Description of the Pension Second Pillar Reform

Accumulating a pension in the Second Pillar has become voluntary. These changes provide the following new options for those accumulating pensions:

1) people have been given the right to decide whether to accumulate pension money into the Second Pillar or not – for both those who have already enrolled in the Second Pillar when the changes enter into force, as well as for those who have not;
2) in addition to accumulating money in pension funds, money can be accumulated via pension investment accounts;
3) people have been given the right to use the money accumulated in the Second Pillar under certain conditions while they are still accumulating their pensions;
4) upon reaching retirement age, each person will be able to decide how to use the accumulated money.

1. Enrolling in the Second Pillar

1.1. When the law enters into force, an individual’s current relationship with the Second Pillar will not automatically change. Thus, people who have already enrolled in the Second Pillar, will remain enrolled in the Second Pillar by default, and people who have not enrolled in the Second Pillar, will remain non-members by default. In order to change this status, a person must take the respective action.

1.2. As is true in the current system, those born in 1983 or later and entering the labour market will be automatically enrolled in the Second Pillar. What’s new, however, is that these people will also have the opportunity to cancel this automatic enrolment in advance, or at some point after enrolment, they will so be able to withdraw from the Second Pillar. In order to take advantage of this option, an application must be submitted.

1.3. The existing procedure for drawing lots in order to select a pension fund will be maintained if the young person entering the labour market has not yet chosen a pension fund or a pension investment account by the time the first contribution is made and he or she has not exercised the option described above not to make contributions to the Second Pillar. In this case, the Pension Centre will draw lots to select a pension fund for the person. When lots are drawn, the choice of funds will include the three pension funds with the lowest current management fee and the most aggressive investment strategy. Aggressive funds are those with investment portfolios of which 75% are comprised of equities, equity funds and other equity-like instruments. A person can change the fund that was drawn by lots at any time, and choose a new fund or pension investment account.

1.4. Individuals (born 1982 and earlier) who did not enrol in the Second Pillar, now acquire the right to do so. However, unlike young enrollers, these individuals have to take an additional condition into account. Namely, the new regulation stipulates that someone born in 1982 or earlier and enrols in the Second Pillar for the first time, will not have the right to discontinue making the Second Pillar contributions or to withdraw money from the Second Pillar during the accumulation period until 10 years or more has passed since the enrolment (also see para. 5).

2. Making contributions to the Second Pillar and ending these contributions

2.1. Current payment rates will also apply to the updated Second Pillar: 4% from social tax and 2% of the person's gross salary[1]. It is important to remember that if a person's income is not subject to social tax, he or she will not acquire pension rights in the First Pillar and will not accrue pension money in the Second Pillar.

2.2. If a person wants to make contributions to the Second Pillar, the procedure remains the same. One's employer withholds and declares 2% of a person's salary, and pays both the social tax and funded pension payments to the Tax Board. The Tax Board sends the Second Pillar money and data to the Pension Centre, which directs the money to the pension fund or pension investment account chosen by the person.

2.3. A person can still have only one active pension fund or pension investment account at a time, which means that one's contribution cannot be divided between several funds or pension investment accounts. However, a person can always change his or her active fund or pension investment account (i.e. redirect the payments). Such an application can be submitted at any time and it will come into effect no later than three working days after the application is submitted.

2.4. A new feature of the Second Pillar is the possibility for people to stop making contributions to the Second Pillar (exemption from making payments). When a person stops making payments to the Second Pillar, the money he or she has accumulated so far remains in the pension fund, where it will continue to be invested. The same applies if a person invests money in a pension investment account, i.e. if he or she stops making the payments, no new money will be added, but the amount already accumulated will remain in the Second Pillar. If a person is not making contributions to the Second Pillar, he or she is only acquiring First Pillar pension rights, i.e. during this period, the 4% of social tax assigned to the Second Pillar will go to the First Pillar instead (20% in total) and 2% of the person's salary will not be deducted. Applications for exemption from payment can be submitted as of January 2021.

2.5. If payments have been stopped, but the person changes his or her mind, and wants to continue contributing to the Second Pillar, he or she can submit the corresponding application and start making payments again. Payments may be resumed provided that at least 10 years have elapsed since the payments were stopped.

2.6. Thereafter, a person who has re-enrolled in the Second Pillar can withdraw from the pillar once more. If 10 years have elapsed since a person resumed payments, he or she can stop making the contributions again (or withdraw the money from the Second Pillar, and thereby also stop making payments). When doing so, he or she will not be able to return to the Second Pillar. If a person simply stopped making contributions, he or she will still have the opportunity to withdraw the money. The money can be withdrawn while accumulating one's pension (see par. 5) or during retirement (see par. 6).

