pension mortgages

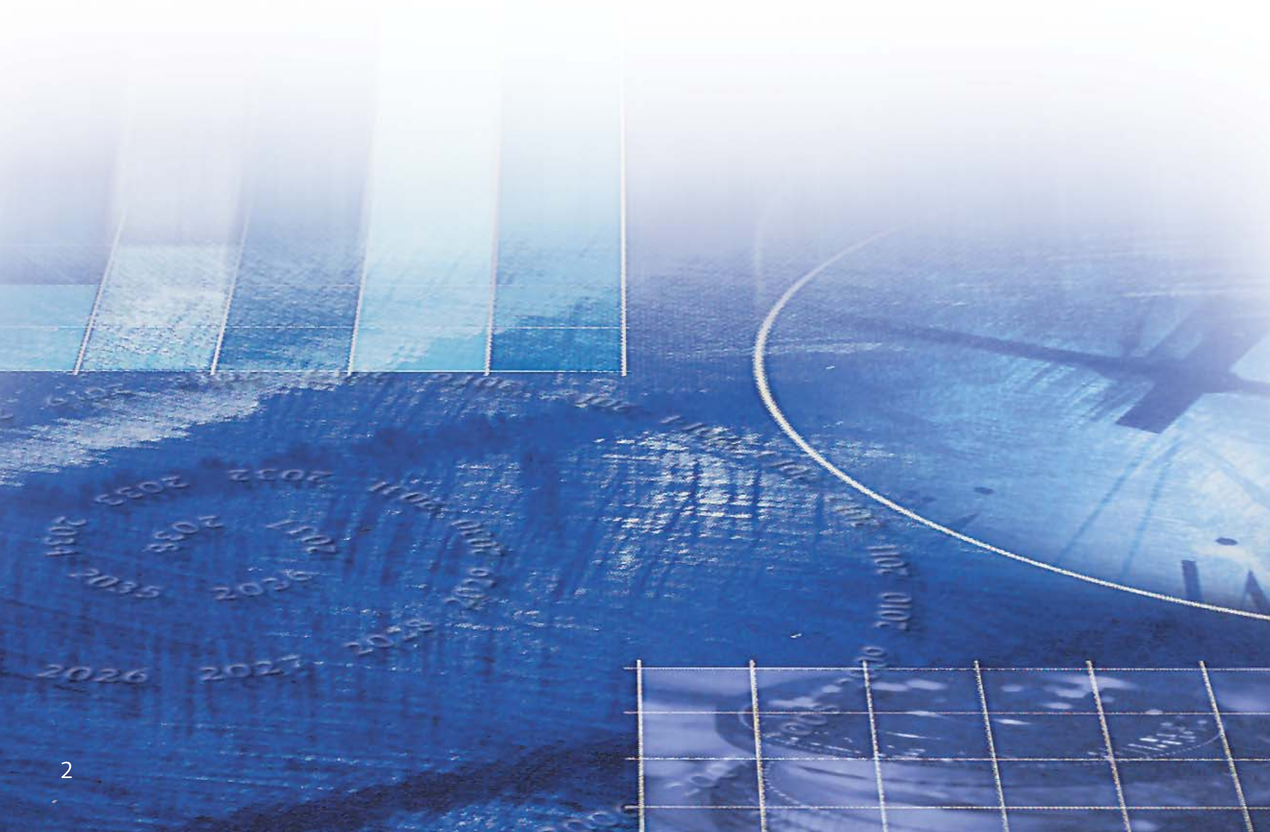
a guide

Irish Life

more options for your future

introduction



Pension mortgages have always been a very tax - efficient way for self employed people and proprietary directors to arrange a mortgage.

However, until recently they were only suitable or desirable for a small number of people.

Recent pension changes have changed all this. Now you are allowed more access to your retirement fund. Previously you could only access 25% of your fund as a cash lump sum. Now, however, you can access a higher percentage, if you are willing to pay tax on some of it. The result is that now pension mortgages have become a real option for many people, but especially for the self employed, partners or directors who own more than 5% of their company.

Generally the pension mortgage route is only suited to company directors and self-employed people buying a commercial property or an investment property. It is really only recommended for people who do not need to use their pension fund to provide an income after retirement. Under current tax rules, the interest payments in respect of commercial or investment property loans can be offset against the rental income for tax purposes. However, pension mortgages are generally not suited to financing the purchase of a principal private residence and we recommend an annuity (repayment) mortgage be used.

