

## Pension Post

September 2019

For financial advisers only

### Taxation of retirement income

In this issue of Pension Post, Tony Gilhawley, Technical Guidance Ltd, observes that because of various tax breaks given to retirees and a highly progressive taxation system, most retirees are likely to pay a low effective tax rate on their private pension income, much lower than the higher rate of income tax.

#### Tax benefits for the over 65's

A number of income tax breaks kick in when a client reaches 65:

- An income tax credit of €245; this is doubled to €490 for a married couple who are jointly or separately assessed for income tax. The credit applies from the year the individual or their spouse reach age 65.
- The income tax exemption limits provide a complete exemption from income tax for those aged 65 or over where their total taxable income (including the State Pension) is less than €18,000 for a single person or €36,000 for a married couple who are jointly or separately assessed for income tax.
- This table shows the maximum level of additional income, such as gross ARF withdrawals, a retiree can have and pay no income tax at all on such income:

|   | Single person | Married one State Pension | Married two State Pensions |
|---|---------------|---------------------------|----------------------------|
| Income tax exemption limit                                    | €18,000 pa    | €36,000 pa                | €36,000 pa                 |
| State Pension (Contributory) (current rate)                   | €12,956 pa    | €12,956 pa                | €25,912 pa                 |
| Available exemption limit for tax free private pension income | <b>€5,044</b> | <b>€23,044</b>            | <b>€10,088</b>             |

Other tax benefits which currently apply to retirees over 65 include:

- PRSI liability on ARF withdrawals ceases at the State Pension Age
- The State Pension when it becomes payable (66 currently but increasing to 67 in 2021 and 68 in 2028) is not liable to USC. This therefore leaves the full €13,000 USC exemption limit available to the retiree for ARF withdrawals
- A reduced 2% maximum rate of USC applies to retirees from age 70 onwards where their taxable income (excluding the State Pension) is less than €60,000. So the vast majority of retirees will pay USC at a maximum rate of 2% on their ARF withdrawals from 70 onwards
- The full Employee Tax Credit (€1,650 max) is provided in respect of the State Pension, even though the State Pension is not paid under PAYE. This means those with other taxable income, say ARF withdrawals, of less than €8,250 still get the full €1,650 tax credit

### Example

Let's take an example of a client who retires at 65 and starts drawing on their ARF immediately at the required minimum rate, i.e. 4% pa up to age 70 increasing to 5% pa from 71 onwards.

For simplicity sake let's assume:

- The ARF earns a zero return after charges
- The retiree is married, subject to joint assessment, and their spouse has no income
- The income tax exemption limit continues at its current level of €36,000
- The retiree will qualify at age 67 for the current maximum personal rate of State Pension (Contributory) with no Qualified Adult increase
- Current income tax bands, credits and rates will apply
- Current USC bands and rates
- Current PRSI rate of 4% on the ARF withdrawals ceasing at age 67 (the State Pension Age for this client)
- The client has no other income apart from the State Pension and the ARF withdrawal

This table shows the gross income, taxes on the ARF withdrawal and the effective tax rate on ARF withdrawals from age 65 to 75, based on an initial ARF size of €300,000:

| <b>Initial ARF size €300,000</b>      |                |                |                |                |                |                |                |                |                |                |                |
|---------------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| ARF                                   | €300,000       | €288,000       | €276,480       | €265,421       | €254,804       | €244,612       | €234,827       | €223,086       | €211,932       | €201,335       | €191,268       |
| Age                                   | 65             | 66             | 67             | 68             | 69             | 70             | 71             | 72             | 73             | 74             | 75             |
| State Pension                         | €0             | €0             | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        |
| ARF withdrawal                        | €12,000        | €11,520        | €11,059        | €10,617        | €10,192        | €9,784         | €11,741        | €11,154        | €10,597        | €10,067        | €9,563         |
| <b>Total gross income</b>             | <b>€12,000</b> | <b>€11,520</b> | <b>€24,015</b> | <b>€23,573</b> | <b>€23,148</b> | <b>€22,740</b> | <b>€24,697</b> | <b>€24,110</b> | <b>€23,553</b> | <b>€23,023</b> | <b>€22,519</b> |
| Income tax                            | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             |
| USC                                   | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             |
| PRSI                                  | €480           | €461           | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             |
| <b>Total taxes</b>                    | <b>€480</b>    | <b>€461</b>    | <b>€0</b>      | <b>€0</b>      | <b>€0</b>      | <b>€0</b>      | <b>€0</b>      | <b>€0</b>      | <b>€0</b>      | <b>€0</b>      | <b>€0</b>      |
| Effective tax rate on ARF withdrawals | 4.0%           | 4.0%           | 0.0%           | 0.0%           | 0.0%           | 0.0%           | 0.0%           | 0.0%           | 0.0%           | 0.0%           | 0.0%           |
| <b>Net income</b>                     | <b>€11,520</b> | <b>€11,059</b> | <b>€24,015</b> | <b>€23,573</b> | <b>€23,148</b> | <b>€22,740</b> | <b>€24,697</b> | <b>€24,110</b> | <b>€23,553</b> | <b>€23,023</b> | <b>€22,519</b> |

