

Budget 2006

December 2005 Issue 2

There have been significant changes made in Minister Cowen's December 2006 budget in respect of pensions. We have highlighted below the main issues affecting pension provision in Ireland and posed some questions as to how the changes will work in practice.

The principal changes are:

- **An individual will be restricted to a maximum fund at retirement in respect of all his or her pension arrangements, which will gain full tax relief**
- **The maximum tax - free lump sum which may be taken at retirement will be limited**
- **Holders of Approved Retirement Funds will be deemed to take income each year which will incur a tax charge**
- **Maximum personal contribution limits will be indexed in line with an earnings growth index.**

Summary of our overall view on the changes

The Minister pointed out that it was important that pension contributions were incentivised so that an ageing population could be supported. The reliefs already afforded to pension provision are substantial - €3billion by way of tax reliefs and a further 1% of GNP each year paid towards the National Pensions Reserve Fund. This budget is the first move by the government to contain the reliefs afforded to pensions. Further provisions will be contained in the Finance Bill that will attempt to encourage the lower paid and those who are not currently availing of their full entitlements to tax relief on pension contributions to save more for their retirement.

We await the government response to the report of the Pensions Board on the National Pensions Review to see what further changes will be implemented to encourage pension saving. Changes in the budget suggest that the aim of the government is to encourage people to increase their pension savings, while at the same time restricting the ability of the very wealthy to benefit from generous tax reliefs.

Whilst it would seem that the restrictions introduced in the budget will only affect a small minority of highly paid individuals, this depends on how the changes are applied in practice, and these details are not yet available. We will be pleased to advise individuals who may be impacted by the new limits (and their employers) on how to deal with these issues once the details become clear.

Maximum Retirement Fund

The maximum allowable pension fund on retirement for tax purposes will be €5 million or, if higher, the value of the fund on 7 December 2005. Both sums will be adjusted annually from the tax year 2007 in line with an earnings index. Where a fund exceeds the relevant limit, the excess in the pension fund will be liable to a once-off income tax charge at the 42% rate when it is drawn down, so as to recover the excess tax relief granted.

The Summary issued by the Department of Finance states that "The relevant maximum will apply to the aggregate value of all pension provision held by an individual". This would appear to encompass benefits from occupational pension schemes, both defined contribution and defined benefit, as well as retirement annuity contracts and PRSAs. In the case of a member of a defined benefit scheme, the basis on which his or her benefits are valued will be crucial to whether or not he or she falls within the €5m limit. If current annuity costs had to be used, an individual retiring at age 60 with a pension of €150,000 per annum, with CPI indexation and 50% spouse's pension would be at the €5m limit. If increases were guaranteed at a higher level e.g. in line with earnings increases as for public sector employees, a higher value should apply. The tax charge on excess funds is described as a once-off charge at retirement. Hence any increase in value post retirement (due to, say, discretionary pension increases) would presumably not give rise to any additional tax charge. There would not appear to be any bar on an individual continuing to fund for pension even after the €5m limit has been

reached, and for this fund to continue to grow tax-free, as the excess will be taxed at retirement. However, there may be little advantage in this and those close to the limit may look for more tax efficient and flexible ways to save for retirement. For a defined contribution arrangement (including RACs and PRSAs) where the fund value at retirement exceeds €5m, the tax charge must be paid at that point. Presumably the Finance Bill will provide for this tax charge to be paid directly from the excess fund i.e. the member does not have to pay the tax from the tax free lump sum they receive on retirement. There will be some administrative complexity in a defined benefit plan where the trustees pay the member's pension from the plan's assets as the member's pension entitlement will be reduced to reflect the tax charge paid from the fund's assets.

There would be some logic to extending the ARF option to members of occupational schemes (both defined benefit and defined contribution) in respect of benefits in excess of the maximum allowable fund on retirement as this would simplify some of the administrative difficulties outlined above.

As the value at 7 December 2005 is taken as the maximum allowable value if it exceeds €5m, it is important that individuals with current values above €5m obtain formal documentation of the value at that date.

Tax free lump sums

Where existing lower limits do not apply, the maximum lump sum which may be taken tax free at retirement on or after 7 December 2005 will be €1.25 million, being 25% of the new maximum fund amount of €5 million. The balance of any lump sum taken which is greater than this amount will be taxed at the marginal rate as income. The restriction applies to a single lump sum or, where more than one lump sum is drawn down, the aggregate value of those lump sums.

Although there is no specific reference in the Summary issued by the Department of Finance to this monetary limit being indexed, the fact that it is explicitly expressed as 25% of the maximum allowable fund, which will itself be indexed, gives some comfort that it will. This will no doubt be clarified in the Finance Bill, if not before.

For occupational pension schemes, the maximum tax free lump sum at normal retirement after at least 20 years' service is 1.5 times final remuneration i.e. the new limit would only affect anybody earning in excess of €833,333. However, if the maximum were not to be indexed over time this would become an issue for middle salary earners.

Approved Retirement Funds (ARFs)

The ability to use an ARF as a vehicle to limit inheritance tax liability has also been restricted. ARFs are available for funds arising from AVCs, Personal Pensions and Proprietary Directors. ARFs are funds which roll up gross meaning there is no income or capital gains tax within the fund. Up until now there was no requirement to draw income from the fund which gave the beneficiary the ability to control their taxable income in retirement, and for many high net worth individuals who did not require income, the funds could be left intact to benefit from the favourable tax treatment on death. In future, an annual 3% drawdown will be deemed to have applied to the value of assets in an ARF at 31 December each year and will be taxable. This will be phased in over three years from 2007, at 1% in 2007, 2% in 2008 and 3% from 2009 onwards. Any actual distributions from the ARF during the year will be deducted from this figure for that year and any net amount will be taxed at the individual's marginal income tax rate. The charge will apply to ARFs created on or after 6 April 2000. This deemed income drawdown will not apply in the case of Approved Minimum Retirement Funds.

Individuals who have not to date drawn income from their ARF may choose in future to draw the amount which would eliminate the deemed tax charge i.e. 1% in 2007, 2% in 2008 and 3% each year thereafter. This is in effect "tax free cash" to the extent that tax is charged whether or not the cash is taken.

Contribution limit

The current annual earnings limit of €254,000 for contributions to personal pensions, and PRSAs and for employee contributions to occupational pensions will also be adjusted annually from the tax year 2007 in line with an earnings index. This will enable higher earners who are currently contributing at the maximum rate to increase their tax deductible contributions each year, which is to be welcomed.

Increases in Social Welfare pensions

The increase in the old age contributory pension is €14 per week, bringing the figure for a single person to €193.30 per week, or €10,051.60 per annum. This is a welcome increase in the retirement income of those who rely on state pensions, and indeed on those who have modest supplementary income from personal or occupational pension arrangements. Of course, if increases to State pensions continue to be higher than those assumed in the actuarial valuations for defined benefit plans which are integrated with State pensions, there will be some saving for employers in the long term.