This guide is a brief outline to how pension mortgages work. If you want to see how a pension mortgage might work and if it is suitable for you, contact your financial adviser.

Irish Life - Ireland's number one choice for pensions.

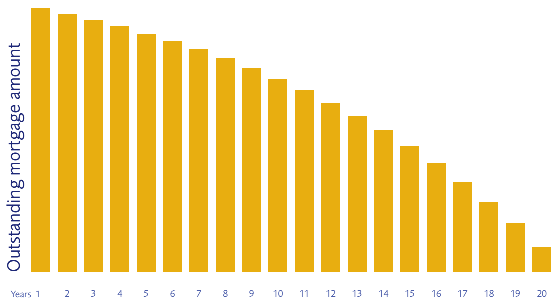
Nobody is trusted more to deliver people's pensions. Each year we pay out €110 million in pensions benefits to thousands of people - only the State pays out more.

what is a pension mortgage?

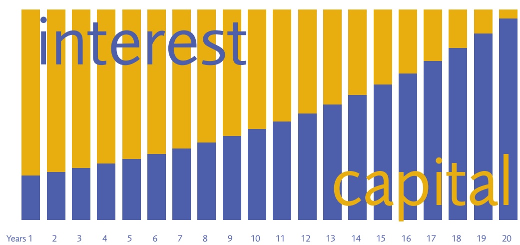
A pension mortgage is a tax-efficient way of buying a property that suits the self employed and proprietary directors. It involves building up a fund through a pension plan and using that to pay off your commercial or investment mortgage. However, before we discuss pension mortgages, it might be useful to briefly outline the differences between a pension mortgage and the more familiar repayment (annuity) mortgage.

Outstanding balance of the mortgage

- Initially, most of the payments go towards paying off the interest. However, because some of the capital is also being repaid, it means that the outstanding mortgage amount gradually reduces over time.



- Because the outstanding mortgage amount gradually reduces, the interest payments reduce as well. Thus the total repayments (which stay the same) repay increasing amounts of the capital, until the full balance is paid off at the end of the term.

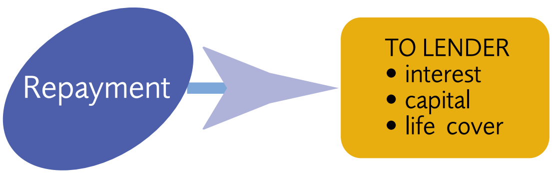


Repayment Mortgages

A repayment mortgage is perhaps the most common form of mortgage on the market and works like this:

- The borrower takes out a mortgage over a certain term (usually 10 to 25 years).

- Each month, the borrower repays a certain amount to the lender. This is split by the lender in three ways:
  a. to pay off the interest on the mortgage;
  b. to pay a portion of the original loan amount (the capital); and
  c. to pay for insurance costs, such as life cover* to pay off the loan, should the borrower die.

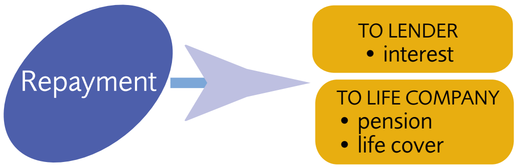


*This may be set up separately and paid to a life company if preferred.

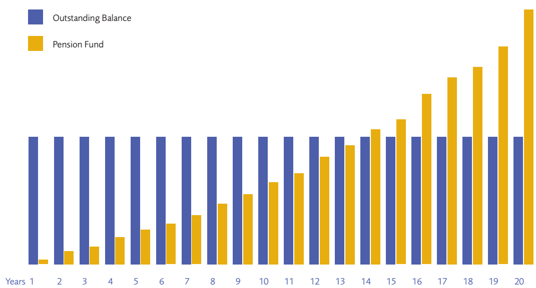
Pension Mortgages

Pension mortgages work on a different principle. The borrower pays three separate payments each month.

- Firstly they pay the interest on the total loan amount to the lender.
- Secondly they pay a contribution into a pension plan to build up a fund which is expected to repay the loan at the end of the term. The customer gets full tax relief on this contribution (up to certain limits).
- Thirdly they pay insurance costs such as payments into a life cover plan.



