that it will be adopted by the end of 2003.

Aim of Directive

- To provide prudential supervision of institutions for occupational retirement provision as there is no coherent community framework at the moment.

- Social security systems under increasing pressure, so occupational pensions will be relied upon increasingly in future. That said, the directive is not intended to call into question the importance of public pensions systems.

- First step for European market for occupational retirement provision- institutions enabled to operate across borders.

- Member states will retain full responsibility for organisation of their pensions systems, and for the role and functions of the various institutions.

- Member states will be able to decide to what extent emphasis is placed on each of the three pillars of the retirement system.


Article 2: Who the Directive will apply to:

- Institutions for occupational retirement provision (IORPs) i.e. institutions which operate on a funded basis and are established separately from the employer for the purposes of providing retirement benefits on an occupational basis, and which carry out activities arising from this.
Article 2- Who will be excluded:

- Institutions managing social security schemes, although if they also operate ring-fenced non-compulsory retirement benefits, these activities will be covered (Article 3)
- Institutions managing life assurance schemes, although if they operate ring-fenced occupational retirement provision business this will be covered too (Article 4)
- Institutions which operate on a pay-as-you-go basis (where the contributions of the current workers pay the pensions of the current pensioners)
- Institutions where the employees of the sponsoring undertakings have no legal rights to benefits
- Companies using book reserve schemes with a view to paying out retirement benefits to their employees

Article 5- Who may be excluded:

- Institutions which manage pension schemes which together have less than 100 members
- Statutory schemes which are guaranteed by a public authority

Article 6- What retirement benefits are:

- Payments, as a rule for lifetime but also for a temporary period or as a lump sum, paid by reference to reaching retirement, whose purpose is financial provision for retirement, and ancillary payments eg. disability benefits, sickness or death.

Article 7- Restrictions on the activities of IORPs:

- The activities of IORPs are restricted to retirement benefit-related activities, unless it is an undertaking which manages its pension provision by ring-fencing its assets and liabilities.

Article 8- Legal separation between employer and pension provider

- The employer and the pension provider must be separate legal entities.

Article 9- Conditions of operation

- The member state must ensure that the institution:
  - is registered by the competent supervisory authority in a national register. If cross-border, the member state in which the institution is authorised must also be indicated.
  - offers its members the options of longevity risk, occupational disability, provision for surviving dependants and guaranteed payment of the contributions
  - is governed by rules of which the members have been informed
  - has the funding it provides for members certified by an actuary or other specialist in this field
  - if the employer guarantees the payment of the benefits, that apt funding is in place
  - that the members are fully informed about the conditions of the pension scheme, including the risks involved
- The member state can impose other conditions if it chooses, in order to safeguard members and beneficiaries
• Cross border activities must be authorised by the home member state of the institution.

**Article 10- Annual Accounts**

• Every member state should require every institution located in its territory to draw up annual accounts and reports for each of its pension schemes.

**Article 11- Information for Members**

• Members must receive, at least, the following information:
  
  o The annual accounts and reports
  o Information on changes to the pension scheme rules
  o The statement of investment principles
  o The target level of the retirement benefits, if applicable
  o The actual financing of accrued pension entitlements
  o The level of benefits in case of cessation of employment
  o Where the member bears the investment risk, the range of investment options, the actual portfolio and information on risk exposure and costs
  o The arrangements for transfer into another scheme
  o Annual brief particulars of the situation of the institution and the current level of individual entitlements

**Article 12- Statement of Investment Principles**

• Every three years the institution should draw up and review a Statement of Investment Principles.

**Article 13- Information to be provided to the competent authority**

• The institution has to provide various information to the supervisory authority such as actuarial valuations, evidence of consistency with the statement of investment principles, proof that contributions are being made as planned.

**Article 14- Powers of competent authority**

• The competent authority will be able to take any measures appropriate to ensure that the members’ interests will not be prejudiced such as prohibiting free disposal of assets, transferring powers of the institution to a special representative, prohibiting or restricting the activities of an institution in their territories if they have concerns about the service it provides, or consider that it does not comply with the social or labour law of the host member state in relation to pension provision.

**Article 15- Calculation of the funding requirement of the scheme**

• The funding requirement of the pension should be calculated on a prudent basis but member states will be able to make more detailed rules.

• The funding requirement of the scheme should be calculated every year, or every three years if an interim report is provided annually.

• The calculation should be carried out by an actuary, on prudent principles.

**Article 16- Funding Rules**
• Cross border pension funds should be funded in accordance with provisions in the institution’s country of origin. (Changed from fully funded at all times which was in previous draft).

• Institutions which do not work on a cross border basis will be allowed to be underfunded, provided that a proper plan is established to restore full funding.

**Article 18 - Investment Rules**

• Investment should be in accordance with the “prudent person rule” and geared towards the membership structure of the institution. The following will apply:
  
  o Investment in the employer should be no more than 5% of the portfolio at all, or investment in the employer’s group should be no more than 10%.
  
  o Institutions must be allowed to invest at least 70% of the fund in shares or corporate bonds
  
  o Institutions must be allowed to invest at least 30% of the fund in assets denominated in different currencies.

• Member states which do not currently apply the prudent person principle will have 5 years to switch to this.

• Member states should be able to set precise investment rules but these must not restrict free movement of capital, except on prudential grounds.

• If the institution works on a cross border basis the investment of the cross-border part of the fund may be subject to the following limits:
  
  o No more than 30% of fund in non-traded shares
  
  o No more than 5% in shares in the employer and no more than 10% in shares in the employer’s group
  
  o No more than 30% in assets denominated in other currencies

**Article 19 - Management and Custody of Funds**

• There should be no limits on the choice of duly authorised asset managers and custodians- they may be from another member state.

**Article 20 - Cross-border Activities**

• Institutions should be able to operate on a cross border basis.

• Institutions who wish to operate in another member state must first be authorised by their home member state and then by the host member state. The host member state should advise what needs to be done to comply with their social security and labour laws. The host member state will monitor the institution in relation to this.