

Pensions Post Commission on Taxation Report



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T A X P A R T N E R S

Following the recent issue of the Commission on Taxation report we thought it useful if we provided an overview of the current pension regime and to specifically highlight the various recommendations which were made in respect of pensions which include:

- ◆ Any tax-free lump sum taken on retirement should be capped at €200,000. The balance of the lump sum should be taxed at the standard rate of income tax (currently 20%).
- ◆ Approved Retirement Funds (“ARFs”) should be extended to all defined contribution occupational pension schemes.
- ◆ Tax relief should be available on pension contributions at an average rate which could be 38.6%.
- ◆ An implicit recommendation that the ceiling on a pension fund should be reduced from the current €5.4 million threshold.
- ◆ It should not be possible to manipulate contributions and remuneration close to retirement.
- ◆ Anomalies in the different treatment of ARFs and PRSAs at retirement should be eliminated.

Many clients are currently considering their pension options prior to the enactment of any recommendations in the Commission on Taxation report.

Types of Pension Schemes

Occupational Pension Schemes

Occupational pension schemes set up by employers for their employees can be in the form of a defined benefit plan or a defined contribution plan. Defined benefit plans provide for a set level of pension at retirement, the amount of which normally depends on an employee’s service and earnings at retirement. However, with defined contribution plans the level of the employee’s pension will depend on the amount invested, the return on the investments and the cost of the pension at retirement.

Self administrated pension schemes are a type of occupational pension scheme, which allow the beneficiary of the scheme to have control over the investments within the pension scheme. Effectively, the employee can choose the assets to be acquired by the pension scheme and in certain circumstances the pension scheme can borrow money in order to fund the acquisition of these assets. There are certain restrictions as to the type of investments that can be made by the pension scheme. For example, loans to the beneficiary are prohibited. Furthermore, a pension scheme is precluded from acquiring assets for use by the beneficiary and also from investing in a company in which the beneficiary has a beneficial interest.

Personal Pension Schemes

Personal pension schemes are mainly used by self employed individuals such as doctors, solicitors and accountants. However such schemes can also be used by certain employees where employers do not have an occupational pension scheme in place. The level of the individual’s pension will depend on the amount invested, the return on the investments and the cost of the pension at retirement.

As we know there are a number of different types of pension schemes which can be utilised depending on an individual’s personal circumstances.

Some pension providers now offer personal pension schemes that allow the beneficiary of the scheme to choose the investments within the pension scheme and in certain circumstances to borrow to finance the acquisition of these investments.

Personal Retirement Savings Accounts (PRSAs) are a form of a personal pension scheme and PRSAs are open to everybody, including employees and the self employed. An employer can also make contributions to an employee's PRSA, depending on certain limits. The level of the individual's pension will depend on the amount invested, the return of the investment and the cost of the pension at retirement.

Tax Relief for Personal Contributions

An individual can claim income tax relief at their marginal rate on personal contributions to a qualifying pension scheme. For tax relief purposes contributions are restricted to an earnings limit, which from 1 January 2009 is €150,000 in any tax year. The maximum contribution rate, as a percentage of qualifying income, on which an individual can receive tax relief is:

Age	Rate
Under 30	15%
30-39	20%
40-49	25%
50-54	30%
55-59	35%
60+	40%

In relation to occupational pension schemes, there is normally an agreement to the amount an employee can contribute. If an employee wishes to contribute more than the maximum level permitted by their employer, they can usually make additional voluntary contributions (AVCs).

Tax relief at source can be obtained by employees on any contributions deducted directly by their employer and paid into their pension scheme (net pay, arrangements). It should be noted where contributions are deducted directly from an employees salary, tax relief is available on PAYE, PRSI and health levies. However, from 1 January 2009 the individual will be required to pay the income levy on their gross salary before taking into account the deduction for pension contributions deducted at source.

Relief can also be claimed for contributions not deducted through net pay arrangements, by either an adjustment to the individual's tax credit certificate, or by submitting an income tax return. If a pension contribution is made after the end of a tax year, but before the following 31 October (or if filing an income tax return on ROS, the extended filing date) relief may be claimed in the previous year's income tax return.

Employer Contributions

There is no earnings ceiling on what an employer can contribute on behalf of an employee to an occupational pension scheme, although the Commission on Taxation has recommended that there should be a correlation between the annual earnings limit and the standard fund threshold of the relevant pension fund. The employer contributions to an occupational scheme are only subject to funding requirements and the amount contributed cannot exceed the amount necessary to fund the benefits to which the employee is entitled. An employer is entitled to a tax deduction for ordinary pension contributions paid in the relevant accounting period.

Careful consideration should be given to when an employer makes a special pension contribution as tax relief may be spread forward over a number of years (maximum of 5 years).

Where an employer makes a contribution to an employee's personal pension scheme or PRSA there will be a benefit in kind charge. In relation to such contributions the employee will be entitled to a tax deduction (within the limits), as if the employee made the contribution personally. Once the payment is within the contribution limits it should be tax neutral overall and the benefit in kind will fall outside the PAYE provisions. However, contributions made by employers to employees from 1 January 2009 will be subject to the income levy.

