Limiting Pension Reliefs
Targets for 2014

David Kingston
Tony Gilhawley
John Tuohy

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Introduction

In the budget of December 2012, the Minister for Finance clarified the Government's policy in relation to supplementary pension provision. In particular, the Minister stated that

- Tax relief on pension contributions would continue at the marginal rate of tax
- The Pension Fund Levy would not be renewed after 2014 and
- The necessary arrangements to give effect to the Programme for Government commitment to cap taxpayers' subsidies for pension schemes that deliver income of more than €60,00 per annum would be put in place in 2014.

The Minister also indicated that consultation would take place on the changes required to give effect to this commitment.

This report deals with the proposed changes and examines how they might be applied in ways which are fair to the various groups – particularly to public and private sector employees and to the employed and the self-employed.

1. Government Proposals

The Minister for Finance is reported in a speech of 31st January 2013[1] as saying –
'In my Budget speech, I announced that the necessary arrangements would be put in place from next year to give effect to the Programme for Government commitment to cap 'taxpayers subsidies for all future pension schemes for politicians (and indeed for everybody) that deliver income in retirement of more than €60,000.'

Delivering on this commitment will require, among other things, changes to be made to the maximum allowable pension fund at retirement for tax purposes (the so called Standard Fund Threshold) first introduced in 2005.

The changes required will likely involve not only a reduction in the current level of the threshold from €2.3m but other changes to ensure equity as between Defined Contribution and Defined Benefit pension arrangements and between the public and private sectors.'

Clearly this will require detailed rules to be introduced by the end of 2013. This report explores how such rules might be drafted.

[1] **Address by Minister for Finance, Michael Noonan, T.D. at the Life and Pension Industry Conference, 31 January, 2013**

2. Broad Practical Considerations

Limiting pension taxation relief involves either limiting the lump sum fund accumulated to buy a pension or limiting the actual annual pension itself.

Whether we start with an annual pension or with a lump sum, it is necessary to introduce factors which convert one into the other. For example, if we start with an annual pension, we need a factor to turn this into a lump sum to prevent overfunding in Defined Contribution schemes.

In calculating equivalence between pension and lump sum, we need (at least in theory) to consider –

- Age of pension vesting
- Marital/Dependency status
- Pension escalation rights
- Interest and mortality

Thus we might define

- Age of vesting as 66 (current Social Welfare Pension age)
- Assume 2/3 married, no dependent children
- Increases in line with CPI
- Investment in Irish Government bonds and current projected mortality

It is desirable that we get a standard reference formula that holds for a period at least. In time, it will need adjustments for age and interest rates – perhaps every five years.

The basic reference formula might give an equivalent cash value of 25:1 – i.e. making €60,000 p.a. pension equal to €1.5m plus tax free lump sum of (say) €0.2m = €1.7m as the basic new Standard Fund Threshold.

These limits will themselves need to be adjusted depending on –

- Age of vesting. Clearly a pension payable from age 60 is more valuable than one payable from age 66.

- Pension escalation rights. A simple formula should be applied to increase the amount of pension allowed if there is no escalation or to reduce if there is 'CPI plus' escalation.

- Marital status/Dependency/Gender. These might be ignored in practise.

- Ill health. This will require particular consideration in exceptional cases.

3. Background to Introduction of the Threshold Limit

The relevant legislation to impose a system of charging additional tax on the value of private pension benefits taken above a certain threshold limit, was introduced in Finance Act 2006 following a Department of Finance Internal Review of Certain Tax Schemes, carried out in 2005.

The Review (Section G) in relation to Tax Relief for Pension Provision, concluded that the then current pension tax reliefs were '*very generous in relation to individuals whose employers are in a position to make substantial tax deductible contributions to their schemes effectively without limit.*' and that the Approved Retirement Fund (ARF) option, introduced in 1999, had effectively turned the pension tax relief system into a near Exempt Contributions, Exempt Investment Return, Exempt Benefits (EEE) system instead of the intended Exempt Contributions, Exempt Investment Return, Taxed Benefits (EET), for those entitled to the option.

