Pension related changes in Budget 2011

At the outset, it should be noted that the vast majority of individuals with pensions schemes, will not be affected by the tax changes announced by the Minister for Finance in his Budget Statement relating to the reductions in the Standard Fund Threshold, the maximum tax-free lump sum and the annual earnings limit.

Reduction in the Standard Fund Threshold

The maximum allowable pension fund on retirement for tax purposes known as the Standard Fund Threshold (SFT) is to be set at €2.3 million as on and from 7 December 2010. This compares with an SFT of just over €5.4 million that applied before the Budget.

Individuals with pension rights whose capital value exceeds this lower SFT on Budget Day will be able to protect that higher capital value by claiming a Personal Fund Threshold (PFT).

A PFT may apply if, on 7 December 2010, the capital value of an individual's pension rights drawn down on or after 7 December 2005 (i.e. crystallised pension rights), if any, when added to any uncrystallised pension rights the individual may have, as valued on 7 December 2010 (i.e. pension rights which the individual is building up but has not yet become entitled to) is greater than €2.3 million. However, in no case may a PFT exceed the level of the previous SFT of €5,418,085.

The following simple examples illustrate the above point.

- The value of Paul's uncrystallised pension rights on 7 December 2010 is €2m. He had not become entitled to any pension rights since 7 December 2005. As the value of Paul's uncrystallised rights is below the SFT of €2.3m, he cannot claim a PFT and the maximum allowable pension fund for tax purpose that Paul can build up is €2.3m.

- The value of John's uncrystallised pension rights on 7 December 2010 is €3m. He had not become entitled to any pension rights since 7 December 2005. As the value of John's uncrystallised pension rights exceeds the SFT of €2.3m, John may claim a PFT of €3m which will be his maximum allowable pension fund for tax purposes.

- Mary has uncrystallised pension rights of €2m on 7 December 2010. She became entitled to pension benefits under another scheme on 1 January 2008, with a capital value of €1.5m. As the combined value of Mary's crystallised and uncrystallised pension rights of €3.5m exceeds the SFT of €2.3m, she may claim a PFT of €3.5m which will be her maximum allowable pension fund for tax purposes.

- Jean has uncrystallised pension rights on 7 December of €4m. Jean had become entitled to pension benefits under another scheme on 1 July 2006 with a capital value of €2m. The combined value of Jean's crystallised and uncrystallised pension rights is, therefore, €6m. This exceeds the SFT of

€2.3m but as it is also greater than the old SFT of €5,418,085. Jean's PFT is restricted to €5,418,085 which will be her maximum allowable pension fund for tax purposes.

Note in the final two examples above, when the uncrytallised pension rights eventually come into payment, the capital value of the pensions rights that Mary and Jean had become entitled to on I January 2008 and 1 July 2006, respectively, will have already "used up" part of their PFTs.

A PFT will have to be claimed by way of a notification and certification procedure. Basically, individuals will have a period of 6 months from Budget Day to send details of their pension schemes and the calculation of their PFT to the Revenue Commissioners. The Revenue Commissioners will then certify the PFT. A PFT application form will be available on this website shortly.

Individuals who already have a PFT under the SFT regime as it applied before Budget Day will retain that PFT and there is no requirement to make a new notification to Revenue.

It should also be noted that where an individual has already become entitled to all of his or her pension rights before Budget Day (i.e. has already retired) and has no uncrystallised pension rights on that day (i.e. is not building up other pension entitlements to which he or she has not yet become entitled) the new lower SFT has no application.

The legislation (Schedule 23B to the Taxes Consolidation Act 1997) sets out the basis on which the capital value of crystallised and uncrystallised pension rights are to be determined at any date.

When the capital value of pension benefits drawn down by an individual exceed his or her SFT or PFT as appropriate a tax charge of 41% is applied to the excess and is paid over to the Revenue Commissioners by the pension scheme administrator. This charge is in addition to any tax charge that may be applied to the pension, annuity etc when it is paid out.

Taxation of Retirement lump sums

Retirement lump sums above €200,000 will be taxed with effect from 1 January 2011.

The new taxation regime for retirement lump sums replaces the existing regime which placed a lifetime limit on the amount of tax-free pension lump sums that could be taken by an individual from 7 December 2005. This limit was set at 25% of the old Standard Fund Threshold and amounted to about €1.35 million.

