Standard Life

Pension Post

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For financial advisers only

How the Pension Threshold limit system works

For this issue of Pension Post, Tony Gilhawley of Technical Guidance Ltd explains how the pension threshold limit system works and outlines some measures that can be taken to reduce potential exposure to chargeable excess tax or to pay the tax more efficiently.

Overview

- A Standard Fund Threshold of €2m applies (since 1 January 2014)
- Those who held higher benefits in the past may have a Personal Fund Threshold (PFT):

Date	Personal Fund Threshold
7 December 2005	€5m
6 December 2010	Between €2.3m and €5.4m
1 January 2014	Between €2m and €2.3m

- DB pensions are valued as a notional capital sum of 20 x the annual pension accrued before 1 January 2014 and using an age related factor varying between 22 and 37 for any part of the DB pension accrued after 1 January 2014
- Where a DB scheme retiree has an option to commute part of their DB pension for a lump sum at retirement, the full DB pre-commutation pension is valued as above, even if part of the pension is in fact commuted for a lump sum
- There are two circumstances where retirement benefits encashed do not count towards the Threshold limit, so, they're ignored:
    - AVCs encashed under the early access scheme between 27 March 2013 and 27 March 2016;
    - Private retirement benefits fully encashed under s787TA TCA 1997 by public servants who have dual private and public service benefits.

Overview continued

- Those who have crystallised total retirement benefits since 7 December 2005 of more than the relevant Threshold limit have a chargeable excess tax liability, currently 40% of the excess over the Threshold limit.
- This chargeable excess tax is reduced by any standard rate tax deducted from pension lump sums since 1 January 2011, and not previously offset against a chargeable excess tax liability.
- The residual chargeable excess tax liability is usually recovered by the administrator of the relevant arrangement reducing the retirement benefits accordingly. Another option is to make a gross transfer from an ARF or vested PRSA held by the retiree to reimburse the administrator.
- Where a chargeable excess tax liability arises in respect of public service retirement benefits, it can be paid by a reduction in gross public service pension over a period of up to 20 years, with no interest added and no recovery of outstanding tax on death within this period.

Example 1 - DC benefits

A proprietary director matures a SSAS at €2,146,000 in 2018 and takes €500,000 as a lump sum, of which €200,000 is tax free and €300,000 liable to standard rate tax. They transfer the balance of the SSAS to an AMRF/ARF. They don't have a PFT.

SSAS matured at	**€2,146,000**
Less SFT	€2,000,000
Chargeable excess	€146,000
Chargeable Excess Tax @ 40%	€58,400
Less credit for standard rate tax deducted from lump sum	-€60,000
Chargeable excess tax due	**Nil**

So in this case, even though the client matures benefits some €146,000 over the SFT, they don't have a chargeable excess tax liability.

If the maximum €60,000 standard rate tax credit is available for offset against a chargeable excess tax liability, then in reality the SFT is €2,150,000 and PFT is really the PFT amount + €150,000.

Example 2 - DC benefits

If the client above had instead matured a SSAS of €2.6m, took the maximum €500,000 lump sum, and transferred the balance to an AMRF/ARF, the revised chargeable excess tax calculation would be:

SSAS matured at	**€2,600,000**
Less SFT	€2,000,000
Chargeable excess	€600,000
Chargeable Excess Tax @ 40%	€240,000
Less credit for standard rate tax deducted from lump sum	-€60,000
Chargeable excess tax due	**€180,000**

This tax liability is payable by the SSAS administrator, who can be reimbursed in one of two ways:

- By the SSAS administrator reducing the transfer to be made to the AMRF/ARF by €180,000; or
- By the retiree making a gross transfer of €180,000 to the administrator from an ARF or vested PRSA he or she already holds.

Example 3 - DB benefits

Let's take an example of a member who retires in June 2018 at age 63 with a private sector DB pension of €110,000 pa, of which some €10,000 pa was accrued since 1 January 2014.

The member has separate DC AVCs related to the same employment of €100,000.

They opt to commute some €8,333 pa of the DB pension for a lump sum of, say, €125,000, leaving a residual DB pension of €101,667 pa; they also take the AVCs as a lump sum so that their total lump sum is €225,000.

They previously matured a PRSA (related to a separate self-employment) at €400,000 in 2015, of which they took €100,000 as a tax free lump sum, and the balance was transferred to an AMRF and ARF. They had a PFT of €2.2m. They took €40,000 from their AVCs in February 2016 under the early access scheme, which was subject to income tax.

In working out whether they have a chargeable excess tax liability in June 2018 note:

- The AVC encashment of €40,000 in February 2016 does not count and so does not eat into their Threshold

Example 3 - DB benefits continued

- The PRSA matured in 2015 at €400,000 eats into their PFT so that they only have €1.8m of their PFT left to offset against their DB and AVC benefits taken in June 2018
- Their June 2018 lump sum will be taxed as:
  - €100,000 tax free (because they already used €100,000 of their €200,000 limit when they matured their PRSA in 2015); and
  - €125,000 taxed at standard rate, so €25,000 will be deducted.
- The DB pension is valued ignoring the fact that they actually commuted some of it for a lump sum. It's valued at:
  - €100,000 (the part accrued at 1January 2014) x 20 = €2,000,000
  - €10,000 (the part accrued since 1January 2014) x 27[1] = €270,000
- The DC AVCs taken in June 2018 are valued at their value taken (€100,000).