You can see that apart from PRSI on ARF withdrawals up to age 67, the retiree's ARF withdrawal income is completely tax free in retirement, based on the assumptions stated above, as his gross ARF withdrawals at all times falls within the income tax and USC exemption limits.

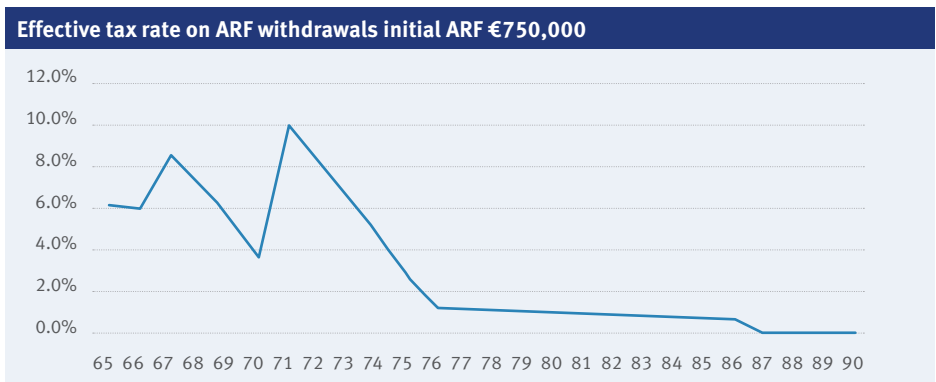
Of course a larger ARF size of €750,000 will produce higher taxes but the effective tax rate on the ARF withdrawals is still very low:

| Initial ARF size €750,000             |                |                |                |                |                |                |                |                |                |                |                |
|---------------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| ARF                                   | €750,000       | €720,000       | €691,200       | €663,552       | €637,010       | €611,530       | €587,068       | €557,715       | €529,829       | €503,338       | €478,171       |
| Age                                   | 65             | 66             | 67             | 68             | 69             | 70             | 71             | 72             | 73             | 74             | 75             |
| State Pension                         | €0             | €0             | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        |
| ARF withdrawal                        | €30,000        | €28,800        | €27,648        | €26,542        | €25,480        | €24,461        | €23,353        | €27,886        | €26,491        | €25,167        | €23,909        |
| <b>Total gross income</b>             | <b>€30,000</b> | <b>€28,800</b> | <b>€40,604</b> | <b>€39,498</b> | <b>€38,436</b> | <b>€37,417</b> | <b>€42,309</b> | <b>€40,842</b> | <b>€39,447</b> | <b>€38,123</b> | <b>€36,865</b> |
| Income tax                            | €0             | €0             | €1,842         | €1,399         | €975           | €567           | €2,524         | €1,937         | €1,379         | €849           | €346           |
| USC                                   | €622           | €574           | €528           | €484           | €442           | €309           | €407           | €378           | €350           | €323           | €298           |
| PRSI                                  | €1,200         | €1,152         | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             |
| <b>Total taxes</b>                    | <b>€1,822</b>  | <b>€1,726</b>  | <b>€2,370</b>  | <b>€1,883</b>  | <b>€1,416</b>  | <b>€876</b>    | <b>€2,931</b>  | <b>€2,314</b>  | <b>€1,729</b>  | <b>€1,172</b>  | <b>€644</b>    |
| Effective tax rate on ARF withdrawals | 6.1%           | 6.0%           | 8.6%           | 7.1%           | 5.6%           | 3.6%           | 10.0%          | 8.3%           | 6.5%           | 4.7%           | 2.7%           |
| <b>Net income</b>                     | <b>€28,178</b> | <b>€27,074</b> | <b>€38,234</b> | <b>€37,615</b> | <b>€37,020</b> | <b>€36,541</b> | <b>€39,379</b> | <b>€38,528</b> | <b>€37,719</b> | <b>€36,951</b> | <b>€36,221</b> |

The effective tax rate on the ARF withdrawals jumps at 67 when the State Pension starts as the State Pension then eats up some of the available standard rate tax band leaving less for the ARF withdrawals. It also jumps at age 71 when the 5% ARF withdrawal rate kicks in.

However the effective tax rate of ARF withdrawals is still very low, in single digits at almost all ages.