By repaying just the interest to the lender, instead of repaying any of the capital, the outstanding balance of the loan stays constant. However, alongside the loan, the pension policy grows as more payments are made.



The chart above is for illustration only. Actual growth will not be steady and will fluctuate over time.

Because some of the pension fund is subject to tax in retirement, the lender will require the pension fund to build up to more than the loan amount. (Some lenders insist that it is projected to build up to double the loan amount.) This should ensure that the fund should be more than enough to repay the mortgage at the end of the term.

Because it is a pension fund, the end of the term must coincide with the borrower being 60 or more, as most people cannot access their pension fund until this time.

The life cover amount equals the loan and, in the event of the borrowers death during the term, repays the loan.

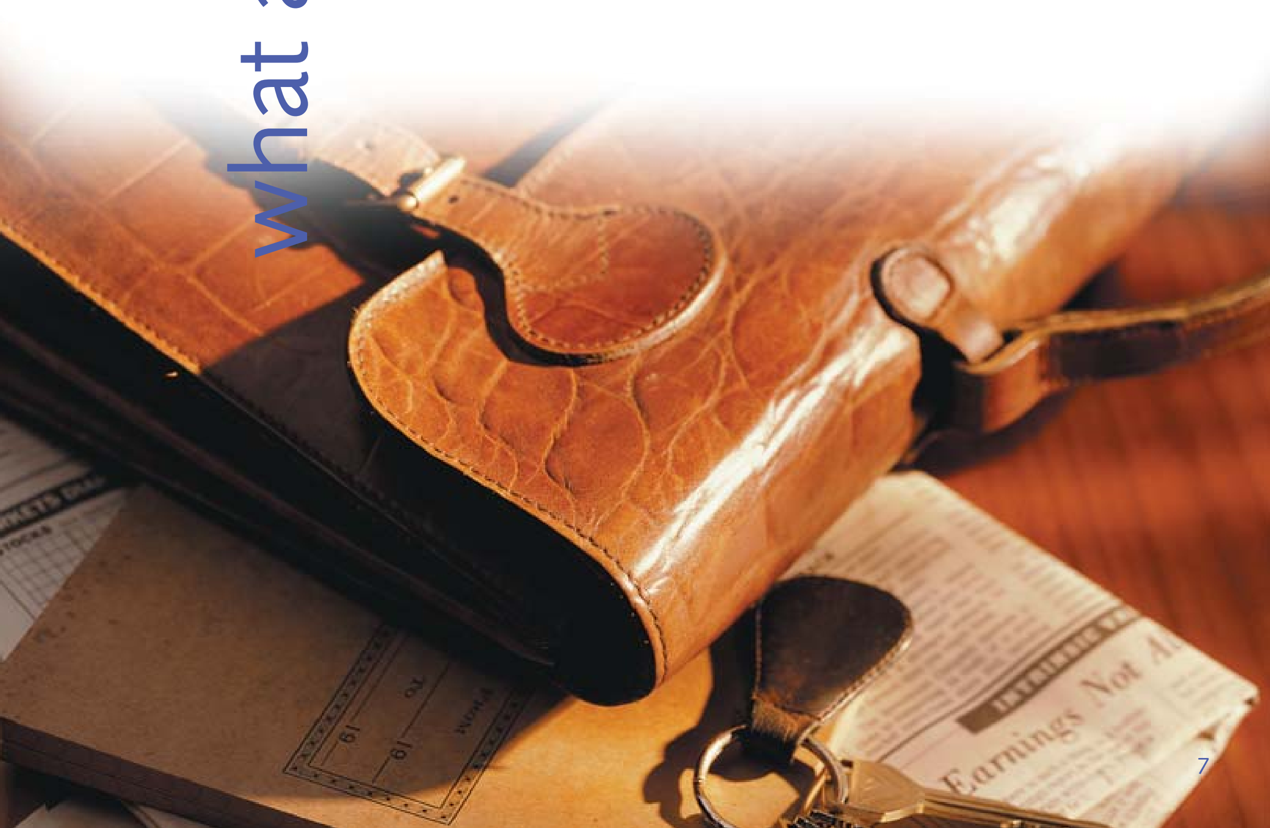
This method is not as secure as a repayment mortgage because, if the fund grows at a slower rate than assumed, the fund may not be enough to repay the mortgage at the end of the term. If it grows faster than assumed, there may be a surplus, which can be taken as cash (taxed as income in some cases).

