Department of Finance
Consultation on the Standard Fund Threshold

February 2024

Introduction

The Society of Actuaries in Ireland ("the Society") is the professional body representing the actuarial profession in Ireland and welcomes the opportunity to engage in this consultation.

In responding, we have highlighted issues that we believe should be considered under the various headings. The Society is available to assist in the analysis of any options being considered.

The response has been prepared by members of the Pensions Committee of the Society and does not purport to reflect the views of the pensions industry.

Executive Summary

The Standard Fund Threshold (SFT) was introduced in 2005 with the purpose of discouraging the build-up of further tax incentivised pension saving once the value of an individual's pension had reached a prescribed ceiling. Originally, the limit was set at €5m (and was subsequently increased to €5.4m to reflect inflation up to 2008) and then reduced to its current level of €2m in 2014 (having been set at €2.3m in 2010-2013). The SFT has remained unchanged since then. We have provided our response to the various questions raised in the Consultation below but thought it helpful to summarise our main points as follows:

1. The Society proposes that the SFT limit be increased at regular intervals (as has occurred previously) to maintain the real value of pension savings and with recognition of the passage of time since the previous adjustment. Linkage to CPI is the Society's preferred means of increasing the SFT limit (see questions 1 and 5 below).
2. We continue to support the purpose of the SFT i.e. limiting the extent to which any individual should benefit from a tax incentivised pension arrangement, but we believe the review should focus on how best to set this limit. When it was originally introduced the SFT affected a relatively small number of the most highly pensioned individuals. Currently, the limit affects a broader contingent of senior employees in the private and public sector. Based on the analysis set out in question 1, the impact of prescribing a capital ceiling for the SFT can be seen to have a significant impact on the pension expectation of members of DC plans – typically those in the private sector. We believe there is merit in seeking to remove this anomaly between members in DC plans and those in DB schemes albeit that any attempt to do so would likely require an increase in

the level of the SFT threshold possibly at the same time as adjusting/simplifying the factors used to value DB pensions (see question 3 below)

3. We feel the tax rate for exceeding the SFT (i.e. effectively 69%[1]) is penal particularly for those where pension accumulation has ceased but who may inadvertently exceed the cap through revaluation of accrued DB pensions or investment growth on legacy DC pension savings. Consideration should be given to whether a lower excess tax rate would achieve the same disincentive to further pension accumulation above the SFT threshold (see question 2 below).

We hope our input is useful and we look forward to discussing and developing any points that may require further elaboration.

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[1] This is determined as the marginal income tax rate (40% higher PAYE rate and 8% USC) applied after the 40% excess tax rate is applied at the point of retirement.

Comments on Issues being considered

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

In the table below (on the left) we illustrate what a €2m fund would purchase at retirement at start, mid and current points over the past decade. We do so for a 66 year old DC member who has accumulated the maximum €2m in savings at retirement age. The pension amounts are derived from market annuity rates and allow for indexation at the rate of 3% p.a. on the pension and for continued pension payments at a reduced rate of 50% to the surviving spouse on the death of the pensioner.

To put the information in context, the table also shows (on the right) an example of a 66 year old public servant retiring in the future on a pension of €70,000 plus a gratuity of €210,000. These retirement benefits would also come close to exceeding the current SFT limit (i.e. using the post-2014 capitalisation factor of 25 as a proxy for the calculation). In practice, most current retirees who are impacted by the SFT will have earned substantial pre-2014 pensions that are assessed using a lower valuation factor of 20. This means that, in the near-term, the SFT limit is unlikely to be breached until a public servant's pension level is higher than €70,000 p.a.

DC member				Public service DB member	
Retirement on 1st Jan	2014	2019	2024		
Fund	€2,000,000	€2,000,000	€2,000,000	SFT valuation	€1,960,000
Lump sum	€200,000	€200,000	€200,000	Gratuity	€210,000
Sample market annuity factors (age 66)	30.3	38.2	28.3	Valuation factor (age 66)	25
Pension p.a.	€59,400	€47,100	€63,600	Pension p.a.	€70,000

It can be seen from the table that annuity factors are volatile since they depend on investment markets (in particular bond yields) at the time of purchase and estimates of policyholder longevity. The annuity factor at 1/1/2019 is provided to illustrate the impact on DC pension expectation which would have occurred when interest rates were near record lows. The person

in our example would have needed an extra c. €0.5m in their DC fund in 2019 to avoid a dip in their pension expectation (and could have achieved this objective by following a conventional "matched" investment strategy). However by so doing they would have breached the SFT threshold resulting in an upfront tax liability of c. €200,000. In short, DC members are subject to far more variability in retirement income than applies to members of DB plans and, depending on market conditions at the time of their retirement, may be far more heavily impacted by the SFT regime.