The Review set out 9 different options '*aimed primarily at proprietary directors and senior executive staff who may be in a position to tailor their remuneration structure and the level of their employer's contributions so as to avail of maximum benefits under the current regime*.' Three of the options were proceeded with in Finance Act 2006:

- *Place an absolute cap on the size of the maximum tax-relieved retirement fund;* an initial limit of €5m was introduced and subsequently reduced to €2.3m with effect from 7th December 2010. (Chapter 2C, Part 30, Taxes Consolidation Act (TCA) 1997.
- *Place an absolute cap on the tax-free lump sum of 25% of fund value that can be taken from an occupational pension scheme;* (Section 790AA TCA 1997). The original limit of €1.25m has been reduced to €200k with effect from 1st January 2011.
- *Deem a notional annual distribution to be made from an ARF;* initially introduced on a phased basis growing from 1% to 3% pa, this is now 5% pa (or 6% for funds > €2m) (Section 790D TCA 1997).

There have been a number of other restrictions[2] on pension tax reliefs since 2006:

- Earnings limits for personal contributions reduced to €115,000 (as high as €275,000 in 2008).
- Cessation of indexation of Threshold limits.
- Disallowance of personal contributions for PRSI and USC purposes, employer and employee.
- Introduction of pension levy of 0.6% pa for the 2011-14 period.

[2] *Tax Strategy Group Paper 11/23 Budget 2012, section 3.3 : "In addition to these measures, Finance (No 2) Act 2011 introduced the pension fund levy which raised over €460 million. When taken with the Budget 2011 measures, it means a total policy adjustment of €750 million has been made in 2011. This is equivalent to 32% of the estimated net cost of pension reliefs in 2008."*

4. System Inequities

Where the Threshold limit is exceeded an upfront tax charge is imposed at the point of crystallisation of benefits of 41% of the value of private pension benefits taken over the Threshold limit (called the chargeable excess). (Chapter 2C, Part 30, TCA 1997).

This is a very blunt instrument, which seems to be designed to act as a deterrent to funding pension benefits beyond the limit, rather than to equitably claw back the value of tax relief granted to accumulate such benefits.

The system contains many inequities:

- **An up front tax charge at retirement is imposed on DB pensions to be received over a lifetime, but which may not be subsequently received in full.**
  A tax charge is demanded and obtained in advance of receipt of DB pensions. There is no 'refund mechanism' where tax is imposed up front on DB pensions which are not subsequently received for whatever reason, such as early death and pension cuts.

- **The tax charge amounts to a penalty by recovering far more than the tax relief deemed to have been originally granted** because the residual excess benefits, after deduction of the 41% chargeable excess tax, are subject again to normal income and USC taxes in retirement:

  $$(1 - 41\%) \times (1 - \text{Income Tax} - \text{USC})$$

  In effect, the marginal rate of tax on the excess benefits over the threshold can be 68%[3], far more than the likely tax relief granted to accumulate those funds.

- **While private sector individuals can avoid the penalty on a chargeable excess by opting out of further accumulation of pension benefits, public service employees cannot** and hence some are forced to exceed the Threshold limit, if they stay in service, and incur a significant tax charge at the point of retirement.[4]

- **A fixed 20: 1 factor is used to value all DB pensions, regardless of age, gender, health, and type of pension**. With increasing longevity and significantly reduced bond yields since 2005, the use of a fixed 20:1 factor undervalues most DB pensions as compared with DC funds. E.g. the current system would allow a DB retiree at 51 to avoid a chargeable excess tax charge, with a CPI linked pension[5] of €100,000 pa and a gratuity of €300,000, whereas a DC retiree would currently need a fund of €6.4m[6] to achieve the same package of benefits, which would attract a chargeable excess tax charge of €1.68m.

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[3] *(1 – 41%) x (1 – 41% - 4%) = 32.45% net.*

[4] *This position has been ameliorated to some extent for public service employees by an amendment to S787Q in Finance Act 2012, by facilitating the spreading of recovery of part of the chargeable excess tax liability through a reduction in pension payments over a period of up to 10 years; however there is still a forced first appropriation of up to 50% of the net gratuity.*

[5] *assumed to also contain a survivor's pension of 50%.*

[6] *based on Irish Life Pension Plant Annuity Quotation system, 28th February 2013*

- **Pension Adjustment Orders (PAO) are treated as if they were never made**[7]. As a result, an individual can end up being assessed for chargeable excess tax on retirement benefits taken by his or her (former) spouse/civil partner; indeed in extreme cases (where the PAO covered 100% of retirement benefits), the individual can end up with the chargeable excess tax liability, but without any retirement benefits from which to pay the tax.