Warning: The value of your investment may go down as well as up.

Important information on how this affects your pension.

The primary aim of a pension plan is to provide an income at retirement. It is therefore very important that, before you put a pension mortgage in place, you are completely satisfied that you already have pension arrangements in place which will fully provide for your retirement needs. Remember your retirement needs may increase.

what are the advantages & disadvantages



A. The advantages

The main advantages are tax based and are as follows:

1 Tax relief on contributions*

You can claim tax relief on contributions into a pension plan up to certain limits. This could be company contributions allowed against corporation tax, or personal contributions allowed against income tax at your marginal rate. These limits depend on age, but if you are self employed, for example, you can pay up to 30% of earnings into a pension plan if you are 50 and get full tax relief on that amount. The rates below are current as at June 2007.

Claiming Tax Relief

When you take out a personal pension plan, you can contact Revenue to claim tax back on your payments, or to have your tax credits adjusted. We will send you a tax-relief certificate which you should retain in case it is requested by Revenue at a later date.

For a company pension plan your employer gets corporation tax relief on any payments the company makes towards a pension plan for employees (provided the payments are within the agreed limits). Your employer can also claim PRSI (Pay Related Social Insurance) relief on any payments you make (where your payments are made before tax is taken off).

You can claim income tax relief on payments you make toward the company pension plan, up to the limits shown below. Your employer will usually agree to take these contributions directly from your salary before tax. In this case, tax relief is immediate, meaning that you also get immediate PRSI relief. If payments are taken from your net salary, you must contact Revenue to claim tax back on your payments, or to have your tax credit adjusted.

The figures for company contributions assume:

- 6% gross investment return each year (investments can fall and rise and could grow at a different rate than illustrated.);
- pension contribution increase of 3% each year;
- pension benefit increase of 2% each year;
- 3% salary inflation every year to retirement age;
- annuity rates based on a post retirement interest rate of 4%; and
- males retiring at 65.
- That no previous pension funding has been made.

So for example, if you were a 45 year old self employed person, paying 41% tax and earning €100,000 per year, you could put up to €25,000 a year into a pension and get full tax relief on that, meaning the net cost to you would be €14,750.

*These percentages are capped at an earnings limit of currently €262,382 (as at June 2007) and include contributions to other approved pension arrangements. This earnings limit will be increased each year in line with an earnings index.

Age	Self employed contributions % of earnings allowed	Company contributions % of earnings allowed (if normal retirement age is 65)
Under 30	15%	Up to 29%
30 to 39	20%	29% to 45%
40 to 49	25%	45% to 84%
50 to 54	30%	84% to 133%
55 to 59	35%	133% and higher
60 and over	40%	

The amount that company directors can get tax relief on depends on a number of factors, but tends to be even higher.

For example, a company will get full tax relief of about 45% of a director's salary towards a pension for that director, if they are aged 40 and aiming to retire at 65. Your financial adviser can talk you through these limits. As an employee, you can also contribute up to the limits applying for the self-employed. Where an employee contributes the percentage in the opposite table reduces for the company.

The maximum Revenue benefits for company pensions are a pension that is two thirds of your final salary, a matching pension for your husband or wife, payable on your death and a pension increase in line with the consumer price index each year.

For tax purposes, the maximum pension fund you can have is €5,165,000 (as at June 2007) from all sources. If you have pension funds in excess of this amount there may be tax implications and you should consult your advisor. This limit will be adjusted annually in line with an earnings factor.

2 Tax-free lump sum

Once the fund is built up and the borrower is at retirement age, they can use the tax-free lump sum (and possibly part of the remaining fund) to repay the outstanding mortgage amount.

- For self employed people, one quarter of this fund can be taken totally tax free and most, if not all, of the rest will be taxed at the higher tax rate, currently 41%.
- For company directors, the tax-free lump sum can be up to 1.5 times final salary, depending on how many years service the director has. Any remaining fund must be taken as a pension.
- Proprietary directors who own more than 5% of company shares have the choice to take 1.5 times final salary (averaged) or 25% of the fund.
- The overall tax free cash from all your pension arrangements can't exceed €1,291,250 (as at June 2007). Any lump sum payment in excess of this limit will be taxed at your marginal rate of tax. This limit will be adjusted annually in line with an earnings factor.