As the assumed level of ARF withdrawals decline from age 71 then assuming no change in the State Pension and tax limits, the effective tax rate on the ARF withdrawal will fall as time goes by:

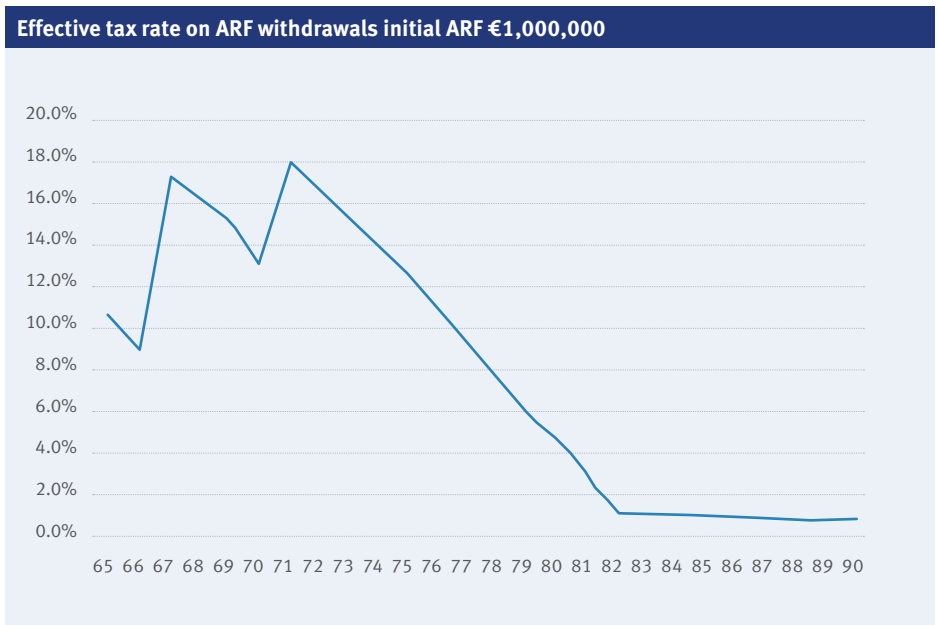


#### 4 Taxation of retirement income

Even a €1,000,000 ARF has a very low effective tax rate on withdrawals, based on the stated assumptions:

| Initial ARF size €1,000,000           |                |                |                |                |                |                |                |                |                |                |                |
|---------------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| ARF                                   | €1,000,000     | €960,000       | €921,600       | €884,736       | €849,347       | €815,373       | €782,758       | €743,620       | €706,439       | €671,117       | €637,561       |
| Age                                   | 65             | 66             | 67             | 68             | 69             | 70             | 71             | 72             | 73             | 74             | 75             |
| State Pension                         | €0             | €0             | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        | €12,956        |
| ARF withdrawal                        | €40,000        | €38,400        | €36,864        | €35,389        | €33,974        | €32,615        | €39,138        | €37,181        | €35,322        | €33,556        | €31,878        |
| <b>Total gross income</b>             | <b>€40,000</b> | <b>€38,400</b> | <b>€49,820</b> | <b>€48,345</b> | <b>€46,930</b> | <b>€45,571</b> | <b>€52,094</b> | <b>€50,137</b> | <b>€48,278</b> | <b>€46,512</b> | <b>€44,834</b> |
| Income tax                            | €1,600         | €960           | €5,528         | €4,938         | €4,372         | €3,828         | €6,438         | €5,655         | €4,911         | €4,205         | €3,534         |
| USC                                   | €1,022         | €958           | €897           | €838           | €781           | €472           | €603           | €563           | €526           | €491           | €457           |
| PRSI                                  | €1,600         | €1,536         | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             |
| <b>Total taxes</b>                    | <b>€4,222</b>  | <b>€3,454</b>  | <b>€6,425</b>  | <b>€5,776</b>  | <b>€5,153</b>  | <b>€4,300</b>  | <b>€7,040</b>  | <b>€6,218</b>  | <b>€5,437</b>  | <b>€4,696</b>  | <b>€3,991</b>  |
| Effective tax rate on ARF withdrawals | 10.6%          | 9.0%           | 17.4%          | 16.3%          | 15.2%          | 13.2%          | 18.0%          | 16.7%          | 15.4%          | 14.0%          | 12.5%          |
| <b>Net income</b>                     | <b>€35,778</b> | <b>€34,946</b> | <b>€43,395</b> | <b>€42,569</b> | <b>€41,777</b> | <b>€41,270</b> | <b>€45,054</b> | <b>€43,919</b> | <b>€42,841</b> | <b>€41,816</b> | <b>€40,843</b> |