- **Public service employees are required to pay a chargeable excess tax liability by a first appropriation of up to 50% of their gratuity[8].** DC and DB retirees in the private sector can choose to pay chargeable excess tax from their *gross* retirement benefits, and avoid a recovery from their tax free lump sum retirement benefit entitlement.

Fluctuating Incomes. The present system of limiting annual contributions may disadvantage those whose incomes vary significantly over time. Once a lifetime cap is in place an annual limit may be redundant.

[7] *S787O(5), TCA 1997*
[8] *after deduction of any standard rate tax imposed by S790AA TCA 1997*

5. Outline Proposals to deal with some Identified Inequities

In the context of a proposed reduction in the Standard Fund Threshold (SFT), allied to a €60,000 pa pension limit, a number of high level proposals are set out below. They do not fully resolve all inequities but would make the system fairer than at present.

Inequity	Outline proposal
For public service employees an inability to avoid a chargeable excess tax liability, other than by leaving service	• Impose a direct cap or limit on new public service employee pension entitlements beyond €60,000 pa, and take such individuals out of the Chapter 2C tax system. OR • allow opt out of further accumulation of retirement benefit beyond the €60,000 pa limit, in return for an increase in taxable remuneration
Use of a fixed 20:1 factor to value DB pensions/Threshold limit	• Reference the €60,000 pa pension limit to : ○ Age 66 (current State Pension Age) ○ CPI linked pension with 50% survivor's benefit ○ Irish Bond yields and projected mortality This might equate to a current 25: 1 factor, or a Threshold of 25 x €60,000 + €200,000 = €1,700,000. • Increase the 25:1 multiple by 2% pa for each year in advance of age 66, at which the DB pension is crystallised. E.g. at age 58, the multiple would be circa 29:1. • The multiple for fixed DB pensions, with no right to post retirement increases, might be reduced by 25%, say, while the multiple for DB pensions with pay parity increases, rather than CPI, might be increased by 15%, say. • Some provision may need to be made for a reduction in the factor for pensions payable only for a temporary period (e.g. bridge pensions) and ill health retirement DB pensions, where expectation of life is below normal. • Gender and survivor's benefits would be ignored.

Inequity	Outline proposal
Penalty tax charge	Remove double tax charge effect by : • subjecting chargeable excess fund to a fixed tax charge of 52%, i.e. notional income tax @ 41% + 4% PRSI + 7% USC • residual chargeable excess fund, after deduction of 52% tax above, not subject to any further tax deduction, i.e. can be paid out to retiree[9]. This effect could be provided by increasing the €200k tax free lump sum limit by 48% of the chargeable excess fund, while continuing to tax other retirement benefits in the current way. E.g. a DB retiree could commute additional pension tax free up to 48% of the chargeable excess fund, once the chargeable excess tax charge is paid.
Pension Adjustment Orders	Either : • Delete current S 787O(5) TCA 1997, and tax each party on the retirement benefit they receive, OR • Delete current S 787O(5) TCA 1997, and tax each party on the retirement benefit they receive but reduce the member's available Threshold by the level of designated benefit or transfer value paid out, so that an individual whose benefits have been subject to a PAO can't refill' their Threshold limit with further tax deductible pension contributions.
Payment of chargeable excess tax liability	Provide equal treatment with regard to payment options to both public and private sector, by providing a right to refund the administrator of the scheme for a chargeable excess tax liability by a reduction in gross taxable retirement benefits.

[9] *This is similar in nature to the tax treatment provided for the Encashment Option in Section 787TA TCA 1997*

6. Summary

In this report we have set out practical ways of implementing the limit proposed by the Minister for Finance. We have attempted to do this in a way which is fair to all concerned.

The main changes required are as follows:

- Adopt realistic multiples to value pension benefits and adjust them to take account of relevant factors such as early retirement and post-retirement increases.
- Remove the penal tax charge on any chargeable excess over the Threshold limit.
- Recognise the impact of Pension Adjustment Orders.

These changes would help achieve fairness between the pensions regimes for public and private sector employees and the self-employed and those with defined benefit and defined contribution pensions.