Under the new approach, the maximum lifetime retirement tax-free lump sum will be €200,000 as and from 1 January 2011. Amounts in excess of this tax-free limit will be subject to tax in two stages. The portion between €200,000 and €575,000 will be taxed at the standard rate of income tax in force at the time of payment, currently 20%, while any portion above that will be taxed at the recipient's marginal rate of tax.

The figure of €575,000 represents 25% of the new lower Standard Fund Threshold of €2.3 million. The standard rate charge is "ring-fenced" so that no reliefs, allowances or deductions may be set or made against that portion of a lump sum subject to that charge.

Although tax free lump sums taken after 7 December 2005 (when the original limit was introduced) and before 1 January 2011are unaffected by the new rules, they will count towards "using up" the new tax free amount. In other words, if an individual has already taken tax- free retirement lump sums of €200,000 or more since 7 December 2005, any further retirement lump sums paid to the individual on or after 1 January 2011 will be taxable. These earlier lumps sums will also count towards determining how much of a lump sum paid on or after 1 January 2011 is to be charged at the standard or marginal rate as appropriate.

It is also important to note that the €200,000 tax–free amount is a lifetime limit and so it will apply to a single lump sum or where an individual is in receipt of lump sums from more than one pension product, to the aggregate of those lump sums. The restriction also applies to all pension arrangements, including occupational pension schemes, Retirement Annuity Contracts, PRSAs, public sector and statutory schemes.

There are certain exclusions from the pension lump sum tax charge. It will not apply, for example, to lump sum death-in-service benefits paid to a widow or widower, civil partner (within the meaning of the Civil Partnership and Certain Rights and Obligations of Cohabitants Act 2010), children, dependants, or personal representatives of a deceased person.

The following examples illustrate how this new scheme will work in practice.

Example 1

A is paid a retirement lump sum on 10 January 2011 of €180,000. This is the first such lump sum he has received. A's retirement lump sum is exempt from tax as it is less than the tax-free limit of €200,000. He has, however, used up €180,000 of his lifetime tax-free limit.

Example 2

A is paid a further retirement lump sum of €150,000 on 30 June 2011. As the tax-free limit applies to the aggregate of all lump sums received on or after 7 December 2005, A must aggregate both lump sums to determine how much of the second lump sum is subject to tax. The aggregate of the lump sums received since 7 December 2005 is €330,000. This exceeds his lifetime tax-free limit of €200,000, by €130,000. The "excess lump sum" of €130,000 is, therefore, subject to tax at the standard rate of tax for 2011 i.e. 20%

Example 3

A is paid a further retirement lump sum of €450,000 on 30 September 2011.

As illustrated in Example 2, his lifetime tax-free limit of €200,000 has been fully used up and he has also used up €130,000 of the amount that is charged at the standard rate (i.e. €375,000; the difference between the tax free limit of €200,000 and €575,000 (25% of the SFT)). The latest lump sum is subject to tax as follows:

- €245,000 @ the standard rate for 2011 (€375,000 – €130,000 = €245,000).
- the remaining €205,000 @ his marginal rate for 2011.

Example 4

B is paid a retirement lump sum of €800,000 on 31 January 2011. This is the first such lump sum he has received. He is charged to tax as follows:

- the first €200,000 is exempt,
- the next €375,000 is taxed at the standard rate for 2011
- the balance i.e. €225,000, is taxed at his marginal rate for 2011.

If B receives any future retirement lump sum, it will be subject to tax at his marginal rate in the year it is paid.

Example 5

C is paid a retirement lump sum on 10 January 2011 of €100,000. She had previously received a lump sum on 30 June 2009 of €300,000. As C's earlier lump sum already exceeds the tax-free limit all of the latest lump sum is taxable. The €100,000 lump sum taken on 10 January is taxable at the standard rate of 20%. The earlier lump sum is unaffected.

Example 6

D is paid a retirement lump sum on 1 July 2011 of €400,000. He had previously received a retirement lump sum of €500,000 on 1 January 2006. The earlier lump sum has "used up" all of D's tax-free limit of €200,000 so that all of the lump sum taken on 1 July is taxable. Even though the earlier lump sum is not taxable, it affects the rate of tax applying to the later lump sum. The earlier lump sum has "used up"

- the €200,000 tax free limit, and
- €300,000 of the €375,000 that is taxable at the standard rate

Therefore:

- €75,000 of the later lump sum is taxed at the standard rate
- the remaining €325,000 of the later lump sum is taxed at D's marginal rate.

