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EMPLOYMENT TAX SERVICES NEWSLETTER
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Pensions – Navigating Through Challenging Times

The pensions landscape has significantly altered with changes to the tax relief afforded to pensions announced during Budget 2011 (7 December 2010) and confirmed in Finance Act 2011. These changes will potentially impact anyone that is providing for their personal pension, as well as employers, and therefore requires immediate attention. There is no doubt that these changes will alter the way many people (both employees and self employed) plan for their retirement as there are now significant limits on the level of tax efficient pension funding that is possible. Employers providing pension benefits to their employees will also be impacted and must re-evaluate how they reward people.

The breadth of these changes cannot be underestimated as they impact tax relief on pension contributions, the amount which can be accumulated in a pension on which tax relief is available, and also the tax charged on pensions on retirement.

We highlight below some of the main points which may concern companies, their employees and also self employed individuals, all of which require immediate consideration. Also, with another budget on the way possible further changes in the pensions area, it is critical to evaluate your options now and plan for retirement. We also include in Appendix One a high level summary of the other principal changes to pensions which were introduced by Finance Act, 2011.

Standard Fund Threshold ("SFT") – Individual Pension Funds

Prior to 7 December 2010 a tax charge was imposed at retirement on the excess value of a pension fund over €5.4m (or such higher amount as agreed with the Irish Revenue Commissioners). This value is referred to as the SFT or Personal Fund Threshold (see below). From 7 December 2010 this threshold has been reduced to €2.3m (subject to some grandfathering – discussed below). Therefore, the value of a pension fund over and above €2.3m on retirement will be liable to tax at 41%. When the net after tax excess is drawn down (e.g. pension is paid out to the individual), it is taxed as income in the individual's hands at up to 48% (marginal rate income tax of 41% and the Universal Social Charge "USC" of a maximum of 7%). This can result in a combined effective tax rate of 69% as set out below:

Excess (over €2.3m)	100
Income tax at 41%	41
After tax excess	59
Income tax at 41% & USC at 7%	28
Total tax payable on excess	69 (i.e. 69% of excess)

Valuation of Pension Funds

For individuals in a defined contribution scheme, the value of the fund at 7 December 2010 is the market value of the net assets in the fund at that date.

For individuals in a defined benefit scheme the value is calculated by multiplying the accrued pension (as if they were to retire on 7 December 2010) by a factor of 20. This means that those individuals who would be entitled to a pension of more than €115,000 (e.g. a salary of €172,500 at retirement x 2/3rds) if they retired on 7 December 2010 will exceed the new €2.3m threshold.

Grandfathering Rules

It was possible for individuals whose pension fund value at 7 December 2010 exceeded €2.3m to apply for a threshold amount of up to €5.4m by 7 June 2011. An application had to be made to the Irish Revenue Commissioners requesting such a Personal Fund Threshold ("PFT"). If an individual already had a PFT in excess of €5.4m (based on Revenue approval following the changes brought in by Finance Act 2006) then no action was required.

An individual whose pension fund was lower than €2.3m in value on 7 December 2010 could not apply to obtain a PFT in excess of €2.3m (even though the SFT of €2.3m may be exceeded in the future based on forecasted pension contributions and values).

Action

1. Clearly it is not efficient to continue funding a pension after the SFT of €2.3m (or higher PFT where appropriate) has been reached and alternative forms of retirement planning should be considered. This will generally necessitate actuarial input to assess the 'value' of pension benefits and the impact of restructuring and other alternatives both for the employer and individual as appropriate
2. Employers should communicate with employees in order to ensure that employees are aware of the changes introduced as soon as possible
3. Employers should consider putting a tracking system in place for their own purposes but more importantly for employees to determine when an individual's pension fund may be coming close to the SFT so that alternatives can be considered in advance
4. Individuals whose pension fund is currently less than €2.3m should consider funding their pension to €2.3m (taking account of a buffer for future investment returns within the fund up to retirement) in light of announcements to decrease tax relief on pension contributions and other potential changes that may be introduced in the forthcoming budget.

We also include in Appendix Two a high level summary of some of the key points and an action list to consider in the context the SFT/PFT.

Tax Free Lump sum on retirement

Another significant change to the taxation of pension benefits is that the maximum tax free lump sum which can be obtained has been reduced from €1.35m to €200,000 for payments made on or after 1 January 2011 (which is a cumulative lifetime limit). Any tax free lump sums taken since 7 December 2005 are aggregated also in determining whether the €200,000 threshold has been exceeded.

The excess pension lump sum will be taxed as follows: Therefore the first €575,000 lump sum on retirement can be obtained at a tax cost of €75,000 (representing a 13% effective tax rate). However, if €1.35m (which was the previous maximum that could be paid tax free) was

Next €375,000	20%
Balance	48% (41% income tax + 7% USC)

due then the tax cost would be €447,000, representing a 33% effective tax rate as compared with no tax cost being applied on such a lump sum up to 31 December 2010.