2.7. Some deadlines must be kept in mind when making payments, as well as when submitting applications to terminate the payments. Applications for making payments or being exempted from payments become effective on the same dates as the exchange of pension fund shares occurs in the current system, i.e. the beginning of January, May and September. Applications may be submitted throughout the year, but application dates have an

[1] An exception is the period from 1 July 2020 – 31 August 2021, when the 4% payments made by the state are halted and the enrollees have the right to suspend their 2% payments for the period from 1 December 2020 to 31 August 2021 (to halt the 2% payments an applications must be filed in Ocotober 2020).

impact on when the application will be implemented. In order for an application to take effect at a specific time, i.e. by the end of November, March or July, it should be submitted at least five months before the application is made.

2.8. Therefore, for example, when someone submits an application to be exempted from payments by the end of March 2021, then as of September 2021, they will no longer have to make any payments. If the application is submitted in April, then the cessation of payments will not end in September, but in January of the following year, i.e. in the next cycle. Once someone has ceased making contributions to the Second Pillar, and 10 years as passed and, for instance, they want to start making Second Pillar payment again as of the new year, the corresponding application should be submitted between the beginning of April and the end of July of the year preceding the year in which payments are to begin. If such an application was submitted as early as March, then the Second Pillar payments would resume earlier, i.e. as early as September (assuming that 10 years had passed since ceasing the payments). However, if such an application was submitted later, for example in August, the payments would not resume until May of the following year. The deadlines for submitting these new applications are similar to those for exchange applications of fund shares, but the application deadline and the realisation date is one cycle longer.

2.9. If the application is submitted prematurely, it is still possible to change the application within the same application cycle. This means, for example, that if someone applies for a waiver in January but reconsiders, the application can be changed until the end of March. In this case, a new application, asking to resume payments, should be submitted. In this case, the latter application would be valid and the person's payments will not end in September. If the deadline for submitting the application has already passed and, for example, a person decides in April that he or she still wants to make payments, then his or her initial application cannot be cancelled and the payments will end in September. However, the person will have the opportunity to start making payments again after 10 years.

2.10. Unfortunately, the greater freedom of choice that people are given in the Second Pillar will significantly increase the administrative burden on employers to declare and pay taxes**.** If until now, employers could assume that anyone born in 1983 or later had compulsorily enrolled in the Second Pillar and their funded pension payment must always be withheld, such an assumption can no longer be made in the new framework. Nor can the Second Pillar status of those born in 1982 and earlier be conclusively determined. Employers must take into account that the Second Pillar status of absolutely all employees (i.e. whether payments must be made or not) may change on three days of each year. Thus, employers have an obligation to regularly check to make sure whether they have an obligation to make these payments at any given time. The same applies when recruiting new employees. The information can be checked in the Pension Register, where everyone's applications are stored. A practical recommendation is to check on this in December, April and August, as the status of the Second Pillar employees can possibly change in January, May and September. Many accounting programs used by employers also support inquiries from the Pension Centre, which greatly facilitates tax accounting for employers. The mass inquiry service offered by the Pension Centre can also be used. Using their personal identification code, everyone can continue checking their Second Pillar status on the Pension Centre's website.

2.11. When accumulating a pension, the status of those enrolled in the Second Pillar is affected not only by the cessation of contributions, but also by the decision to withdraw money from the Second Pillar (if someone has not stopped making contributions but has withdrawn the money from the Second Pillar, he or she will also not be able to make contributions again for the next 10 years). The logic behind the submission and entry into force of these applications is the same as for the applications described above, and all the relevant information is available in the Pension Register. All that matters to the employers is whether or not they have to withhold 2% of the employee's salary, and this can be determined by checking the register kept by the Pension Centre. The withdrawal of money from the Second Pillar is discussed in more detail in par. 5.

2.12. As in the current system, it cannot be automatically assumed that once someone has reached retirement age, he or she will no longer have to pay the Second Pillar contributions. In the updated Second Pillar, a person acquires the right to start receiving their Second Pillar pension five years before retirement age, as well as if he or she has been designated as being incapable of work. However, as long as the person does not exercise his or her right and has not stopped making contributions, the employer must continue withholding the payment of the funded pension from his or her salary. However, receiving a Second Pillar pension does end his or her contributions, whereas they can continue working (i.e. receiving a salary and a pension at the same time). This information also exists in the Pension Register and is available to employers for making the correct tax calculations.