While the annuity factors provided can translate the accumulated savings into a retirement income, it should be acknowledged that most DC members who get close to the SFT limit will choose to drawdown their income with the flexibility provided by an ARF. In this case it is more informative to consider how the purchasing power of retirement savings has changed since the SFT was set at its current €2m level in 2014. See question 5 below for how the effects of inflation have eroded the purchasing power of pensions since 2014.

Overall, the Society supports the view that the regime should include a mechanism for adjusting the value of the SFT. The Society has considered the following practicalities of increasing the SFT on a regular basis and proposes how best to implement them in practice:

Consideration:	**Proposed response:**
Whether the adjustment should be a Ministerial decision each time (e.g. State pension increases) or automatic / quasi-automatic (e.g. Ministerial revaluation of deferred benefits or pension increases applied in the Single Scheme).	The Society's preference is for an automatic defined methodology which allows for ease of implementation and provides individuals with more certainty and transparency around how the SFT will change.
Whether the adjustment should relate to pay / pensions / prices only or also relate to the price of pensions (interest rates, inflation expectations, life expectancies)	The Society's preference is for the adjustment to increase with price inflation.
Which specific index or benchmark should be used	The Society's preference is for the SFT to be indexed in line with the Consumer Price Index (CPI).
How often adjustments should be made	The Society proposes that the SFT increases on an annual basis.

Whether adjustments should be "upward only" and, if not, whether the Personal Fund Threshold (PFT) process will apply where the SFT is lowered	The Society proposes that the increases in the SFT be upward only.
Whether an initial adjustment should be made to the €2million limit in respect of past experience since its introduction in 2014 and whether it should be on the same basis as the future adjustments	The Society proposes that the €2m limit introduced in 2014 be indexed at the appropriate rate to allow for the inflation since then.
Whether there should be a timescale included in the regime for a more fundamental review at regular intervals	The Society proposes that the SFT be subject to a fundamental review every 5 years to ensure that it is still achieving the purpose for which it was set and that it is calibrated at the correct level.
Whether the adjustment should apply only to the SFT or also to the €200,000 limit on tax-free cash and the €500,000 / limit on lump sums taxed at 20%	The Society proposes that consideration be given to indexing the €200k and €500k limits annually in line with any increase in the SFT.
Whether there should be adjustments to the capitalisation factors for DB pensions	The Society proposes that the capitalisation factors be reviewed every 5 years.

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.

The rationale for the SFT is largely unchanged from the time of its introduction at an initial level of €5m. The reductions to €2.3m and subsequently to €2m, and the elimination of indexation, were at a time when Financial Emergency Measures in the Public Interest (FEMPI) were being introduced following the financial crisis of 2008 and its subsequent impact on Irish public finances. Many of the FEMPI measures have since been reversed. There remains a strong rationale for the SFT.

Relevant changes to the pension landscape since the SFT was introduced include:

- A substantial conversion from DB to DC pension provision amongst private sector workers
- A much larger proportion of DC only members with much larger DC funds
- A trend towards facilitating later retirement and later drawing of State pensions
- The removal of some contribution limits, in particular for PRSAs
- More members with benefits earned in multiple jurisdictions
- Strong equity market and risk asset performance (The benchmark US equity index, the S&P 500, was up 160% and the benchmark European equity index, the Eurostoxx 50, was up 45% in the 10 years to beginning 2024).
- Most of the past 15 years has been an era of low and ultra-low interest rates where high rated bond yields have been close to zero. This had a major impact on annuity rates which offered poor value for money by historical standards. The resurgence of inflation in 2022 and the subsequent rise in interest rates have meant that bonds are now a much more appealing asset class.

We believe that the SFT regime has substantially succeeded in capping the level of tax-relieved pensions available to an individual. However, we feel the tax rate for exceeding the SFT (i.e. effectively 69%) is penal, particularly for those where pension accumulation has ceased but who have inadvertently exceeded the cap through revaluation of accrued DB pensions or investment growth on their legacy DC pension savings. Consideration should be given as to whether a lower excess tax rate would achieve the same disincentive to further pension accumulation above the SFT threshold.

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.

Impact of changing the SFT on overall tax expenditure

Raising the SFT would result in reduced tax receipts through greater tax-relieved pension provision and also due to lower direct tax receipts from benefits exceeding the SFT.

The SFT has been reducing in real terms since 2014. By not indexing the level of the SFT and the associated limits, there has been a gradual shift in the distribution of overall tax expenditure associated with pension provision away from those who have been impacted by the SFT. If no benchmarking is introduced, this shift will continue over time.

