Standard Life

Pension Post

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For financial advisers only

PAOs and the Threshold limit

Tony Gilhawley of Technical Guidance Ltd looks at a client who takes retirement benefits subject to a Pensions Adjustment Order may be over the Threshold limit, even if the benefits taken are under the limit.

The PAO never happened

The principle in the legislation is that for Threshold limit purposes, the PAO never happened. You have to suspend reality and assume it was not made.

This means, for example that where a client loses part of his or her fund through a PAO TV paid to their ex, for Threshold limit purposes you treat the client as crystallising the higher notional fund he or she would have had if the TV had never been paid out.

Example 1

A client had a PRSA fund of €2m two years ago, when his ex-wife took a PAO TV of €1m to her own Buy Out Bond, reducing his then PRSA value to €1m. Since then his PRSA has achieved investment growth of +20%, so that his PRSA is now valued at €1.2m. No new contributions were added to the PRSA after the PAO TV was paid out.

If this client crystallises his PRSA of €1.2m today, for Threshold limit purposes he is treated as crystallising a PRSA worth €2m x 1.20 = €2.4m, i.e. what his PRSA would have grown to if the €1m PAO TV was not paid out two years ago.

Two important client advice points emerge from the above example:

- When the client goes to mature their PRSA of €1.2m it initially looks like he is under the Standard Fund Threshold; in fact in this example he is considerably over it, because he will be treated as crystallising €2.4m and not the €1.2m that his PRSA is actually valued at

- When the PAO TV of €1m was paid out 2 years ago and his PRSA value fell to €1m, while he may have thought he then had scope for future pension funding of another €1m to bring him up to the €2m Standard Fund Threshold, in fact he didn't as for Threshold purposes it is assumed the €1m PAO TV was never paid out of his PRSA.
- Take another example, where the PAO is still in force, i.e. no PAO TV has been paid out, when the client crystallises their benefits

Example 2

Take a client who crystallises an SSAS valued at €2.5m subject to a PAO of 60% in favour of his separated wife.

The administrator of the SSAS will pay out in benefits:

- 60% x €2.5m, i.e. €1.5m to the client's wife under the PAO, and
- 40% x €2.5m, i.e. €1m to the client, i.e the balance of the fund after the PAO has been satisfied

However for Threshold limit purposes, this client is assumed to crystallise the full fund of €2.5m, i.e. the PAO is treated as never having happened

The PAO beneficiary

The other side of the coin is that the PAO beneficiary is not treated for Threshold limit purposes as crystallising any benefits when he or she takes benefits under a PAO. So in the two examples above:

- In **Example 1**, when she matures her Buy Out Bond funded by the PAO TV, she is not treated for Threshold limit purposes as crystallising any benefit;
- In **Example 2**, when she gets €1.5m in benefits from the SSAS, she is not treated as crystallising any benefits in the SSAS. The full SSAS fund is treated as being crystallised by the client

Splitting the chargeable excess tax liability

However where a chargeable excess tax liability arises because of treating a PAO as never having happened, the resulting chargeable excess tax liability is split between the two pro rata to the value of retirement benefits each gets.

Lets take **Example 2** where the SSAS fund on retirement was €2.5m; for Threshold limit purposes the client is deemed to crystallise this full fund and assuming he does not have a Personal Fund Threshold the chargeable excess tax arising (before any credit for standard rate tax paid on lump sums) is:

40% x (€2.5m less €2m) = €200,000

The administrator of the SSAS is required to split this tax liability pro rata to the level of retirement benefit each actually gets:

- 40% x €200,000 = €80,000 to the client, to be recovered from his €1m share of the fund he gets; and
- 60% x €200,000 = €120,000 to the client's wife, to be recovered from her €1.5m share of the fund she gets

Each is then allowed against their chargeable excess tax liability a credit for any lump sum tax they may pay on their own lump sum benefits. For lump sums, each are entitled to their own €200,000 tax free lump sum limit, with standard rate tax then applying for the next €300,000 of lump sums.