3. Accumulating pensions in pension funds

3.1. The updates will not result in any significant changes for all those who are already in the Second Pillar or enrol later when the changes come into force and do not plan to terminate their contributions, withdraw funds or start using a pension investment account for savings.

3.2. Enrolees will continue to be able to choose between several pension funds; as well as apply to exchange of all or part of the shares for the shares of another pension fund and change the pension fund to which contributions are regularly made. These applications can be made on the Pension Centre's website, in an Internet bank or by communicating directly with a pension adviser.

4. Using a pension investment account to accumulate money in a Second Pillar pension investment account

4.1. As of April 2021, a pension investment account will be created in the Second Pillar alongside the pension funds. In the future, anyone can invest their Second Pillar money in a pension investment account. The use of a pension investment account is not considered to be a withdrawal from the Second Pillar. It is important to understand that a pension investment account is not the same as a regular investment account. Even if a person already uses a regular investment account, he or she must open a separate pension investment account for the Second Pillar.

4.2. If you want to use a pension investment account, you must open this account in a bank. This is essentially a current account which is distinguishable from other current accounts by means of a special identifier. Only the Second Pillar money can be deposited in this current account. Account information is automatically communicated to the Pension Centre. In principle, a person can have several pension investment accounts. This might make sense if the accounts are open at different credit institutions because the service or price thereof provides different opportunities for the account holder. However, it should be borne in mind that only one of them can be 'active', i.e. the received payment cannot be divided between several accounts and/or pension funds. By submitting a selection application, the account holder can determine which pension investment account is active at any time. <u>Pension investment accounts can be opened from April 2021 and applications for the selection of a pension investment account can be submitted from September 2021.</u>

4.3. It is also possible for a person to have both pension fund shares and a pension investment account at the same time. An example that could be quite realistic is that after the changes come into force, the future pensioner wants to leave all or part of the accumulated money in the pension fund, while starting to invest new money in a pension investment account. In this case, the pension investment account will be where the money will be actively accumulated, but in no way will this impact the money in his or her pension fund that the management company will continue to invest. If at some point someone decides that his or her pension fund is the active choice, no new money will be transferred to the pension investment account (this will now go to the pension fund instead), but this will not impact the investments that have already been made.

4.4. When the Pension Centre receives a Second Pillar contribution of a person who has chosen a pension investment account for his or her the Second Pillar contributions from the Tax Board, the Pension Centre deposits this money to his or her account. The money stays in the pension investment account until the person makes the relevant investment decision(s). Thus, a person using a pension investment account must be significantly more active than if he or she were accumulating funds through a pension fund. To sum it up, the main difference between the two collection methods is that when collecting money in a fund, the management company makes all the decisions within the framework of any investment restrictions. When accumulating money into a pension investment account, the decisions are made by the person himself or herself while considering any investment restrictions. If a person doesn't make any decisions, the money is simply left standing in the account.

4.5. It is also possible to transfer all or part of the money previously accumulated in the funds to the pension investment account. In essence, this is analogous to changing pension funds today. Since, in this case, the movement of money takes place within the Second Pillar, no income tax is payable, as is also the case when a change is made in funds. In order to transfer money from the pension fund to the pension investment account, an already familiar exchange application must be submitted. In order to transfer money from a pension fund to a pension investment account, an exchange application must be submitted, stating how many and which fund shares are to be exchanged and to which pension investment account the money should be transferred. The Pension Centre takes back the fund shares (the shares are cashed in) and transfers the money to the person's pension investment account. <u>Exchange applications for the transfer of the Second Pillar funds to a pension investment account can be submitted as of April 2021. Exchange operations will take place in early September based on the applications submitted by the end of July 2021 at the latest.</u>

4.6. If at some point someone decides that he or she no longer wants to manage his or her own investments, but wants to continue accumulating in the Second Pillar, he or she can choose a pension fund and the new contributions will start to be deposited there. He or she may also transfer all or part of the money accumulated in one's pension investment account to one's pension fund. The precondition for this is the realisation of the investments to the desired extent, followed by the deposit of the received money in one's pension investment account and the issuance of pension fund shares based thereon. In order to transfer money from a pension investment account to a pension fund, a person must give a corresponding order to the bank that opened his or her pension investment account. Here, too, the movement of money occurs within the Second Pillar, and no income tax is levied on the money.

4.7. An important difference between a regular investment account and a pension investment account is, that in the latter case, the transactions made on the account do not have to be declared in one's income tax return. In the case of a regular investment account, the difference between income and disbursements, i.e. the income from investments, is taxable. In the case of the Second Pillar, however, the entire payout must be taxed because the pension investment account contribution has not been taxed. The same taxation logic applies when a person accumulates a pension in a pension fund and withdraws the money from the pillar. The income tax is paid when withdrawing money, i.e. the Pension Centre, which organises the payments, withholds the income tax.