Annual earnings limit

The earnings limit which, in conjunction with age related percentage limits, governs the maximum amount of tax relievable contributions an individual can make in any one year to pension products has been reduced from €150,000 in 2010 to €115,000 for

2011. This means that the maximum tax relievable pension contribution that can be made in 2011 is €46,000 i.e. €115,000 @ 40% (assuming the individual is aged 60 or over).

In addition, the earnings limit for 2010 is deemed to be €115,000 in respect of contributions that are paid in 2011 but which the individual elects to have treated as if paid in 2010.

For example, assume A who is 61 had net relevant earnings in 2010 of €150,000 (equal to the earnings limit for that year). Under the rules the maximum tax relievable pension contributions A can make in 2010 is €60,000 i.e. €150,000 @ 40%. Assume A only made contributions of €40,000 in 2010 to a personal pension. In 2011 A makes a further contribution of €20,000 and under the rules wishes to elect to have that treated as paid in 2010 so as to maximise his tax relief in that year. Under the new provisions the earnings limit for 2010 is deemed to be €115,000 for the purposes of this election. The maximum tax relievable pension contribution A could make in 2010 if the limit had been €115,000 would have been €46,000 (i.e. €115,000@ 40%). Therefore, only €6,000 of the €20,000 contribution made in 2011 can be pushed back into 2010. Had A's actual contribution made in 2010 been €46,000 or more, he would have no capacity to elect to have a contribution made in 2011 treated as being paid in 2010.

Approved Retirement Funds

The annual imputed distribution which applies to the value of assets in an Approved Retirement Fund (ARF) at 31 December each year is being increased from 3% to 5% in respect of asset values at 31 December 2010 and future years.

Extension of flexible options on retirement

The National Pensions Framework published in March 2010 contained a commitment that flexible options on retirement in relation to pension funds (e.g. access to Approved Retirement Funds (ARFs) etc.) be extended to all Defined Contribution (DC) pension arrangements. As mentioned in the Minister for Finance's Budget speech, this commitment is being fulfilled in 2011.

Prior to the Finance Act 1999, any person taking a pension under a DC scheme was required to purchase an annuity with the pension fund moneys remaining after the drawdown of the appropriate tax-free lump sum. The Finance Act 1999 introduced significant changes which gave a considerable degree of control, flexibility and personal choice to certain categories of individual, which included the options to purchase an annuity or to invest in an Approved Retirement Fund (ARF) or Approved Minimum Retirement Fund (AMRF), as appropriate.

The option to have all or part of an individual's accumulated pension fund placed in an ARF must be exercised not later than the date on which the annuity or pension would otherwise become payable and is conditional on the individual having a guaranteed pension income for life of at least €12,700 in payment at that time. Where this guaranteed income test is not met, a maximum of €63,500 of the net pension fund (after taking the tax free lump sum), or the whole of the remaining fund, if less, must be either invested in an AMRF or used to purchase an annuity.

Where the AMRF route is taken the capital invested in the AMRF cannot be used by the individual until he or she reaches 75 (or dies) whereupon the AMRF automatically becomes an ARF. Up to now, the fact that the owner of an AMRF was able to meet the guaranteed income requirement after retirement was of no consequence – if the test was not met at the point of retirement the AMRF route had to be taken and the capital was "locked in" until age 75.

In the context of extending the flexible options, the Minister indicated the following changes to the legislation and transitional arrangements:

- The AMRF option is being retained but the "set-aside" requirement will now be the lesser of 10 times the maximum rate of State Pension (Contributory) – about €120,000 – or the remainder of the pension fund after taking the tax-free lump sum, as compared with €63,500 at present.

- The specified or guaranteed income limit of €12,700 per annum is being increased to 1.5 times the maximum rate of the State Pension (Contributory) bringing the "specified income" limit to close on €18,000 per annum.

- The guaranteed income requirement, if not satisfied at the time of retirement may be satisfied at any time after retirement, at which point the Approved Minimum Retirement Fund (AMRF) becomes an ARF.

- As a transitional measure, the current guaranteed income requirement of €12,700 per annum will continue to apply for a 3 year period in the case of individuals who have already retired. If they satisfy the existing requirement within 3 years (of the 2011 Finance Bill becoming law) their AMRF becomes an ARF. After this 3 year period, the new higher guaranteed income test referred to above will have to be satisfied.

The deferral of annuity purchase arrangements for members of occupational DC schemes which is operated administratively by the Revenue Commissioners is being extended pending these changes being signed into law.

Full details of the above will be reflected in the Finance Bill.