Total valued crystallised in June 2018 €2,270,000 (DB pension) + €100,000 (AVCs))	**€2,370,000**
Less remaining PFT	€1,800,000
Chargeable excess	€570,000
Chargeable Excess Tax @ 40%	€228,000
Less credit for standard rate tax deducted from lump sum	-€25,000
Chargeable excess tax	**€203,000**

The member's options for paying this €203,000 chargeable excess tax liability are:

- The DB scheme trustees may seek to recover it from the member's €225,000 lump sum; this would not be very tax efficient for the member as it would be recovered from 'net' funds (tax free or funds subject to standard rate tax).

OR

- The DB scheme trustees may allow the member to pay it by commuting sufficient pension equal to a value of €203,000; for example, if the normal commutation terms in the scheme were 15:1, the member may be able to give up some €203,000/15 = €13,533 pa of their pension (in addition to the part already commuted to provide their lump sum) to reimburse the scheme administrator. This is more tax efficient as the member gives up gross pension to pay for the tax, rather than tax free lump sum or lump sum subject to standard rate tax only. But the member is still commuting DB pension for cash at a poor rate.

[1] = The factor for age 63

OR

- The member instructs the QFM of their ARF (which arose from the PRSA maturity in 2015) to pay €203,000 gross (assuming its value is at least that) to the DB scheme administrator.

Planning tips

- **For those with DC benefits, stop funding early or target future contributions to plan to mature the DC benefits at just under the available Threshold.**

  For example, take someone aged 50. Assuming an effective SFT of €2,150,000 and a future investment return of 3% pa after charges, this table shows when the current DC fund, at different values, will hit a future value of €2,150,000, **assuming no further contributions are made**:

Current DC Fund	Fund will reach €2.15m at age	Projected DC Fund at 60	Projected remaining available Threshold at 60
€500,000	99.3	€671,958	€1,478,042
€600,000	93.2	€806,350	€1,343,650
€700,000	88.0	€940,741	€1,209,259
€800,000	83.4	€1,075,133	€1,074,867
€900,000	79.5	€1,209,525	€940,475
€1,000,000	75.9	€1,343,916	€806,084
€1,100,000	72.7	€1,478,308	€671,692
€1,200,000	69.7	€1,612,700	€537,300
€1,300,000	67.0	€1,747,091	€402,909
€1,400,000	64.5	€1,881,483	€268,517
€1,500,000	62.2	€2,015,875	€134,125
€1,600,000	60.0	**€2,150,266**	€0
€1,700,000	57.9	**€2,284,658**	€0
€1,800,000	56.0	**€2,419,049**	€0
€1,900,000	54.2	**€2,553,441**	€0

Planning tips continued

If your client has a current fund of €1.6m or more, they should stop funding now, as on the assumed investment return of 3% pa after charges, the current fund will grow to over the effective Threshold limit by age 60.

If your client has an existing DC fund of, say, €1m currently and wants to take their DC benefits at 60, just at the Threshold level, they should only make future contributions to produce an additional €806,084 DC fund at age 60. Using the same investment assumption of 3% pa after charges, the estimated future contribution required to produce this additional €806,074 fund at age 60 is about €60,000, increasing by 3% pa, or a level contribution of some €68,000 pa.

- **Consider taking benefits on early retirement (if possible and subject to Revenue restrictions), before benefit values go through the available Threshold limit.**

  Remember ARFs can roll up tax free and aren't subject to the imputed distribution until the year your client reaches 61, so there is no loss of gross roll up to age 61.

- **Individuals with a mix of private DC and public sector DB benefits, for example, HSE Consultants, who are likely to have a chargeable excess tax liability, may be better off taking their private DC benefits first and then the public DB benefits last.**

  In this way, they can ensure the chargeable excess tax liability turns up on their public service benefits where it can be paid in instalments by way of a deduction from gross pension over 20 years, and with no recovery of outstanding tax on early death. Also on death the full spouse's death in retirement pension is payable.

- **Individuals with a mix of private and public sector benefits can potentially eliminate a prospective chargeable excess tax liability by encashing part or all of their private benefits under S787TA TCA 1997 after age 60 but before taking their public sector benefits**: the amount encashed does not count towards their available Threshold limit, and so the individual can encash enough to bring their remaining benefits to the Threshold level,

- **Individuals with a mix of private sector DB and DC benefits who are likely to have a chargeable excess tax liability, may be better off allowing the tax to turn up on their DC benefits**, as that way the tax will be taken from gross funds; if the tax liability turns up on their DB benefits, the individual runs the risk that the administrator will attempt to recover the tax in the first instance from the individual's lump sum, that is from net funds, or by encashing DB pension at poor commercial terms.