4.8. Both the Second Pillar funds and the regular investment accounts in use today are subject to investment restrictions. The financial assets that can be used for regular investment accounts are listed in §17[1] of the Income Tax Act. In general, these are various securities and other financial instruments. The same financial asset can also be used for a pension investment account. The bank that has opened the pension investment account will check to make sure that the account holder directs the pension money to investments permitted by law; and whether the money is returned to the pension investment account when cashing in the investment. Any movement of pension funds outside the pension investment account (except for its transfer to a pension fund or utilisation upon retirement) is equivalent to a withdrawal of money from the Second Pillar, regarding which a number of restrictions and tax rules have been enacted.

4.9. Payments (withdrawals) from a pension investment account are dealt with in para. 5 and 6.

4.10. If a person decides to take advantage of a new opportunity and withdraw the money accumulated in from the Second Pillar, the law does not limit what a person can do with this money thereafter. Thus, in principle, it is also possible to transfer the money withdrawn from the Second Pillar to your ordinary investment account or declare the account to which the money was transferred as an investment account in one's income statement for the following year. Contributions to a regular investment account are not limited to the Second Pillar money – all other income may also be deposited to such an account. However, it should be taken into account that income tax is withheld when withdrawing money from the Second Pillar, so income that has already been taxed will be transferred to the ordinary investment account. The purpose of using a regular investment account is to defer the income tax liability arising from the income received from financial assets. Therefore, the account holder should keep records of all account deposits and withdrawals and declare them in his or her annual income statement.

5. Withdrawal during pension accumulation

5.1. All those saving for a pension have the right to withdraw all the accumulated money in the Second Pillar if they so wish. It is important to note that withdrawals impact contributions to the Second Pillar. It is only possible to withdraw money twice while accumulating one's pension.

5.2. People born in 1982 and earlier who enrol in the Second Pillar after the new regulation enters into force cannot withdraw money from the pillar for at least 10 years. This restriction will not apply to young people who were born in 1983 or later and have already enrolled or will be added to the system automatically in the future. This restriction will also not apply to people (born in 1983 or earlier) who have voluntarily enrolled in the Second Pillar before the new regulation enters into force, i.e. they can withdraw their money from the Second Pillar for the first time at a time that suits them.

5.3. If a person has withdrawn money from the Second Pillar, he or she has the right to start collecting money in the Second Pillar again, but he or she does not acquire such a right until 10 years after leaving the Second Pillar. In order to exercise this right, an application to that effect must be submitted.

5.4. If someone has enrolled in the Second Pillar again and accumulated money therein, he or she has the right to withdraw the accumulated money again 10 years thereafter if they so wish. By withdrawing the money, the requirement to make payments to the Second Pillar will be cancelled.

5.5. If a future pensioner has withdrawn money from the Second Pillar twice, he or she can no longer enrol and start making payments again. Thus, he or she will no longer be accumulating money in the Second Pillar and will only have a First Pillar pension when retiring. It should be noted that for the period when a person was enrolled in the Second Pillar, his or her pension rights under the First Pillar are based on 16% of his or her social tax (not 20%).

5.6. If a person wishes to withdraw his or her Second Pillar money while accumulating a pension, he or she must withdraw all the pension savings, i.e. a partial withdrawal is not allowed.

5.7. Withdrawal applications are subject to the same deadlines as applications for payment or waivers. This means that the application must be submitted at least 5 months before the application is realised. The money will be paid out of the Second Pillar in January, May or September and must therefore be applied for by the end of July, November or March. <u>Withdrawal applications can be submitted as of January 2021. On the basis of applications submitted before the end of March, the money will be paid out in September 2021.</u> Of course, applications can also be submitted after 31 March, but then you just have to take into account that they will be realised in the next period.

5.8. If someone has made a withdrawal application in haste and doesn't really want to withdraw the money, application can be withdrawn. Withdrawal applications submitted no later than 31 March can be withdrawn until 31 July. Applications submitted no later than 31 July can be withdrawn until 30 November and applications submitted no later than 30 November can be withdrawn until 31 March. The application cannot be withdrawn in the last month before the payment is due to be paid. In this case, a new opportunity to enrol in the Second Pillar will not occur until 10 years later.

