An Chomhairle Pinsean
The Pensions Council

Pensions Council Submission in response to the 2024 Consultation on the Standard Fund Threshold

To: **Minister for Finance, TaxPolicyUnit@finance.gov.ie**

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Important notes:

The Department of Public Expenditure, NDP Delivery and Reform has recused itself from the preparation of this submission. Accordingly, this submission is fully independent of, and without representation from, the Department.

This document reflects the Pensions Council collective views, excluding the Department as outlined above. It may not represent the views of the individual members of the Council or their employers.

About the Pensions Council

An Chomhairle Pinsean, also known as the Pensions Council (the "Council"), was established under section 26B of the Pensions Act, 1990 as amended (the "Act"). Its role is to advise the Minister for Social Protection on matters relating to policy on pensions. The Council also represents and protects the consumer interest and helps to ensure that the system has a far stronger consumer focus.

The Council comprises the Pensions Regulator, representatives of the Departments of Social Protection, Public Expenditure NDP Delivery & Reform and the Central Bank of Ireland, as well between 4-8 other members, each of whom the Minister considers to have the relevant skills, specialist knowledge, experience or expertise to enable them to carry out the functions under the Act. All members are appointed by the Minister and no members are remunerated for their role. The Minister appoints the Chairperson.

Summary of the SFT regime

As outlined in the Consultation document, the Standard Fund Threshold (SFT) sets the maximum amount for a tax-relieved pension at retirement. Where a pension exceeds the SFT, the excess is subject to an upfront, ring-fenced income tax charge (known as "chargeable excess tax" or CET) at 40%. The SFT and CET apply to all types of pensions in both the private and public sector. The SFT has been set at €2 million since 2014.

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The Pensions Council notes that the net impact of the CET plus other taxes for benefits over the SFT is an effective tax rate of approximately 69%.

The CET payable is reduced by any income tax paid at the standard rate on lump sums taken from private pension arrangements since 1st January 2011, and not previously offset against a chargeable excess tax charge. Therefore, while the quoted SFT is €2.0m, the effective SFT limit can be as high as €2.15m before a chargeable excess tax charge arises.

Up to 31 December 2013 Revenue used a factor of 20 to convert defined pension benefits into a cash equivalent and therefore the maximum pension was €115,000 as this equated to €2,300,000 when converted to a fund using the 20 Capitalisation Factor. Whilst this may not have been viewed as equitable (for example a pension available at age 50 was valued on exactly the same basis as a pension available at 70), it was very easy to value a defined benefit.

The Finance (No 2) Act 2014 reduced the pensions cap to €60,000 and introduced a new formula for calculating the value of Defined Benefits. The new system came into operation on 1 January 2014. With effect from that date all DB entitlements must be converted to a fund value based on a new age-related system with capitalisation factors ranging from age 50 to age 70.

The €2m SFT is a function of the maximum pension (€60,000), a capitalisation factor at age 60 (30) and the maximum tax-free pension lump sum (€200,000).

1. **The recommendations of the Commission on Taxation that the SFT be benchmarked at "an appropriate and fair level of estimated retirement income."**

   The Pensions Council represents and protects the consumer interest. It is therefore in favour of benchmarking the SFT at an appropriate and fair level. This should apply consistently to all pension savers, regardless of private/public sector, DB or DC. What is not clear is what the level of that retirement income should be.

   The Pensions Council has commenced an important project to develop a set of Retirement Living Standards that reflect the financial basic needs and aspirations of older people in Ireland.

   It is anticipated that three ranges for retirement income levels will be developed:

   - Minimum (a base line minimum standard where retirees could cover their living expenses);
   - Moderate (a living standard offering more financial security and flexibility) and;
   - Comfortable (a living standard associated with more financial freedom and some luxuries).

   These ranges will differ by household – e.g. homeowner or not, single person or couple. This project will also examine the factors that influence the retirement living standards of older people in Ireland.