Action

Therefore, while availing of a lump sum upfront will remain an important part of retirement planning, individuals will need to consider alternative ways of providing for their future to ensure that they have sufficient after tax funds available up to and after retirement.

Conclusion

If any of the changes introduced in Finance Act 2011 may impact you, then we would be delighted to meet with you to analyse your position, valuation of pension benefits and discuss alternative remuneration strategies with you.

Equally important is a review of your current pension and remuneration arrangements in the context of the forthcoming budget and possible further changes that may be introduced.

APPENDIX ONE

SUMMARY OF OTHER CHANGES TO THE TAXATION OF PENSIONS

APPENDIX TWO

PENSION SFT/PFT ACTION LIST

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APPENDIX ONE – SUMMARY OF OTHER CHANGES TO THE TAXATION OF PENSIONS

Issue	Pre-Budget 2011	Post-Budget 2011
Earnings cap (maximum amount on which tax relief can be claimed)	€150,000	€115,000
Employee PRSI (on employee pension contributions)	None	4%
USC on employee pension contributions	N/A (income levy applied)	Up to 7%
Employer PRSI (on employee contributions)	None	50% of employee contributions
Employer PRSI (on employer contributions)	None	None
ARF annual deemed distribution	3%	5%
ARF availability	Personal pensions, AVC funds, & > 5% proprietary directors	DC pension schemes also
ARF, minimum income levels & AMRF	€63,500 to AMRF unless annual income of €12,700	€120,000 to AMRF unless annual income of €18,000

All of the above are effective from 1 January 2011, with the exception of the availability of ARFs to defined contribution schemes, which is effective from the date of the passing of the Finance Act
The 5% annual deemed distribution applies to values from 31 December 2010 onwards.

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APPENDIX TWO – PENSION SFT/PFT ACTION LIST

- The SFT of €2.3m at 7 December 2010 applies to retirement savings from all sources (defined benefit, defined contribution, additional voluntary contributions, personal pensions etc). Consideration should be given to excluding pension benefits that may be exempted (e.g. State pensions)
- In assessing the value of a defined benefit pension, the amount of pension earned / accrued to 7 December is what is taken into account – not the prospective pension
- A factor of 20 applies to any defined benefit pension
- Consider how to value any 'term-related' investments e.g. guaranteed fixed term investments

Individual currently impacted

- Where the sum of pension benefits from all sources exceeded €2.3m at 7 December 2010 a PFT should have been applied for on or before 7 June 2011.
- The PFT is set as the value of all pension benefits (where these exceed €2.3m) on 7 December 2010

  However the PFT cannot exceed €5.4m and there is currently no provision for indexation of either the SFT or PFT into the future
- For individuals above the SFT, consideration should be given to ceasing pension contributions, ceasing further pension accrual and reducing investment risk on all pension benefits.

  This is because any additional pension benefits (over and above an individual's SFT/PFT) whether through funding or investment out-performance will be taxed at an effective rate of up to 69%
- Consider alternative remuneration strategies and subject to agreement with the employer and pension trustees on how an individual will save for retirement outside of pension arrangements.

Individual not currently impacted

Identify whether the individual could be impacted by the SFT in the future

- Consideration should be given to using a ready reckoner to assess whether a given combination of investment growth plus any additional pension contributions will bring the individual over the cap in the future, remembering to take account of pension from all sources
- For individuals that are close to the SFT, consideration should be given to reducing investment risk (employing a de-risked pension investment strategy – e.g. cash/bonds), with increasing urgency depending on how close one is to the SFT
- Consider whether each of employer and/or employee should cease funding
- If the individual is a member of a Defined Benefit scheme and likely to breach the cap, enquire about a 'restructured pension' which may help to keep the valuation within the limit
- If an individual has scope for significant funding, consider funding quickly and retiring early to prevent investment growth resulting in exceeding the SFT, subject to discussion with the corporate and pension trustees.

Pension SFT/PFT – other Employer-initiated actions

Identifying affected individuals

- Request that the pension scheme administrators write out to any individuals whose pension fund is in excess of the SFT

Enabling employees to self assess

- Consideration should be given to providing access to a ready reckoner for all employees so that they can monitor the value of their pension fund at any given time

Alternative remuneration strategies - considerations

- Consider alternative reward strategies with employees and how these will be structured
- Consider whether a common approach to all affected is adopted or assess each on a case by case basis?
- For cash compensation, consideration should be given to what method is used to calculate this
- If attempting to be 'cost neutral', in terms of cash and other compensation, this needs to be examined further to review the likely total costs (including tax) of alternative reward strategies
- For defined benefit schemes consider an exercise to restructure pensions of affected and potentially affected individuals.

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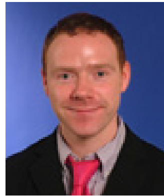

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