5.9. The money is paid out in a lump sum, regardless of the amount. The payment will be made by the Pension Centre.

5.10. During the accumulation of one's pension, income tax must be paid when withdrawing money from the Second Pillar, at a rate of 20%. The income tax will be withheld by the Pension Centre, who will make the payment.

5.11. When withdrawing money from the Second Pillar while accumulating one's pension, no substantive distinction is made between withdrawing money from a pension fund or a pension investment account – the same rules apply.

5.12. Thus, a person who was born in 1982 or earlier and enrols in the Second Pillar after the changes take effect, he or she may not withdraw money from the Second Pillar during the first 10 years, regardless of whether the money is being accumulated in a pension fund or a pension investment account. After withdrawing one's money from the Second Pillar, one can no longer accumulate money in the Second Pillar in either a fund or a pension investment account. If a person decides to re-enrol, he or she cannot leave the system for the next 10 years. And by using the opportunity to withdraw again, he or she will no longer be able to accumulate money in the Second Pillar.

5.13. A precondition for everything that a person has accumulated in the Second Pillar being paid out is that all the investments made via the account have been realised and the money has been deposited in the pension investment account. A person may have investments that cannot be realised quickly enough, but it is not possible to only withdraw part of the money. Before someone can apply to withdraw one's money, he or she must have cashed in all the investments.

6. Withdrawal after retirement

6.1. All the people who have enrolled in the Second Pillar, can retire from the Second Pillar when they are of retirement age. As of January 2021, one can retire up to five years before reaching retirement age (hereinafter *retirement age*).

6.2. As of January 2021, a person will be able to retire from the Second Pillar even if he or she has been declared to be incapable of work, regardless of how old they are. The law treats people who are incapable of work similarly to those who have reached retirement age. Payments made to these people will not be subject to income tax and not be taken into account in the calculation of a person's tax-free income.

6.3. When a person reaches retirement age, it is up to each person to decide how to use the money accumulated in their Second Pillar account – as a lump sum, funded pension or pension contract. In order to utilize state tax policy to stimulate the purposeful use of money accumulated in the Second Pillar, a taxation model similar to the Third Pillar is being applied to the Second Pillar.

6.4. When a person has reached retirement age, the Second Pillar payment is taxed at an income tax rate of 10%.

6.5. However, if a person of retirement age enters into a lifetime pension contract with an insurer, such payments are not subject to income tax. The same applies if a person enters into a fixed-term contract with an insurer, the duration of which is at least the average life expectancy based on the person's age published by Statistics Estonia. Or if the person has made an agreement for a funded pension of at least the same length (with the pension being paid directly from the fund)

6.6. The Third Pillar payments made at retirement age are not included in a person's calculation of tax-free income.

6.7. It is important to note that although new choices related to Second Pillar payments will develop as soon as the law enters into force, all tax changes will not apply until January 2021. Therefore, it is worthwhile for people to be prudent when applying, to ensure that they also take advantage of the more favourable tax conditions.

6.8. The funded pensions already agreed upon when the amendment to the Second Pillar enters into force will continue to be valid by default and their terms will not change. However, as now, people have the right to terminate their current funded pensions under the new rules. If a person decides to terminate his or her funded pension, he or she has the right to agree on a new funded pension (for example, with another term), enter into a pension contract with an insurance company, or withdraw the money immediately.

6.9. Even people who have already concluded a pension contract with an insurance company can cancel their contracts and withdraw the remaining money at the same time if they wish. This process will begin in January 2021, when the person is informed by the insurance company with which the contract has been signed. Thereafter, people can consider their options and decide whether they would like to continue with a Second Pillar pension or withdraw the money at once. These choices must be made in accordance with the dates provided by law. By default, contracts are assumed to remain in force. People who want to terminate a valid contract, must submit a cancellation application to their insurance company by the end of March 2021 at the latest. In this case, the insurance company will continue to pay the pension until the end of August 2021, with which the contract expires and the recoverable of the contract will be paid to the person in September 2021.

6.10. If a person has accumulated money in a retirement investment account, then the aforementioned possibilities and taxation conditions also apply.

7. Concurrent changes in the Third Pillar

7.1. The Third Pillar retirement age is currently 55 years. As of January 2021, the Third Pillar retirement age will be equivalent to the Second Pillar retirement age. This means that you can retire up to five years before reaching the national retirement age (see para. 6.1). For people who have already enrolled in the Third Pillar or will enrol before the end of 2020, the current Third Pillar retirement age of 55 will remain in force.

7.2. As of January 2021, income tax rates of 10% and 0% will also be applied to the Third Pillar, under conditions similar to those described for the Second Pillar, and these payments will be excluded from the calculation of tax-free income (see para. 6).