Finance Bill 2011 – Advisory Services Update

This is not a customer document and is intended for financial advisors only.

The Finance Bill 2011 was published today, 21st January 2011. Following on from the Budget, it provides further detail on a number of issues affecting the pensions industry.

Pensions Overview

Key Points:

- ARF/AMRF options have been extended to all members of Defined Contribution company pension schemes with effect from the passing of the Finance Act, which is expected in the coming weeks.
- New limits have been set for guaranteed pension income and AMRF/annuity purchase price requirement for those who wish to avail of an ARF. These new limits are effective from the passing of the Finance Act.
  - Guaranteed pension income requirement has increased from €12,700 p.a. to €18,000 p.a.
  - AMRF/Annuity purchase price requirement has increased from €63,500 to €119,800.
- No change to the imputed distribution requirement from that announced in the Budget. The ARF imputed distribution requirement remains at 5% per annum. The imputed distribution requirement does not apply to PRSAs.
- Unfortunately there has been no change to the treatment of employer contributions to a PRSA as announced in the Budget. Employer contributions to a PRSA are treated as BIK, and will result in a PRSI and Universal Social Charge liability for the employee. This is less favourable than the treatment of employer contributions to a company pension, which are not BIK and which do not give rise to PRSI or Universal Social Charge for the employee.
- The self assessment pay and file deadline has been brought forward by one month from 31st October to 30th September. An additional 14 days extension will be given to those who pay and file using the ROS system.

Extension of flexible options on retirement

All members of Defined Contribution pension arrangements will have access to ARF options on retirement, subject to certain conditions.

- The specified or guaranteed income limit of €12,700 per annum is being increased to about 1.5 times the maximum rate of the State Pension (Contributory) bringing the “specified income” limit to €18,000 per annum.

- The AMRF option is being retained but the requirement will now be about 10 times the maximum rate of State Pension (Contributory) which is €119,800 as compared with €63,500 at present. If the remainder of the pension fund after taking the tax-free lump sum is less than this then the full amount will be set aside in an AMRF.

- The requirement to set aside €119,800 can also be met by purchasing an annuity where the annuity purchase price is at least €119,800, even if the income from the annuity is less than €18,000. It is also possible to meet this requirement to set aside €119,800 in total with a combination of the AMRF investment and annuity purchase price.

- Where an employee wishes to avail of the ARF option their tax free lump sum may not exceed 25% of their pension fund.

The new guaranteed income and AMRF amounts are linked to the maximum State Pension (Contributory) personal rate. As the State Pension rate changes so too will the guaranteed income and AMRF amounts.

Irish Life

Summary of company pension retirement options

For both regular employee and non-Proprietary Directors in Defined Contribution schemes

Option 1:	Option 2:
Lump Sum Option Based on the member's salary and service, to a maximum of 150% of final salary based on having 20 years service at Normal Retirement Age Balance of Fund Option • Purchase an annuity	Lump Sum Option 25% of the value of the pension fund Balance of Fund options • Purchase an annuity • Invest in an ARF* • Take as taxable lump sum*

* These options are subject to meeting either the guaranteed income requirement of €18,000 or the AMRF/annuity purchase price requirement of €119,800

We expect there will be some debate regarding the mixing of ARF and annuity benefits under option 2, as the legislation is somewhat unclear in this regard. However, we would see this as something of a technical debate. Even if the final position is that members are not able to receive a mix of ARF and annuity benefits directly from their company pension scheme, it will be possible for them to invest in an ARF (subject to the above requirements), and then immediately use part of the ARF value to purchase an annuity. As such we have no doubt that a member who wishes to have a mixture of ARF and annuity benefits can achieve the desired result.

Deferred Annuity Purchase
Members of DC company pension schemes have had an option since December 2008 to take their lump sum benefit at retirement but defer the purchase of an annuity. Those who availed of this option can now also avail of the ARF options.

As a concession the current rules as regards the guaranteed income (i.e €12,700) and the AMRF amount (€63,500) will apply where they exercise the ARF option. These changes apply on the passing of the Finance Act, and clients will have one month from that date to exercise their retirement options.

Choosing between an annuity and an ARF is something that will require careful consideration, and individuals will need advice in this area. As was stated by the Government in the Budget measures "it should be borne in mind that the option to invest in an ARF or AMRF as opposed to purchasing an annuity on retirement may not be appropriate for everyone".