From 31 January 2008 salary sacrifice legislation was introduced, which specifically relates to any attempt by an employee to circumvent the limits imposed on personal contributions to pension schemes by foregoing salary in return for an employer making a pension contribution on behalf of the employee. This new legislation ensures that such salary sacrifice arrangements are subject to income tax to be collected by the employer.

Benefits on Retirement

The maximum tax free lump sum an employee can take from an occupational pension scheme at normal retirement age is based on 150% of their final remuneration. On a strict basis this benefit accrues at a rate of 3/80 of final remuneration for each year of service. The maximum pension that the individual can receive on retirement age is normally based on two-thirds of their final remuneration depending on the number of years the employee contributed to the pension scheme. The balance of the pension fund is used to acquire an annuity, which will provide the individual with an income for life.

In December 2008 a deferral arrangement was introduced in relation to the acquisition of an annuity by members of defined contribution occupational pension schemes. Under this arrangement, members of defined contribution schemes who retire in the period from 4 December 2008 to 31 December 2010 can defer the purchase of an annuity up to 31 December 2010. Individuals who choose the deferral option can still take their tax free lump sum on retirement, but must purchase an annuity on or before 31 December 2010, regardless of their date of retirement.

Where a self administered pension scheme is set up by a director with at least a 5% shareholding in the employer company, the director can at normal retirement age choose to either take a tax free lump sum based on 1.5 times their final salary and use the balance of funds to acquire an annuity, or take 25% tax free and transfer the balance to an approved retirement fund (ARF). The Commission on Taxation has recommended that ARFs should be extended to all defined contribution occupational pension schemes.

Certain pension plans allow the employee to take up early retirement (i.e. between age 50 and 60). It should be noted that where a director with at least a 20% shareholding in a company wants to retire early, Revenue must be satisfied that the retirement is in fact genuine. This is satisfied by the employee clearly ceasing to have any involvement in the company including a disposal of his/her shares and the severance of all links with the business, including ceasing their employment and directorship.

In relation to personal pension schemes and PRSAs, at normal retirement age the individual can currently withdraw a tax free lump sum equal to 25% of the fund. The balance of the fund is used to either acquire an annuity, which will provide the individual with an income for life, or instead can be transferred to an ARF.

The maximum tax free lump sum an individual can take for their pension is €1,354,521 (2009 tax year).

The Commission on Taxation has proposed a cap of €200,000 on the tax-free lump sum with the balance taxed at the standard rate of income tax.

Approved Retirement Funds (ARFs)

Approved retirement funds were created as an alternative to annuities. An ARF offers the pension holder the option of transferring the accumulated pension fund value at the date of retirement to an investment vehicle without realising the tax exposure on the full drawdown. The pension holder takes full ownership and control of the fund and can determine the investment strategy, withdraw funds at their discretion, and on death leave the balance of the fund to a chosen beneficiary. The ARF is a very tax efficient method of transferring assets to family members.

It should be noted that an approved minimum retirement fund is required if an individual does not have a guaranteed income of €12,700 when the ARF option is exercised. A minimum of €63,500 must be placed in this fund and cannot be accessed until the individual reaches 75 years of age. This is a form of protection for the individual if the ARF does not perform as strongly as expected.

A deemed annual distribution applies in respect of ARFs, where the individual is 60 or more for the entire year. Tax is payable on this deemed distribution from an ARF based on 3% of the ARF assets each year. Actual distributions made during the year are deducted when calculating the deemed distribution.

Pensions Cap

In 2006 the Revenue introduced a cap on the overall pension fund value, which at the date of retirement cannot exceed €5,418,085 (2009 tax year). If the fund is in excess of this threshold at the date the funds are drawn down, the excess will be subject to tax at 41%. A situation where this tax charge will be triggered is at the first benefit crystallisation event, e.g. an individual becomes entitled to a pension, annuity, or lump sum or where the individual exercises the option to convert the fund to an ARF or AMRF, or to transfer the fund to an overseas fund. You should note that there is no prohibition on making contributions in excess of the limit, and tax relief will still apply subject to normal limits. The additional tax charge will only be applied on the excess at the time of the first benefit crystallisation event. The Commission on Taxation has suggested that the pension fund ceiling should be correlated with the earnings limit (€150,000). If implemented this is likely to result in a significant reduction in the ceiling of €5.4 million.

Pensions and Separation/Divorce

In a legal separation or divorce, the pension can be considered to be an asset of the couple. Sometimes, it is the last asset that is split due to the cost involved. Under the legal separation or divorce, a couple can agree to a Pension Adjustment Order (PAO), which states the legal entitlement of the contributing and non contributing spouse in relation to the pension. Alternatively, the Courts have the power to make a PAO which will entitle a spouse (and/or dependants) to a specific proportion of an individual's pension benefits.

This document is intended as a general guide to recent developments in the area of Pensions. It is not intended to be a comprehensive guide to every aspect of Pensions. While every care and attention has been taken to ensure the accuracy of the information contained in this document no action should be taken on the basis of the above without obtaining professional taxation advice.

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