Standard Life

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For financial advisers only

Those who work in the public service and also have substantial private pension benefits which when combined cause a prospective chargeable excess tax charge at retirement, can use a little known option called the Encashment Option, to surrender part or all of their private benefits in advance of retirement and wipe out their potential chargeable excess tax charge.

Tony Gilhawley of Technical Guidance Ltd, looks at who can use this option, how it works, and how it stacks up with other ways of dealing with a potential chargeable excess tax charge arising on a mix of public and private sector retirement benefits.

The public service encashment option

An individual can use the Encashment Option (provided for in Section 787TA TCA 1997) on a once off basis if they:

- are currently employed in the public service and so have not yet drawn their public service benefits;
- are over age 60 (or earlier on ill health retirement); and
- have private pension benefits (crystallised and uncrystallised) which when combined with public service benefits would give rise to a chargeable excess at retirement over the relevant Threshold (Standard or Personal).

The most likely potential users of the encashment options are:

- HSE hospital consultants employed who also have private practice income and hence have a mix of public and private sector retirement benefits;
- members of the judiciary who hold or previously encashed private retirement benefits; and
- higher paid individuals in the civil service or other public service bodies who accrued significant private retirement benefits before they joined the public service.

How much can be encashed?

An individual entitled to exercise the option can't choose the amount to encash. The legislation defines the amount which must be encashed, if the option is used. There are two types of encashment:

- **Total,** where all of the private pension benefits are encashed. This occurs where the public service benefits on their own are likely to exceed the Threshold amount and hence all of the private pension benefits will be chargeable excess

Example 1

Joe has prospective public service benefits of €2.3m and private benefits of €500,000, i.e. total benefits of €2.8m. He has a Personal Fund Threshold (PFT) of €2.3m. The prospective chargeable excess tax liability is assumed to be 40% x €500,000 less €60,000 (standard rate lump sum tax credit) = €140,000.

In this case ALL of the private benefits, i.e. €500,000 must be encashed if the option is exercised by Joe. The encashment will reduce his prospective chargeable excess to nil.

- **Partial,** where the public sector benefits on their own are likely to be under the Threshold, but the addition of the private benefits brings the individual over the Threshold. The part of the private benefits which bring the individual over the Threshold is the amount which must be encashed, if the option is exercised.

Example 1

Joe has prospective public service benefits of €2m and private benefits of €500,000, i.e. total benefits of €2.5m. He has a PFT of €2.3m.

In this case only €200,000 of the private benefits can be encashed, that is, the part of his private benefits which would bring Joe over the Threshold. By exercising the encashment option, he reduced his prospective chargeable excess to nil.

Why encash?

The benefit of using the Encashment Option is that the amount encashed is not treated as a benefit crystallisation even (BCE) for the purposes of the Threshold limit. In effect the amount encashed drops out of the Threshold system and this will reduce or eliminate the prospective chargeable excess tax liability.

Using the option can wipe out the chargeable excess caused by private benefits; it can never be used to wipe out a chargeable excess caused by public service benefits on their own.

The amount encashed is subject to a fixed ring fenced income tax charge at higher rate, currently 40%, and a fixed USC charge of 2% (in 2018). The amount encashed is not subject to PRSI, so that in 2018 the charge for encashing is 42%.

Comparing the two options

Let's take Example 2 above again:

- Private benefits : €500,000
- Public Service benefits: €2,300,000
- Personal Fund Threshold: €2,300,000
- Prospective chargeable excess tax : 40% x €500,000 less €60,000[1] = €140,000

Joe has two main options in this case to deal with the chargeable excess tax problem:

A. Use the Encashment Option over the private benefits before he retires from the public service; this reduces his projected chargeable excess to nil

or

B. Mature the private benefits first, and then the public service benefits, and pay the resulting chargeable excess tax of €140,000 by way of a reduction of €7,000 pa in his gross pension for 20 years, or until death if earlier.

To compare the options we have to work out the **net cost** to him of using each option.

Net cost of using the Encashment Option

Joe could mature the €500,000 of private benefits in the normal way or by way of the Encashment Option. Let's look at the **net benefit** to him of both ways of maturing the €500,000 of private benefits

Mature in the normal manner (chargeable excess tax will be paid by 20 yearly reductions in gross public service pension)	**Mature under Encashment Option**
Net private benefits value: €500,000 x 25% x (1 – 20%[2]) + €500,000 x 75% x (1 – 40% - 8%[3]) = **€295,000**	Net private benefits value: €500,000 x (1 – 40% - 2%) = **€290,000**

[1] Assumes he will take €500,000 of pension lump sums.