Additional benefits for company directors

The pension mortgage route can be particularly attractive for a company director. This is because the director can arrange an "interest only" mortgage and buy the property personally. At the same time, the company pays the required contribution into a pension plan. This company contribution for the benefit of the director is not liable to benefit in kind tax (BIK). At retirement, the original loan is repaid out of the pension fund.

The advantage of this approach for directors is that the capital repayment is in effect paid by the company, through the pension contribution. The director continues to pay interest only on the mortgage. This interest cost can be offset against rental income, thus reducing the net cost. At the end of the mortgage term, the individual director owns the property, not the company. In effect, this approach allows the company to fund the purchase of the property for the benefit of the director.

How exactly is the loan paid off?

At retirement, the customer should have built up a fund that can be used to repay the mortgage. This fund is often designed to be twice the loan amount and can be split in three ways by self employed people and propriety directors who own more than 5% of company shares.

1 Tax free lump sum

25% of the fund can be taken totally tax free, as mentioned on page 9.

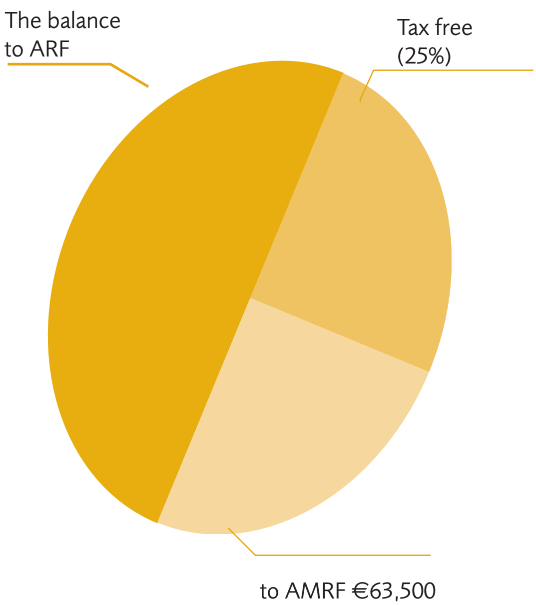
2 Approved Minimum Retirement Fund (AMRF)

Unless the customer has a guaranteed life long income of €12,700 or more per year (from State or other pensions), €63,500 has to be invested in an AMRF. This fund must be kept intact until they reach 75 (unless the client opts to purchase a pension before the age of 75). Any growth on the fund can be taken as an income. After age 75 it can be cashed in or used to provide an income and will be subject to normal income tax. Alternatively, the €63,500 can be used to buy a guaranteed income for life, called an annuity.

None of the mortgage is repaid from this fund. Your quotation should assume that €63,500 will be invested in an AMRF.

3 Approved Retirement Fund (ARF)

The balance after taking the 25% tax-free cash and an AMRF (if required) can be invested in an ARF. This fund can be used to provide an income and/or repay the balance of the mortgage. Any money taken out of this fund is taxed at the customer's marginal tax rate. PRSI health levy may also be due.



Example

The best way to explain this is to go through an example of both types of loan.

Here a customer is a 45 year old, non-smoking male, earning €100,000 and who has a €500,000 loan over 20 years, paying a notional interest rate of 5%*. We assume that the lender requires the pension fund to build up to €1 million - if requirements are less than this, the cost of the pension mortgage will be lower.

*The rate of 5% is assumed. You may decide to choose a variable or fixed rate and this may be different to the current assumed rate.

At age 45 you can fund for your pension tax-free at 60% of your salary if you are a company director. Assuming a salary of €100,000, this example would mean that almost half of your pension funding allowance will be used to fund your mortgage. Please review the figures provided on page 8.