   While the final output will not be available by the time the SFT Review is complete, the Pensions Council would be pleased to provide support in any way it can to help identify what *"an appropriate and fair level of estimated retirement income"* means.

   Given that the current SFT of €2m is a function of the maximum pension (€60,000), a capitalisation factor at age 60 (30) and the maximum tax-free pension lump sum (€200,000), we recommend that each of these elements are reviewed in the interim in order to revalue the SFT set in 2014 to 2024 levels in the first instance.

In our view revaluation would need take into account:

- Price inflation or earnings inflation between 31 December 2013 and 31 December 2023. Of the two metrics earnings inflation represents the more appropriate measure in our view (as any pension represents a portion of pre-retirement income). Noted also that the State pension broadly tracks earnings inflation given the target to retain it at 34% of national average earnings;
- Changes in annuity rates in the period or a method for approximately allowing for these changes by reference to changes in long term interest rates, net of inflation changes and any changes to mortality / life expectancies; and
- Changes in the lump sum which would increase commensurately with the €60k pension i.e. in line with the agreed inflation metric.

Overall using the above approach €2m would increase to €2.89m (say €2.9m rounded) or €2.15m would increase to €3.1m. Further detail of the approximate calculations undertaken is set out in the Appendix.

Where current open market annuity rates were used rather than an approximation for the change in the 30 factor the valuation increases further as set out in the Appendix.

2. **The relevance of the rationale for the SFT in the context of the current pension landscape and the factors that may impact the SFT's role as a limit on tax-relieved pensions.**

A longstanding State policy[1] is to encourage workers to 'top up' their State Pension in retirement with private pensions. In the private sector, private pension tax relief is designed to act as a financial incentive[2] to encourage voluntary supplementary retirement provision. There may also be an associated objective to provide the private sector with the opportunity and incentive to fund pensions and gratuities in line with those provided by the State to those who work in the public service.

Where membership of unfunded superannuation schemes is a condition of employment, private pension tax relief provided on employee contributions might be more accurately described as a subsidy to a contractual commitment, rather than an incentive to make voluntary retirement provision.

The cost to the Exchequer for private pension tax relief is significant. Discouraging future contributions/ pension accrual is the main way by which SFT controls the cost of private pension tax relief and not the chargeable excess tax which results from the SFT limit.

[1] *"The overall objective of our pensions system is to provide an adequate basic standard of living through direct State supports and to encourage people to make supplementary pension provision so that they may have an adequate income in retirement" Green Paper on Pensions Executive Summary,* *http://www.welfare.ie/en/downloads/greenpaperexecsummary.pdf*

[2] *'it is considered that marginal relief represents a significant incentive to encourage pension savings and to a degree represents a deferral of taxation*.'. Minister for Finance Mr Paschal Donohoe, Dáil Question 31st May 2018

3. **The impact of any change to the SFT on the overall tax expenditure associated with pension provision and its associated distribution, and the need for equity in treatment across taxpayer groups and between public and private sector workers.**

There are two main effects of the SFT:

a. It strongly encourages high earners to cease pension funding sometime before expected retirement, as investment growth alone can carry the value of their benefits over the SFT. This assumes individuals can stop funding for retirement. These people are unlikely to breach the SFT with careful planning and if they do breach it, the excess is likely to be minimal. When an individual stops funding in anticipation of reaching the SFT later on, the cost of tax relief on contributions ceases immediately but the individual continues to benefit from tax-free investment returns until benefits are taken.

   Where a high earner chooses to cease pension funding, they may not be able to benefit from the employer contribution through additional pay.

b. Some people may be unable to stop funding for their retirement, for example public sector workers or those who are in DB or DC pension schemes that are compulsory. Several semi-state organisations operate DC schemes with compulsory membership.

Therefore, if the SFT is increased:

- It will increase the cost of pension tax relief generally (if the SFT increases, high earners will presumably contribute more up to the higher limit).
- The amount of CET payable by individuals who breach the SFT will reduce; i.e. generally those who cannot stop funding for their retirement when they can foresee reaching the SFT.

