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Examination of Standard Fund Threshold Regime
Taxation Division
Department of Finance
Government Buildings
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Dublin 2

By email: TaxPolicyUnit@finance.gov.ie

26 January 2024

Response to the Consultation on the Standard Fund Threshold

Dear Sir/Madam

The Irish Tax Institute welcomes the opportunity to contribute to consultation on the Standard Fund Threshold (SFT). The Institute recognises that the objective of the SFT regime, when introduced, was to act as a deterrent to prevent over-funding of supplementary pension provision from tax-relieved sources. However, there are a number of issues with the current SFT regime.

The level of the SFT has remained unchanged for a decade resulting in its value being diminished. In addition, the rules underpinning the operation of the SFT regime are complex and there are inequities in how the rules apply across different cohorts of taxpayers. We have set out these issues in more detail below.

The level of the SFT

On its introduction, the SFT was initially set at €5 million. It was subsequently reduced to €2.3 million from 7 December 2010 and further reduced to €2 million from 1 January 2014. The €2 million threshold has not been indexed since 2014.

When a pension benefit is crystallised, which typically occurs on retirement, its value is assessed. Broadly speaking, if the SFT is exceeded, the excess over the threshold, known

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as the “chargeable excess”, is subject to an upfront, ring-fenced income tax charge, on top of the normal taxes at the marginal rate due on drawdown of the pension funds. This tax is known as the chargeable excess tax (CET) and is charged at a rate 40%.

Our members have noted that while an individual may seek to comply with all the necessary requirements relating to the funding of a pension, if inflation or investment growth is greater than expected, CET will apply because the SFT is not indexed linked. Indeed, had the SFT been indexed in line with the Consumer Price Index since 2014, the level of the SFT today would be in the region of €2.4 million.

Consequently, while the SFT was intended to prevent over-funding of pensions from tax-relieved sources, it has now become penal in nature and a revenue raising measure because the threshold has not been indexed in the 10 years since it was set at its current level.

The Commission on Taxation and Welfare recommended that the SFT threshold to be reviewed and benchmarked regularly to an appropriate and fair level of retirement income having regard to prevailing market earnings. At the same time, the Commission recognised that estimates of the level of retirement income the current SFT cap could provide will depend upon an individual’s pension strategy and prevailing market conditions at the point of drawdown and will vary over time.

We consider it is essential that there is stability for both pensioners and those saving for retirement so that they understand what their financial position will be going forward. In our view, the SFT should be increased to compensate for the lack of indexation of the threshold over the last decade. At a minimum, the SFT should be maintained at its current level and index linked, possibly to wage inflation, going forward. Such an approach would take into account the time value of money.

Reducing the SFT below its current level would create challenges as individuals would have to review their existing pension funds to determine whether they exceed the new threshold level. It would also disproportionately impact workers in the private sector due to the different rules which apply to workers in the public sector and private sector for the purposes of the SFT. Reducing the SFT could also lead to instability in the market as it could potentially be perceived as an indication that Ireland does not have a clear policy on pensions.

Options for payment of the CET

As set out above, CET is chargeable at the rate of 40% on any excess over the SFT. However, there are significant differences in terms of the payment options for the CET and the valuation factors used to determine if a pension fund exceeds the SFT. These differences depend on whether the pension in question is a public sector or private sector pension and also whether the pension is a defined benefit or a defined contribution pension. In our view, there should be consistency in the application of the SFT rules across all cohorts of taxpayers and pension types.

In the case of public sector defined benefit arrangements, the individual can opt to pay the CET in instalments over a period of up to 20 years by way of a reduction in the gross

pension payable to the individual. If the individual dies before the debt is fully discharged (i.e., before the CET is fully recovered), the outstanding tax is written off.

Section 787TA TCA 1997 also provides an opportunity for individuals who have private pension benefits, in addition to their public service pension and who meet certain conditions, to encash their private pension rights, in whole or in part, from age 60 (or earlier, where retirement is due to ill health), to help eliminate or reduce the chargeable excess that would otherwise arise when their public service pension crystallises. The exercise of this option attracts income tax at the point of encashment at the higher rate plus USC at a fixed rate of 2%. By availing of this option, any amount encashed does not count towards the SFT limit. However, if the additional public sector benefits create a CET, then they have the option to pay this CET over 20 years.

In contrast, there is no flexibility available to private sector employees regarding the payment of CET. The CET is payable upfront from their fund at retirement and no refund is provided if the retiree dies shortly afterwards. In addition, there is no facility to encash any excess private pension benefits over the SFT limit.

In our view, the facility provided to public sector employees to pay the CET in instalments over a period of up to 20 years with outstanding instalments written off on death within the 20-year repayment period, should equally apply to workers in the private sector. In addition, we consider that the encashment option afforded to public sector employees under section 787TA TCA 1997 should also be available to employees in the private sector.

Valuation methodologies for the purpose of the SFT

For those with defined contribution pensions, determining whether the SFT has been exceeded is a straightforward exercise, which is simply based on the value of the pension fund.