Monthly Repayments	Pension Mortgage	Repayment Mortgage
Interest (and capital for repayment)	€2,037	€3,269
Pension premium	€2,519	€0
Gross cost	€4,556	€3,269
Less tax relief on interest	(€835)	(€486)
Less tax relief on pension	(€1,033)	€0
Net cost	€2,688	€2,783
Cost of life cover	€120	€83
Total cost	€2,809	€2,886
Guaranteed to repay loan	No	Yes
Impact on pension funding	About half of his pension funding allowance is used to clear mortgage	None

Pension Mortgage*

- The target fund from which the loan will be repaid is set at €1 million (twice the loan). To build up this fund over 20 years, assuming a 6% investment growth, requires a monthly pension contribution of €2,519. After allowing for tax relief at an assumed annual rate of 41%, the net contribution is €1,486.
- Based on an interest rate of 5% each year, the level monthly interest payment is €2,037. It is assumed that this cost can be offset in full against rental income for tax purposes, thus reducing the net interest cost to €1,202.
- The cost of separate life cover (level cover) of €500,000 over 20 years is €120 per month.

Warning: The entire amount that you have borrowed will still be outstanding at the end of the interest-only period.

Warning: These figures are estimates only. They are not a reliable guide to the future performance of this investment.

Repayment Mortgage

- The total gross repayment is made up of both an interest element and a capital element each month. The total gross repayment is €3,269 per month. When allowance is made for the average interest payment being offset against the rental income, this results in an average tax saving of €486 per month, giving an average net monthly cost of €2,783 over the term of the loan.
- The cost of separate life cover on a mortgage protection basis (reducing cover) over 20 years is €83 per month.

*Note

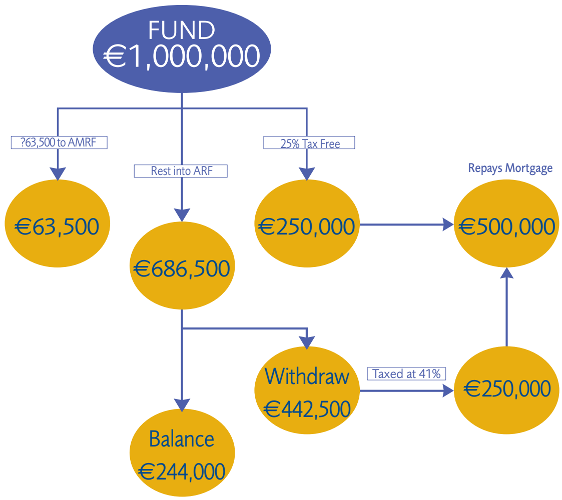
The actual costs are not guaranteed as unit values may fall as well as rise. The fund values under the Pension Mortgage are likewise not guaranteed and assume an **Executive** *performance* pension plan, investing in the Consensus Fund with level premiums and an investment growth of 6% each year. It assumes a 41% tax payer. For the purpose of simplicity, it is assumed that both mortgages benefit from mortgage interest relief. All figures quoted are for illustration purposes only. Specific figures based on prevailing interest rates will be available to customers on request.

How the loan is repaid

Assuming 6% growth, the fund is estimated to be €1 million, of which the client can take €250,000 tax free, equivalent to half the loan. €63,500 will go into an AMRF, leaving €686,500 in an ARF. To get the remaining €250,000 after 41% tax and 2.5% PRSI health levy, the customer will need to withdraw just under €442,500, leaving a balance of €244,000 in the ARF and €63,500 in the AMRF.

So, because of the tax advantages, for approximately the same cost per month as the repayment option, the pension mortgage provides a potential surplus of just under €244,000 remaining in an ARF that can then be used to provide an income for life (subject to tax), or withdrawn to give €137,860 after tax. In addition, the €63,500 remains in the AMRF until age 75.

Our current assumption is that in 20 years time, €244,000 would provide an annual pension of €14,103 for a 65 year old male. In today's terms, this would be a pension of €7,808 (using a discount rate of 3%)



Note

The actual costs are not guaranteed as unit values may fall as well as rise. The fund values are likewise not guaranteed and assume an Irish Life **Executive** *performance* pension plan. If mortgage interest rates rise or tax rates change, the monthly costs of the pension mortgage may be higher than the equivalent repayment mortgage.

B. The disadvantages

The main disadvantages of the pension mortgage are based around the restrictions that apply to pensions and the risk of tying up some of your pension funding.