Observation: High wealth individuals (HWIs) make little use of pension tax relief, because they are limited by the SFT and because they frequently have low earnings liable to income tax by using other means (e.g. capital allowances and loss relief) to reduce their taxable earnings (Comptroller and Auditor General Management of high wealth individuals' tax liabilities, 2017. https://www.audit.gov.ie/en/Find-Report/Publications/2018/2017-Annual-Report-Chapter-18-Management-of-high-wealth-individuals%E2%80%99-tax-liabilities.pdf)

Whilst any increase in the SFT will increase the cost of pension tax relief generally, it is arguable that the cost of pension tax relief has been artificially low over the past number of years as the SFT set in 2014 has been reduced in real terms due to the impact of price inflation and particularly high price inflation in recent years.

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4. **The current calibration of the SFT including potential impacts on net pension at retirement and consequential impacts on recruitment and retention in the public and private sector.**

   The impact of the Standard Fund Threshold's €2m cap on retirement savings has gained publicity recently. It has been reported[3] that the cap discourages senior gardaí promotions where they would face a significant tax bill for excess pension savings above the €2m limit.

   This €2m limit has been in place since January 2014 and has not been indexed. As a result, more employees are breaching or are at risk of breaching this limit and face the prospect of a significant tax bill.

   Because public servants cannot voluntarily opt of their pension scheme for further pension accrual and receive cash in lieu of future as tends to happen in the practice, public servants at / near or above the cap may be leaving the public service or retiring rather than facing a significant tax bill.

   Public service employees who hold private sector pension benefits likely to exceed the SFT due to a combination of their private and public sector benefits, can encash[4] these private sector benefits prior to retirement with one tax charge, currently 42%. In effect such public sector employees can hand back the income tax relief assumed to have been obtained on the 'excess' private benefits, and hence avoid a double tax charge on those benefits as chargeable excess.

   This allows such public service employees avoid (or reduce) the CET on retirement. There is no corresponding provision for those in the private sector holding only private pension benefits or public sector workers holding only public sector benefits.

   The Pensions Council's view is that it should be considered whether this anomaly supports necessary public sector recruitment.

5. **The rate at which the SFT should be set having regard to economic factors including changes in the Consumer Price Index and wage inflation since 2014, the cost of the tax expenditure and its distribution, and the Department's Guidelines for Tax Expenditure Evaluation.**

   The Pensions Council notes that there is precedent in regard to indexation: the SFT was indexed up to 2008 to €5.4m before being reduced in stages to its current level of €2m.

   The monetary limits have not increased in line with inflation/earnings in recent years. As earnings/inflation increases, the real values of these limits decrease. Over the period December 2014 – November 2023, the CPI indexation was 20.1%, indicating that if the SFT were to be indexed in line with the CPI, its value now would be of the order of €2.4m.

   By reintroducing CPI or wage indexation to the SFT, this could be an automated way to help ensure the value of peoples' retirement benefits are not eroded by a penal tax being applied on a larger portion of their benefits.

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[3] For example https://www.independent.ie/irish-news/senior-gardai-threaten-to-quit-amid-pensions-timebomb-stand-off/a1850136929.html

[4] S787TA TCA 1997

The state pension is increased each year as part of the budgetary process. The target for the State pension is 34% of national average earnings. The increases in the state pension granted have meant that the level of the state pension has broadly kept pace with national average earnings.

In our view applying a similar targeting approach to indexation the SFT components (€60k pension in line with average earnings), capitalisation factor of 30 in line with changes in interest rates/ open market annuity rates would work well. Two examples for indexing between 2014 and 2024 have been set out in the Appendix. Similar approaches could be taken annually at regular intervals to revalue.