Again the effective tax rate falls from age 71 onwards as the assumed gross ARF withdrawal falls:



## Warning ... there are many variables and assumptions

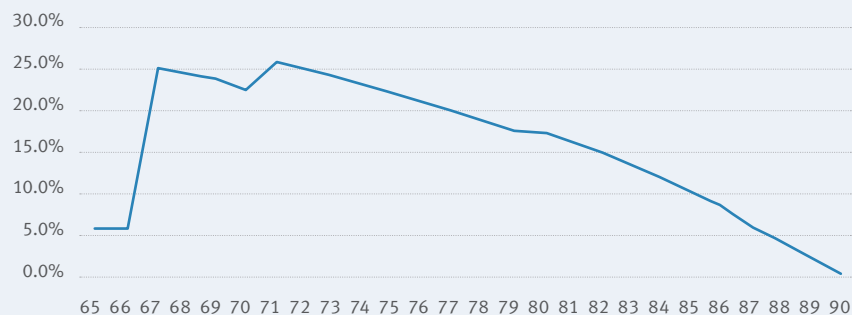
There are many variables and assumptions in the projections above. Changing these variables and assumptions can give rise to higher effective tax rates than illustrated above.

For example, let's assume that the retiree in addition to qualifying for the maximum personal rate of State Pension (Contributory) also gets the maximum personal rate of Qualified Adult increase in respect of his or her spouse, currently €11,610 pa. This will eat up more of the standard rate band and income tax exemption limit and hence increase the effective tax rate on the ARF withdrawals.

Let's take the same €750,000 ARF example as before but this time assume the State Pension income will be **€12,956 + €11,610 = €24,566 pa:**

| Initial ARF size €750,000             |                |                |                |                |                |                |                |                |                |                |                |
|---------------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| ARF                                   | €750,000       | €720,000       | €691,200       | €663,552       | €637,010       | €611,530       | €587,068       | €557,715       | €529,829       | €503,338       | €478,171       |
| Age                                   | 65             | 66             | 67             | 68             | 69             | 70             | 71             | 72             | 73             | 74             | 75             |
| State Pension                         | €0             | €0             | €24,566        | €24,566        | €24,566        | €24,566        | €24,566        | €24,566        | €24,566        | €24,566        | €24,566        |
| ARF withdrawal                        | €30,000        | €28,800        | €27,648        | €26,542        | €25,480        | €24,461        | €23,353        | €22,886        | €26,491        | €25,167        | €23,909        |
| <b>Total gross income</b>             | <b>€30,000</b> | <b>€28,800</b> | <b>€52,214</b> | <b>€51,108</b> | <b>€50,046</b> | <b>€49,027</b> | <b>€53,919</b> | <b>€52,452</b> | <b>€51,057</b> | <b>€49,733</b> | <b>€48,475</b> |
| Income tax                            | €0             | €0             | €6,486         | €6,043         | €5,619         | €5,211         | €7,168         | €6,581         | €6,023         | €5,493         | €4,990         |
| USC                                   | €622           | €574           | €528           | €484           | €442           | €309           | €407           | €378           | €350           | €323           | €298           |
| PRSI                                  | €1,200         | €1,152         | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             | €0             |
| <b>Total taxes</b>                    | <b>€1,822</b>  | <b>€1,726</b>  | <b>€7,014</b>  | <b>€6,527</b>  | <b>€6,060</b>  | <b>€5,520</b>  | <b>€7,575</b>  | <b>€6,958</b>  | <b>€6,373</b>  | <b>€5,816</b>  | <b>€5,288</b>  |
| Effective tax rate on ARF withdrawals | 6.1%           | 6.0%           | 25.4%          | 24.6%          | 23.8%          | 22.6%          | 25.8%          | 25.0%          | 24.1%          | 23.1%          | 22.1%          |
| <b>Net income</b>                     | <b>€28,178</b> | <b>€27,074</b> | <b>€45,200</b> | <b>€44,581</b> | <b>€43,986</b> | <b>€43,507</b> | <b>€46,345</b> | <b>€45,494</b> | <b>€44,685</b> | <b>€43,917</b> | <b>€43,187</b> |

### Effective tax rate on ARF withdrawals initial ARF €750,000



## 6 Taxation of retirement income

The effective tax rate is higher than the previous €750,000 ARF example where the retiree only had the personal rate State Pension, but overall the effective tax rate is still low and reaches a peak of about 25% at age 71 and falls thereafter.

The same effect would arise where the retiree had additional taxable income such as rental and investment income.

## **Conclusion**

Most retirees whose only income arises from ARF withdrawals and the State Pension are likely in retirement to pay a declining rate of tax on their ARF withdrawals considerably lower than the higher rate of income tax.

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