Retirement income

As stated earlier, the main purpose of a pension plan is to provide a replacement income in retirement. If most of your pension fund is used to repay a pension mortgage, you will have virtually no replacement income, unless you have other sources of income after you retire. As such, it is strongly recommended that payments into a pension plan for mortgage purposes should be **in addition** to payments to build up a retirement income.

Tax relief

In putting a pension mortgage in place, you are committing a significant proportion of your allowable tax relief. There may not be further relief available for additional pension funding.

Investment risk

The pension fund aims to repay the mortgage based on certain assumed growth rates. If the fund grows by a lower amount than assumed, there may not be enough to repay the mortgage at the end of the term. You may be required to increase the amount of the contribution payments if the plan is not sufficient to repay the loan.

An annuity (repayment) mortgage is the lowest risk method of repaying a mortgage.

Restrictions on term

Normally, the earliest you can retire is 60, although directors can opt for early retirement after age 50 (subject to certain conditions)*. This means that you cannot repay the mortgage until that date, as the mortgage is repaid by the retirement fund. As such, because mortgage terms are usually not longer than 25 years, the minimum age for pension mortgage customers is 35. However, for example, if you are looking for a 10 year mortgage, you would need to be 50 or older to qualify. Also, because the real aim of a pension is to provide income at retirement, you cannot access your pension fund until age 60, if for some reason you decide to discontinue the mortgage (unless you are entitled to opt for early retirement).

*For example, directors who own more than 20% of company shares, either alone or together with their spouse and minor children, would have to sell their shareholding and sever all links with the company.

Early redemption of your mortgage

If you wish to redeem your mortgage before the end of the term and before you retire, the full capital balance will still be outstanding, as you will not be able to access your pension fund until you retire. Your pension mortgage fund will not be available at that time to redeem any of the mortgage.

Tax changes

Pension mortgages are reliant on tax legislation and current tax rates. If the revenue reduces the tax advantages of pensions, this option will become less tax efficient.

Also, if tax rates are higher when you take the benefit there will be a higher tax levy on your ARF. However, the opposite will be the case, if tax rates are lower.

Assignment.

Assigning a policy means that the lender actually becomes the legal owner of that policy and will be paid any benefits that accrue.

For pension mortgages, the life cover is assigned, but the pension is not. This is because the Revenue Commissioners do not allow the assignment of individual pension policies. As such, lenders tend to be more careful and certain criteria are put in place to help ensure repayment of the loan – these will be outlined by your particular lender.

what is the next step?

The next step to is talk to your financial adviser to get a full quotation. This will show you the cost of taking out a pension mortgage both before and after tax. It will also show likely surplus funds based on different growth rates.

Your financial adviser should complete a supplementary customer analysis to ensure that you are fully informed about the advantages and disadvantages of this type of mortgage and if it suits your needs. They can also lead you through the documentation you need to complete.

Once the documentation has been completed and you have been accepted for your pension mortgage, you will receive:

- confirmation of the loan and your cheque;
- copies of the loan agreement;
- a copy of your life cover policy (the original policy will be with the lender); and
- your pension terms and conditions booklet.

You will also receive an annual benefit statement showing the value of your fund. This will help you ensure that your pension payment is on track to repay your mortgage.

Statutory Notices as required by Consumer Credit Act, 1995.

WARNING: YOUR HOME IS AT RISK IF YOU DO NOT KEEP UP PAYMENTS ON A MORTGAGE OR ANY OTHER LOAN SECURED ON IT.

THE PAYMENT RATES ON THIS HOUSING LOAN MAY BE ADJUSTED BY THE LENDER FROM TIME TO TIME.

WARNING: THERE IS NO GUARANTEE THAT THE PROCEEDS OF THE INSURANCE POLICY WILL BE SUFFICIENT TO REPAY THE LOAN IN FULL WHEN IT BECOMES DUE FOR REPAYMENT.

WARNING: IF YOU DO NOT MEET THE REPAYMENTS ON YOUR LOAN, YOUR ACCOUNT WILL GO INTO ARREARS. THIS MAY AFFECT YOUR CREDIT RATING.

Notes

Irish Life

Irish Life Assurance plc
Lower Abbey Street
Dublin 1
t 01 704 2000 f 01 704 1900
www.irishlife.ie

ILA 1043 (REV 06-07)