For example, assuming neither had taken any prior lump sums:

	Client	Client's wife
Fund taken	€1,000,000	€1,500,000
25% lump sum	€250,000	€375,000
Standard rate tax deducted from lump sum	€10,000	€35,000
Chargeable excess tax allocated to each	€80,000	€120,000
Less credit	-€10,000	-€35,000
Chargeable excess tax to be recovered from each retirement fund	**€70,000**	**€85,000**

The PAO TV has already been paid out?

Things get more complicated where, as in **Example 1** earlier, the PAO TV has already been paid out by the time the client crystallises their benefits giving rise to the chargeable excess tax liability.

Example 1
A client had a PRSA fund of €2m two years ago, when his ex-wife took a PAO TV of €1m to her own Buy Out Bond, reducing his then PRSA value to €1m. Since then his PRSA has achieved investment growth of +20%, so that his PRSA is now valued at €1.2m. No new contributions were added to the PRSA after the PAO TV was paid out. If this client crystallises his PRSA of €1.2m today, for Threshold limit purposes he is treated as crystallising a PRSA worth €2m x 1.20 = €2.4m, i.e. what his PRSA would have grown to if the €1m PAO TV was not paid out two years ago.

Let's say this client has no PFT and so a chargeable excess tax liability arises on the maturity of his PRSA as follows:

40% x (€2.4m less €2m) = €160,000

His ex-wife's share of the €2.4m deemed crystallised by the client is taken as the actual TV paid out to her two years ago, i.e. €1m.

Therefore the €160,000 chargeable excess tax liability is split between the two of them as follows:

- (€1m/€2.4m) x €160,000 = €66,667 to the client's ex-wife; and
- (€1.4m/€2.4m) x €160,000 = €93,333 to the client to be recovered from his PRSA (less any standard rate lump sum tax credit)

The €66,667 tax allocated to the clients ex-wife will be recovered from her Buy Out Bond on the earlier of:

- she takes a TV from the BOB to another arrangement and
- she takes her benefits from the BOB

So the recovery is not taken immediately; it is suspended until she does something with the BOB, either transfer out or matures it.

Nasty surprise for PAO beneficiary

You can see from the above **Examples 1 and 2** that:

- a chargeable excess tax charge could arise for her from her husband's actions many years down the line over which she has no control, e.g. the order in which he matures his retirement benefits, growth on his funds, when he takes his benefits, etc.
- she could mature benefits which appear to be substantially under the Threshold limit, e.g. her €1m BOB, and yet a chargeable excess tax liability could be recovered from the maturity proceeds

Things can get even more complicated

Even more complex scenarios can arise. Let's assume in **Example 1** that after the PAO TV of €1m was paid out reducing the clients PRSA value to €1m, he then transferred his PRSA valued at €1m to a new PRSA 2 which earned a return of +40% over the following two years (no new contributions were added), so that he matured PRSA 2 at €1.4m. PRSA 2 therefore has no PAO over it when he matures it.

For the purpose of the Threshold limits:

- we have to go back and assume the PAO over the first PRSA never happened;
- this means we have to assume the PAO TV of €1m was not paid out two years ago from the client's first PRSA and so the TV paid to PRSA 2 by the client is assumed to be €2m and not the €1m actually transferred;
- we therefore have to assume PRSA 2 is matured at €2m x 1.40 = €2.8m, giving rise to, say a chargeable excess tax liability of €320,000;
- The client's ex-wife is assumed to take €1m (the original PAO TV paid out to her under the client's first PRSA) of this notional maturity value so that the chargeable excess tax liability of €320,000 is split between the two of them as follows:
  - (€1m/€2.8m) x €320,000 = €114,286 to be recovered from her BOB when she matures it or transfers it on; and
  - (€1.8m/€2.8m) x €320,000 = €205,714 to be recovered from his PRSA 2

Advice

It's clear from the above that both the client whose benefits are or were subject to a PAO and the PAO beneficiary who benefitted from or will benefit from a PAO both need advice. Both, if the retirement benefits are substantial, could be in for a nasty chargeable excess tax surprise down the line.

In particular, clients whose benefits have been reduced by a PAO TV in the past should realise that their future funding scope before they hit the Threshold limit may be much less than they think from their current fund values.