Headlines

Worldwide Pay and Benefits

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Brazil

New tax rules change the playing field for retirement plans

The Brazilian government has signed into law a new provisional rule (MP No. 209) that ends the double taxation of supplementary pension plans in Brazil and offers a new incentive for long-term pension savings. The new tax rule applies to both company-sponsored plans and individual pension products offered by insurance companies, and its overall intent is to put defined contribution (DC) and defined benefit (DB) plans on a more level playing field. The rule takes effect 1st January, 2005. MP No. 209 provides the following:

- Pension investment returns in both company-sponsored plans and individual plans will no longer be taxed. Instead, taxation will occur only upon distribution of benefits. Previously, investment returns on closed plans (ie trusts) with employee contributions and post-2001 investment returns on open entities (ie insured arrangements) were subject to taxation.
- For DC plans established after 1st January, 2005, participants will be eligible for reduced marginal tax rates depending on the length of the period in which the assets were accumulated in the plan before they are withdrawn. Withdrawals of assets that have been

held in a qualified account for less than two years will be taxed at 35 per cent. For each additional two years, up to a total of ten years, the tax rate decreases by 5 per cent. Assets held for at least ten years will be taxed at just 10 per cent upon distribution. It is up to employers sponsoring these new DC plans to choose between the declining tax structure and the current marginal tax rate of 27.5 per cent.

Also under the new rules, for plans not under the reduced tax regime (ie DB plans and DC plans implemented before 2005), a 15 per cent withholding tax will apply to early withdrawals.

Implications for employers

The new tax rule will have the effect of reducing cost for those DB plans whose investment returns had been taxed, and increasing the benefit under the new DC plans. DB plan sponsors should review the plan formulae and expected plan targets in light of adjusted expected returns. Expected return assumptions in actuarial valuations will also need to be reviewed. In addition, non-contributory DB plans, whose earnings are currently tax-exempt, will have more flexibility to add employee contributions.

Participants of pre-2005 plans not subject to the declining tax scale, may pressure employers to create a tax-advantaged mirror plan to cover

future benefits. Employers will need to consider whether the impact is positive or negative for different groups of employees.

Social security reform brings changes for company pension plans

Although Brazil's long-promised reform of the country's social security system remains a piecemeal effort, recent legislation approved by lawmakers contains changes that will have a direct bearing on company-sponsored pension plans.

The legislation, among other things, increases the ceiling on social security pensionable pay for non-public sector employees from approximately R\$1,800 per month (US\$645, €497) to R\$2,509 per month (US\$899, €692). While the full impact of this change on individual benefits will be realized gradually over time, the result is that companies with pension plans that provide benefits linked to social security payouts (typically in the form of a supplement) may see a decrease in plan obligations.

In addition, company-sponsored plans that are not directly integrated with social security might now find that participants are receiving a greater total benefit than was originally targeted.

Accordingly, companies in Brazil that sponsor pension plans are advised to review whether the benefits and contribution rates should be adjusted in light of overall financial management objectives. The social security reforms have been in effect since January 2004.

Europe

EC acts against Belgium and Italy over tax discrimination

The European Commission (EC) has referred Belgium to the European Court

of Justice over its discriminatory cross-border tax policies and requested Italy to change its legislation.

In both countries, pension contributions paid to foreign pension plans do not qualify for the favourable tax treatment that applies to contributions to domestic plans. Belgium also discriminates in other ways, such as imposing a special tax on the transfer of pension fund assets to non-domestic plans.

Although the Belgian government has agreed to change its legislation by September 2005, which is the deadline for implementing the European Pensions Directive, the EC considers this insufficient and went ahead with the referral to the European Court. It referred Spain earlier this year for the same reason. The EC's request to Italy for legislation is the second stage of its infringement proceedings following a request for information in December 2003 that has remained unanswered.

Besides Belgium and Italy, the EC has opened infringement proceedings against Denmark (the first state to be referred to the European Court), Ireland, France, Portugal, Spain and the UK. The proceedings are confidential, so it is not known how each is progressing.

Germany

Court ruling on cuts in pension benefits stirs new interest

An important ruling by the German Federal Labour Court, that has been in existence for a number of years, is stirring new interest because it sets forth specific guidance for companies that would like to reduce their pension obligations because of economic difficulties.

The ruling was issued in 1985 and confirmed in several legal cases in the

following years. It may be of particular interest to large employers doing business in Germany because the country is often viewed as one with high labour costs and strict protection for workers that do not offer companies much flexibility in managing their pension and other benefit programmes.