Determining whether the SFT has been exceeded for defined benefit schemes is more complex as the fund must be valued and different valuation or capitalisation factors apply depending on when the benefits accrued.

For benefits accrued up to 31 December 2013, a fixed capitalisation factor of 20 applies. For any benefits accrued from 1 January 2014, the capitalisation factors set out in Chapter 5 of Revenue's Pensions Manual apply. Neither the fixed factor of 20 nor the capitalisation factors set out in Revenue's Manual are regularly updated to reflect open market annuity rates. Depending on market fluctuations, using these capitalisation factors can mean that those with defined benefit pensions are less likely to exceed the SFT and therefore, have less exposure to CET than those with defined contribution pensions.

In our view, the capitalisation factors used to value defined benefit schemes to determine if the SFT has been exceeded must reflect market norms. In addition, there should be no distinction between benefits accrued up to 31 December 2013 and benefits accrued after 1 January 2014. Such an approach would simplify the regime and it would also assist in equalising the tax treatment of defined benefit and defined contribution schemes.

Tax expenditure associated with pension provision

The Terms of Reference for the review of the SFT include consideration of the impact of any change to the SFT on the overall tax expenditure associated with pension provision.

In considering the overall tax expenditure associated with pension provision, it is important to recognise that pension tax relief is an important tool in encouraging workers in the private sector to save for retirement. In addition, it must be acknowledged that tax will be paid on the drawdown of the pension at a later date.

It should be noted that workers in the public sector obtain income tax relief, which is not restricted by the age-related or the €115,000 net relevant earnings limits, on mandatory additional superannuation contributions (ASCs) towards their pension. On the other hand, both public and private sector workers are restricted to the age-related and the €115,000 net relevant earnings limits on all their personal contributions whether mandatory or voluntary.

As we have set out above, the SFT has been reduced a number of times since its introduction before being set at the current €2 million threshold. Changes were also introduced in 2011 to pension tax relief including the imposition of PRSI and USC on pension contributions; the reduction in employer PRSI relief on employee pension contributions by 50%; and a reduction in the annual earnings limit for which tax relief is allowed on an employee's pensions contributions from €150,000 to €115,000.

We firmly believe that any further reduction of the SFT would disproportionately impact private sectors workers due to the differences in the existing rules which apply to public sector and private sector workers.

The tax expenditure associated with pension provision must also be balanced with the cost of unfunded pensions to the Exchequer. Public service pension entitlements are generally unfunded operating on a Pay As You Go basis, though public service employees make mandatory contributions and ASCs towards their pension. As such, no explicit employer contributions are made annually.

The 2020 Report of the Interdepartmental Pensions Reform & Taxation Group noted that "*any alteration in the tax treatment of explicit contributions made by employees and employers would result in horizontal inequity if not paralleled with regard to the State's implicit contributions."* Notably, payments in respect of public service pensions amounted to approximately €4.2 billion in 2021.[1]

Making pension documentation available on ROS/ myAccount

Individuals may have different types of pensions crystallising at different times. Tracking previous benefit crystallisation events (BCEs) can be difficult, as in many instances documentation may no longer be available due to the passage of time.

[1] Actuarial Review of Public Service Occupational Pensions in Ireland, As required by Regulation (EU) No 549 / 2013, Department of Public Expenditure, NDP Delivery and Reform - https://www.gov.ie/pdf/?file=https://assets.gov.ie/280001/e74d6f2b-9753-4853-9051-cdfa545ea010.pdf#page=null

Where details of BCEs are filed with Revenue, it would be helpful if such information could be recorded on ROS or myAccount and made available to the taxpayer concerned. For example, a pension administrator who deducts tax from the part of an excess lump sum that is charged under Schedule D Case IV must make a return to Revenue using a Form 790AA. An administrator must also file a Form 787S within three months of the end of the month in which a BCE giving rise to the chargeable excess occurs. Making documents such as these available to an individual on myAccount or ROS, would facilitate the ease of compliance for taxpayers and their agents.

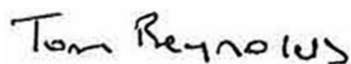
Conclusion

It is important that there is stability in the pension sector for both pensioners and workers saving for retirement so that they understand what their financial position will be in the future. To ensure that the value of the SFT is preserved, we firmly believe that the SFT should, at a minimum, be maintained at its current level and index linked going forward. Much of the complexity with the SFT regime arises due to the fact that different rules apply depending on whether the taxpayer is employed in the public or private sector and also whether the pension in question is a defined benefit scheme or a defined contribution scheme.

In our view, similar treatment should apply to all cohorts of taxpayers irrespective of whether they have a defined benefit scheme or a defined contribution scheme. Applying similar treatment would align with the recommendation of the Commission on Taxation and Welfare which noted that anomalies in the tax treatment of different retirement arrangements should be eliminated, as far as possible. Such an approach would also simplify the SFT regime.

Please contact Anne Gunnell at agunnell@taxinstitute.ie or (01) 6631750 if you require any further information in relation to this submission.

Yours sincerely



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