6. The operation of the SFT regime including the inputs and valuation factors which form part of the methodology and the chargeable excess tax.

a. Defined benefit and public sector employees:

The SFT system values DB/public-sector pensions accrued up to 1 January 2014 at a fixed 20:1 but values such pensions accrued after that date at higher age-related multiples.

This benefits those who substantially accrued their DB/public sector pension prior to 1 January 2014.

The SFT system values DB pensions at the same rate, regardless of whether the pension will or will not increase in retirement, and regardless of whether a survivor's pension is payable or not.

This particularly benefits public service pay parity pensions with 50% survivor's pension, which are valued the same as a funded DB pension with no increases and no survivor's benefits.

b. Defined contribution:

The value of the pension savings on the day of benefit crystallisation is used for SFT purposes. As the value of the benefits is not related to the multiples, the DC individual is treated differently to the DB/public sector worker.

There are also no equivalent grandfathering arrangements for DC pension savings.

Options to make the SFT limit more equitable across different types of pension saver:

1. value DB and public service pensions at a realistic more open market rate for the purposes of the SFT,
2. take into account the value of post-retirement increases and survivor's pensions; and
3. tie the age-related factor to interest rates / open market annuity rates.

7. Options for payment of Chargeable Excess Tax when it arises.

Public service employees who incur a chargeable excess tax liability on public service superannuation benefits can opt to pay the tax by way of equal annual instalments (no interest added) via a reduction in their gross pension over a period of up to 20 years. On death within this 20-year period, there is no recovery of outstanding instalments and no reduction in the spouse's death in retirement pension.

Chargeable excess tax on funded private sector pension arrangements is payable in full within 3 months of the end of the month in which the benefits giving rise to the chargeable excess tax are crystallised. There is no refund on early death.

For some DB members, they may have to commute pension using the scheme commutation factors (eg 9:1). These may have no bearing on market rates (closer to 25:1). This will mean they may have to commute more pension to pay the CET than others. The commutation factors are typically set by the trustees and may only be reviewed infrequently.

The Pensions Council is of the view that all categories of retirees should be treated the same, regardless of how they saved for retirement.

8. Options for simplifying the SFT regime.

The fixed monetary amount is easy to understand and apply, particularly for DC savers.

The application of factors and trying to make them equitable across different types of pension savers is complex. A decision will have to be made to balance the importance of simplicity with equity and fairness.

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Appendix – Revaluing the SFT to 2024

1. If inherently assume the €60k pension and factor of 30 was correct in 2014:

	Pension	Factor	Value	TFLS	Total SFT
2014	€60,000	30	€1,800,000	€200,000	€2,000,000
2024	€78,600	33	€2,625,240	€262,000	€2,887,240

The pension of €60k, was increased by 31% where 31% represents the increase in average earnings as measured by the CSO.

CSO average weekly earnings NACE all economic sectors at 31/12/2013 was €36,090 and increased to €47,201 by Quarter 3 2023, a 31% increase

The factor of 30 going to 33 reflects the changes in long term interest rates net of inflation.

	(a) 5.75% French tresor 2032	(b) 3.15% France Tresor 2032	Implied inflation ie (a) less (b)	Net
31/12/2023	2.47%	0.36%	2.11%	
31/12/2013	3.10%	1.08%	2.02%	
Change	0.63%		-0.09%	0.54%

Approximately 0.5% net change for 20 years =1.0054^20 = 1.11%

Overall, the €2m increases to €2.89m or €2.9m rounded and the €2.15m increases to €3.1m

2. If inherently assume the €60k pension correct and reflecting a factor of 35 rather than 33 in the above table, where 35 represents open market annuity rate for a 60 year old, 50% spouses pension indexing at CPI capped at 5%.

	Pension	Factor	Value	TFLS	Total SFT
2014	€60,000	30	€1,800,000	€200,000	€2,000,000
2024	€78,600	35	€2,751,000	€262,000	€3,013,000

Overall, the €2m increases to €3.01m or €3.0m rounded and the €2.15m increases to €3.2m

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