A number of German employers are looking for ways to alter their company-sponsored pension plans in order to manage cost, and in some instances they are seeking to introduce DC plans. The ruling makes clear that employers may restructure and, in certain conditions, reduce pension benefits if they meet the required tests and are careful to comply with the law.

Under current law in Germany, any pension plan change must have no effect on current pensioners and individuals who have left the company and have vested benefits. However, companies are free to close pension plans to new employees or to redesign their plans for current employees, subject to certain legal restrictions. The principle is that any reduction in either past or future entitlement must be reasonable and justified by the particular situation.

Three-tier approach

The Federal Labour Court ruling set out specific conditions under a three-tier approach in which an employer may make pension plan cutbacks for current employees.

- *Tier 1*: In a situation of severe financial stress, such as when the company is close to bankruptcy, accrued benefits may be reduced. The company must explain why the change is essential to its financial rescue.
- *Tier 2*: An employer may make cutbacks in the factors that affect automatic increases in accrued benefits provided the company is in a deteriorating financial position that requires strong measures. In a final pay plan, for example, the company might exclude some items of salary that were previously included in the calculation or may even freeze the salary on which the benefit is based.
- *Tier 3*: This allows reductions in the rate at which benefits accrue for future service under less stringent business conditions than in Tier 1 or Tier 2. For example, an employer sponsoring a final pay plan may wish to cut the benefit from 2 per cent to 1 per cent of annual pay, times years of service. In these situations, the employer must have 'objective' reasons for the reduction, such as a difficult economic situation requiring a reduction in jobs or cutbacks in pay. Other reasons might include harmonisation of different benefit plans, reduction of benefit levels to a market average or to avoid overly generous benefits.

Implications for employers

Employers that are planning to freeze or reduce their pension plans should do the following:

- Have a clear rationale for any action based on the company's economic situation.
- Make sure that the process of making the benefit change is in line with labour court rulings.
- Seek negotiations with employee representatives at an early stage.
- Be clear about the road map and the timeline in the entire process of making the change.
- Make sure an appropriate communication programme is in place to accompany any action.

Italy

Pension reforms set in motion new choices in workforce management strategies

Employers are starting to feel the effects of the pension reform legislation (Law 243/04) approved by the Italian government in July 2004.

While the government has a year to publish the many decrees required to bring the new law into effect, one important decree was published in the official gazette in October. It allows employees who have reached retirement age to apply to their employer to continue working and have the social charges of around 32 per cent of pay redirected to their pay packets in the form of a tax-free bonus. The reforms are designed to relieve the ailing state pension system by encouraging people to work later into life and to stimulate private savings for retirement. Here's a summary of key changes:

- *State pension age increased:* Beginning in 2008, employees will need to have paid 40 years' social security contributions or be older than 60 with 35 years' contributions to get a full state pension. The age threshold will be raised to 61 in 2010 and possibly 62 in 2014. At present, employees can claim a full pension beginning at age 57 if they have paid 35 years' contributions.
- *Choice of pension fund for employees:* The new law will give employees the right to choose a DC pension plan. Currently, if they qualify to join an industry-wide, multi-employer DC plan corresponding to the relevant national labour agreement, then they can only join that plan.
- *TFR redirected to pension fund:* Future accruals of the employees' termination indemnities or *trattamento di fine*

rapporto (TFR) must be paid into a pension fund, unless the employee explicitly requests otherwise. At present, employees can decide whether or not to join a pension fund, and for those hired before 1996 only a small percentage of their TFR accrual is paid into the pension fund. Unlike the TFR accounts, which are unfunded, the pension funds will require employer payments on a regular basis.

- *Tax incentives for DC plans:* At present, tax relief on plan contributions by employees is very limited and an unpopular 11 per cent tax on investment returns is applied each year. The new law will raise tax relief limits and reduce the 11 per cent investment tax, although the extent of the changes is not yet known.

Implications for employers

In Italy, it is especially important for employers to plan for an older workforce. The aim of the legislation is to encourage employees to apply to work past their retirement age and work longer before seeking a full state pension, and to delay drawing down their TFR accounts to support an earlier retirement.

The reforms will also force employers to reassess their cash flow requirements and to consider the cost and administrative implications. A shift from TFR into pension funds could have significant implications, although reluctance by employees to give up TFR in favour of a pension fund is likely to mitigate this. On the other hand, better tax incentives could encourage greater use of pension plans, increasing employer cost.