AMRF converting to an ARF at a later date
Up until now, where the AMRF route is taken the capital invested in the AMRF cannot be used by the individual until he or she reaches 75 whereupon the AMRF automatically becomes an ARF. From the passing of the Finance Act, if a client with an AMRF meets the guaranteed income requirement at a later date, the AMRF becomes an ARF at that time.

As a transitional measure for existing AMRF holders, the current guaranteed income requirement of €12,700 per annum will continue to apply for a 3 year period. If they satisfy the existing requirement within 3 years of the Finance Act being enacted their AMRF becomes an ARF. After this 3 year period, the new higher guaranteed income limit will have to be satisfied.

Changes to PRSI and Universal Social Charge Relief - Impact on Taxation of Employer Contributions to PRSAs

PRSAs
The taxation treatment of an Employer contribution to a PRSA is that it is treated as Benefit-in-Kind for the Employee. When PRSAs were introduced this treatment of employer PRSA contributions did not generally disadvantage employees, as an employee could claim relief provided total contributions were within the individual's

15% to 40% tax relief limit. This changed with the introduction of the Income Levy, and has now changed further because of changes announced in Budget 2011.

From 1 January 2011, employee contributions to occupational pension schemes (including AVCs), PRSAs and Personal Pensions will no longer qualify for relief for employee PRSI and the Universal Social Charge (USC). This means the tax treatment will be:

- Employer PRSA contributions are subject to Income Tax, PRSI and the USC
- The individual employee can immediately receive relief on Income Tax within limits as if they had paid the contribution themselves. The net effect is that in most cases the employee will be in the same net position for Income Tax as if BIK did not apply.
- However, no relief is available in respect of PRSI and the USC

Company Pensions

From 1 January 2011, employee contributions to occupational pension schemes (including AVCs) and Personal Pensions will also no longer qualify for relief for employee PRSI and the USC. However, an important difference is that employer contributions to an exempt approved company pension arrangement are not liable to income tax as BIK for the employee.

Example – Employee PRSI and Universal Social Charge Payable

The example below highlights the different tax treatment of employer contributions to company pensions and PRSAs.

Where an employer contributes €1,000 and the employee contributes €2,000, to a company pension arrangement. The income tax position will be the same. The employee pays income tax based on the Net Taxable Salary of €38,000.

PRSI and the USC are based on the Salary of €40,000. There is no increase in the Gross Taxable Salary because the employer company pension contribution is not BIK for the employee.

In comparison looking at a PRSA, the employer's contribution is BIK for the employee and therefore increases their Gross Taxable Earnings. The income tax position will be the same as it is based on the Net Taxable Earnings. PRSI and the USC however are charged against the increased Gross Taxable Earnings (employee's earnings plus employer PRSA contribution).

The table below clearly highlights this

	No Pension Contribution	**With Employer Company Pension Contribution**	**With Employer PRSA Contribution of €1,000**
Salary	€40,000	€40,000	€40,000
Employer Contribution	**€0**	**€1,000**	**€1,000**
Employee Contribution	€0	€2,000	€2,000
Gross Taxable Earnings (for PRSI & USC)	€40,000	€40,000	€41,000
Net Taxable Earnings (for Income Tax)	€40,000	€38,000	€38,000
PRSI Payable	€1,336	€1,336	€1,376
Universal Social Charge Payable (2% to €10,036 4% to €16,016 7% above €16,016)	€2,119	€2,119	€2,189
PRSI and Universal Social Charge Increase		**No Change**	**€110**

Conclusion
While PRSA contributions are still a tax efficient way for employers to remunerate employees, as income tax relief is still available to employees so long as the total contribution falls within the age related tax limits (15% to 40% depending on age), the removal of PRSI and USC relief is that it has made an employer pension contribution to a company pension more attractive than an employer pension contribution to a PRSA. Irish Life, along with the life assurance industry, are currently discussing this treatment with the Department of Finance, and have requested that the equal treatment of employer contributions to a company pension or PRSA be restored.

Recap of Pension Items announced in Budget 2011

Employer PRSI
In addition to the changes for the employee, from 1 January 2011 the **employer PRSI** exemption for **employee** contributions to occupational pension schemes and other pension arrangements is reduced by 50%. The employer PRSI rate is typically 10.75%, so the employer PRSI saving changes from 10.75% of the employee's contribution, to 5.375% of the employee's contribution. In order to avail of PRSI relief the employee contribution must be deducted from salary via the net pay arrangement.