[2] Assumed the public service gratuity will fully use up his €200,000 tax free lump sum limit and so the 25% of private benefits lump sum will attract 20% tax.

[3] Assumed that taxable ARF withdrawals arising from the 75% would be taxed at 40% income tax and 8% USC.

So the net cost to him of using the Encashment Option, as compared to maturing in the normal way, is just **€5,000**.

Net cost of paying by reduction in public service pension

The net cost will be: €7,000 x (1 – 40% - 8%) = **€3,640 pa for up to 20 years.**

Therefore if Joe is likely to survive in his public service retirement by more than about 16 months, the net cost of using the Encashment Option to deal with the Encashment Option is by far the better option for him.

In this case, Joe can effectively wipe out a prospective chargeable excess tax liability of €140,000 at a net cost to him of about €5,000. It's a good deal in this case.

How?

The requirements to use the Encashment Option are as follows:

- first the individual must meet the qualifying conditions outlined at the start, principally be over age 60 (or earlier if ill health retirement) and be an active member of a public service pension arrangement and have a prospective chargeable excess tax charge caused in part or total by private pension benefits;
- The public service benefits will be taken last, after all private benefits have been taken;
- the individual must notify the Revenue Commissioners (and supply certain specified information) at least 3 months before the individual intends to take their public service benefits;
- the individual then issues an irrevocable encashment instruction to the administrator(s) of the relevant private arrangement(s), citing Section 787TA Taxes Consolidation Act 1997.
- the individual must notify Revenue within 7 days of receiving the net encashment amount, setting out a schedule of the encashment amounts and the net amount received.
- The Encashment Option can only be used **once.**

Deemed encashments

In most cases the Encashment Option will be used over private pension benefits which have not yet been drawn on, in other words uncrystallised benefits. However the option can be used in respect of private benefits which have already been crystallised between 7 December 2005 and the 8 February 2012.

Joe has prospective public service benefits of €2.3m. His Personal Fund Threshold is €2.3m. He matured a €500,000 PRSA in 2015 for a tax free lump sum of 25% (€125,000) and transferred €63,500 to an AMRF and €311,500 to an ARF at that time, which he still holds.

So Joe has past BCEs of €500,000 which with his public service benefits now put him over the Threshold.

In this case all of Joe's private benefits must be **deemed** encashed, if he decides to use the s787TA Encashment Option.

The total deemed encashment amount is, in this case, €500,000, which attracts a current encashment tax liability of 42% x €500,000 = €210,000 to be deducted as follows:

- 42% x €63,500, from the AMRF by the QFM holding the AMRF
- 42% x €311,500 from the ARF by the QFM holding the ARF
- 42% x €125,000 (in respect of the tax free lump sum) from either the AMRF or ARF or both. This will usually be taken from the ARF.

The balance in the AMRF/ARF, after deduction of the encashment tax above, is then paid out to the individual as a distribution subject to PAYE, but cannot be used to fund another private pension contribution. The AMRF and ARF ends. So, using the deemed encashment option kills off the AMRF and ARF, which may not be desirable in some cases.

The €125,000 previously taken from the PRSA as a tax free lump sum and now deemed to be encashed, is disregarded for the purposes of the €200,000 limit on pension tax free lump sums, as it has now been taxed at 40% income tax.

In this example, the exercise of the deemed encashment over the PRSA benefits already taken in 2009:

- drops them out of the Threshold system and hence the individual then has the full €2.3m PFT available against his public service benefits he will take.
- open up the full €200,000 pension tax free lump sum to Joe, in respect of the public service benefits he is about to take.

Use with caution

The s787TA Encashment Option is a once off silver bullet which can be used by certain individuals in the public service to deal with part or all of a potential chargeable excess tax charge which may arise in the future from having or previously matured private retirement benefits. It is best to delay using it until close to public service retirement, when there is a clearer view of the prospective chargeable excess tax liability and the amount required to be encashed.

However it should be used with caution, particularly when the client is in bad health with a reduced life expectancy. So it’s horses for courses. You have to look at the figures in each individual case.