Some larger companies, especially those with headquarters outside Italy, may wish to set up their own retirement plan to gain greater control and tailor the

plan to suit the company's needs instead of relying on an industry-wide plan.

Until the relevant decrees are issued, the details of the new pension law will not be known, and unions and employer organisations are likely to influence the outcome.

Netherlands

Government seeks to end tax breaks for early retirement

The Dutch government is pushing ahead with its plans to scrap tax breaks for early retirement arrangements as part of its strategy to encourage older employees to remain in the labour force.

Draft legislation submitted by the government to Parliament in September calls for ending favourable tax treatment for employee and employer contributions to voluntary early withdrawal (VUT) and pre-pension plans. The changes, with some modifications, were accepted in the compromise agreement over welfare reform reached by the Dutch cabinet with trade unions and employer associations on 5th November, 2004 and approved by the Lower House on 29th November, 2004.

VUT plans

VUT plans, which are unfunded, are designed to pay a monthly benefit to employees who leave their employer before normal retirement age. Under the government's proposed legislation, beginning in 2011 employees will no longer qualify for tax deductions on their plan contributions. Employers will be subject to a tax of 52 per cent on their notional contributions. Between 2006 and 2011, half of the employer's contribution will be subject to the 52 per cent tax, and half of the employee's contributions will be tax-deductible.

Once in payment, the VUT benefit itself would continue to be fully taxed.

Pre-pension plans

Many employers fund early retirement through pre-pension plans, paying a temporary pension until the main plan pension starts or until the government pension begins. Under the government's proposal, employee contributions to pre-pension plans will no longer be tax-deductible, and the employee will essentially be fully taxed on employer contributions. Once in payment, the benefits will not be taxed, but the value of the benefits to be paid will be treated as a private asset of the individual and will be subject to savings tax on a notional interest earned each year.

The new tax rules will take effect 1st January, 2005 for new VUT plans and pre-pension plans, provided the final legislation is approved by the Upper Chamber. Existing plans (on 31st December, 2004) can be maintained until 1st January, 2006. However, the new tax rules (under conditions) will not apply to individuals who have already reached age 55 on 1st January, 2005.

Life cycle savings arrangements

The legislation also includes arrangements whereby employees can save up to 12 per cent of salary up to a maximum of 2.1 times the annual salary and then use the accumulated savings to take a career break or to create an early pension arrangement. The savings are deducted from gross salary before tax.

Implications for employers

VUT and pre-pension plans are widely used by employers. If adopted, the government's proposals would make these plans very unappealing in terms of tax

benefits and prompt employers to redesign them.

Government seeking more stringent code on pension fund governance

The Dutch government has said it will take action itself and seek legislation if the Dutch pension organisations do not develop a voluntary code on pension fund governance that is consistent across the different types of pension plans in the Netherlands.

In November 2003, the government established a working group that was chaired by a representative of the Ministry of Social and Economic Affairs and included representatives of the two main pension fund associations, the Company Pension Funds association (OPF) and the Industry Pension Funds association (VB). The group went on to formulate a process for developing a new governance code.

In addition, the government asked the law firm Allen & Overy, in conjunction with consultants Boer & Croon, to carry out an independent study to come up with recommendations for minimum governance standards.

The OPF issued 24 recommendations for improved governance of pension funds on behalf of its members in May, and the VB released a 27-page code for pension funds of its members in June.

Recommendations for company-sponsored plans

Among the 24 OPF recommendations for employers are the following:

- Define pension fund governance procedures;
- Assure independent and transparent

- operations by the pension fund board;
- Define procedures for policy formulation and decision making;
- Test the legitimacy, financial soundness and implementation procedures of the plan;
- Master and manage outsourced activities;
- Communicate with all parties concerned;
- Periodically evaluate all pension fund activities;
- Account for all pension fund activities.

Draft code

Both reports were used in a discussion meeting organised by the government in June. Allen & Overy joined the meeting and issued a final report in September. The government subsequently concluded that the recommendations from the industry were not strong enough or consistent enough to meet the country's needs. As a result, the Ministry of Social and Economic Affairs announced plans to pursue legislation that could take effect as early as 2006, unless the pension fund associations draft a revised code themselves.

Implications for employers

For employers and pension funds this is an appropriate time to consider their current governance practices and take steps to set up a more effective policy framework with clear standards that are understood by everyone. The recommendations already provided by the pension industry provide a good base from which to start.

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