To take an example of an employer pension contribution of €1,000 and an employee contribution of €2,000:

- The employer can offset the €1,000 contribution as a trading expense
- The employer also saves 50% of 10.75% PRSI on the employee contribution provided this is deducted through payroll (however, as this saving is a reduction in expenses that would otherwise be set against Corporation Tax, the PRSI saving is in effect subject to Corporation Tax as shown in line 2 below *).

Employer PRSI saving 50% of 10.75% of €2,000	= € 107.50
*Less Corporation tax on Employer PRSI saving (107.50 X 12.5%)	= - € 13.44
Corporation tax saving on Employer contribution (1,000 X 12.5%)	= € 125.00
Total Employer tax saving	= € 219.06
Net cost to Employer : €1,000 less €219.06	**= € 780.94**

Retirement lump sums
Pension tax free lump sums in excess of €200,000 are to be taxed at the standard rate of income tax (currently 20%).

The following example shows how a Personal Pension client with €1 million of a fund is affected by only a reduction of €10,000. So in this example, tax of €10,000 on a lump sum of €250,000 is equivalent to a tax rate of 4%.

	Previous Position	**New Position**
Total Fund	€1,000,000	€1,000,000
Tax Free Lump Sum	€250,000	€200,000
Balance of Lump Sum (after tax at 20%)	N/A	€40,000 (after €10,000 tax)
Balance to ARF/AMRF or annuity	€750,000	€750,000

Tax free lumps sums taken on or after 7 December 2005 will count towards using up the new tax free amount so that if an individual has already taken tax free retirement lump sums of €200,000 or more since 7 December 2005, any further retirement lump sums paid to the individual on or after 1 January 2011 will be taxable.

In addition the existing maximum lump sum limit from all pension plans has been reduced from €1.3 million (approx) to €575,000 (this is, 25% of the reduced Standard Fund Threshold of €2.3m). The excess of retirement lump sum payments over €575,000 will be taxed at the taxpayer's marginal rate of income tax. Alternatively the excess could be invested in an ARF / AMRF.

These limits do not apply to lumps sums paid on death.

Maximum allowable pension funds

The maximum allowable pension fund on retirement for tax purposes (known as the Standard Fund Threshold (SFT)), has been reduced from €5.4 million (approx) to €2.3 million.

A higher personal fund threshold (PFT) may apply if, on 7 December 2010, the value of the individual's pension is greater than €2.3 million. The value of any pension benefits already taken (since 7 December 2005) will also be included. Individuals will have until 7th June 2011 to send details of their pension schemes to the Revenue Commissioners in order for the PFT to be certified. The maximum PFT that will be certified by Revenue is the previous SFT of €5.4 million.

The capitalisation factor for use in determining the value of Defined Benefit pension rights for the purposes of an individual's SFT is 20 times the pension payable.

Individuals who already have a PFT under the existing arrangements will retain that PFT

Earnings limit for employees and the self-employed

The annual earnings limit which, along with age-related percentage limits, determines the maximum tax-relievable contributions for pension purposes has been reduced to €115,000 for 2011.

This reduced earnings limit of €115,000 also applies to clients making a contribution in 2011 before the 31st October 2011 pay and file tax deadline, and backdating the relief against 2010 earnings. In order to avail of the €150,000 earnings limit for 2010 the entire pension contribution to be set against 2010 earnings must have been made before 31st December 2010.

Approved Retirement Funds – Imputed Distributions

The annual imputed distribution which applies to the value of assets in an Approved Retirement Fund (ARF) each year was increased from 3% to 5% in respect of 2010 and future years.

Irish Life have pointed out that a 5% rate of drawdown increases the risk that ARF values could reduce to the point where it is incapable of providing a reasonable income in retirement if a client lives a long time. We will continue to lobby that a lower imputed distribution rate, perhaps 4% per annum, would be more appropriate.

There has been no change to the imputed distribution treatment of PRSAs and AMRFs. There is no compulsory imputed distribution for PRSAs currently. The imputed distribution requirement does not apply to AMRFs until age 75, at which point the AMRF becomes an ARF.