There are an unknown number of individuals who currently hold uncrystallised benefits with values above the SFT. This has arisen through continued accrual of benefits in DB schemes and continued contributions in DC schemes once the SFT has been reached. It has also arisen for some individuals despite cessation of pension accrual / contributions due to the application of Ministerial revaluation or salary increases within DB schemes or through investment growth in DC schemes. The benefits above the SFT will be subject to a high effective rate of tax (circa 69%). Increasing the SFT or reducing the applicable rate of tax will reduce the amount of these unknown tax receipts.

Appropriate benchmarking would broadly maintain the ongoing distribution of overall tax expenditure associated with pension provision and stop or reduce the gradual shift away from those who have been impacted by the SFT.

If the SFT is benchmarked, it may be appropriate to consider the impact on other related thresholds, particularly the €200,000 limit on drawing tax-free cash at retirement and the further limit of €300,000 (i.e. total of €500,000) on lump sums liable for a reduced rate of tax of 20%. Without consistent benchmarking to these related limits, the gradual shift away from tax relief to wealthier pension members would continue but at a slower pace.

Equity in treatment between different categories of DB member

The equity between different categories of DB members is largely driven by the capitalisation factors. In considering these factors, there is a trade-off between simplicity and equity. For example, the original factor of 20 applied to capitalise a DB pension is a good approximation for the current cost of securing a joint life pension without pension indexation from age 66. By contrast the factor of 25 now applying to post-2014 pension may be a reasonable approximation for the capitalised value of a public sector pension with salary-related indexation but there is a strong argument that it overstates the value of a pension without any scope for pension indexation i.e. as often occurs in the private sector. There may be an argument for reverting to the original factor of 20 in circumstances where a scheme can confirm that no form of pension indexation will ever be provided to the person impacted by the SFT.

Equity in treatment between DB and DC members

The ultimate pension arising for members of DC schemes is dependent on variable factors such as the level of stock-market performance on their pension savings and the cost of securing a retirement annuity etc. The table in Question 1 shows the variability in pension outcomes over

the past 10 years. In terms of achieving equity with members of DB schemes regarding the impact of the SFT, this depends mainly on how prevailing annuity rates compare with the factors used to capitalise DB pensions. In very broad terms current annuity rates are reasonably consistent with the post-2014 factors if the comparison is between pensions subject to a form of indexation. However, it can be seen that a person retiring during the ultra-low interest rate environment pertaining in 2019 would have needed a far higher fund (i.e. approximately +35%) to secure the same retirement income so this illustrates the unique and additional challenges faced by a DC member when the SFT is established as a fixed capital threshold.

It is difficult to improve equity of treatment between DB and DC without introducing complexity but consideration could be given to framing the SFT regime as a pension income rather than capital threshold. Alternatively, given that variability in fund value is a feature of the DC system (so breaches of the SFT threshold are likely to occur even after pension contributions have ceased) there is an argument for reducing the level of the excess tax rate.

DB members in the private sector can be impacted by having to pay the excess tax from after-tax assets or from penal commutation factors being applied where the scheme pays the tax and reduces the pension. This issue does not arise for DC members.

Equity in treatment between public sector and private sector members

Equity between the public sector and the private sector is similar to the equity between DB and DC since the public sector is largely DB and the private sector is largely DC. Also, where DB schemes exist in the private sector, they tend to have lower or no form of pension indexation so their members are, arguably, more heavily impacted by the SFT regime. Public sector workers also benefit from a number of options in the regime that are not generally available to private sector workers:

- The option to defer the tax by pension deduction spread over 20 years with no clawback on death. By contrast members of DC schemes have no option other than to pay the tax upfront and members of private sector DB schemes are reliant on whatever form of present value pension exchange for tax arrangement may be available within their scheme.
- The option to encash their previous private sector pension with a view to eliminating or minimising the chargeable excess that would otherwise arise when public sector pension crystallises

It may be possible to extend some of the public sector options to the private sector (see Question 7).

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.

For this question we consider public and private sector separately:

Private Sector

It is difficult to be certain of the impact the SFT may have on recruitment/retention. Many employers in the private sector have facilitated opting-out once the SFT limit is close to being breached and some have offered alternative remuneration arrangements thus neutralising retention/recruitment decisions. On the other hand, particularly where there is a strong policy of enforcing common benefit policies across all employees, some employers may refuse to make adjustments to accommodate Irish tax rules and this may act as a deterrent to continued employment once pension limits are breached.

Public Sector

Members of DB schemes with high salaries and long service are most likely to be affected by the SFT. Based on a blended capitalisation factor of 25 at age 60 (i.e. 20 in respect of pre 2014 pension accrual and 30 for post 2014 pension), a current retiree from the public service with an accrued pension by that age of just over €70,000 p.a. (plus a 3 times gratuity) could breach the SFT.

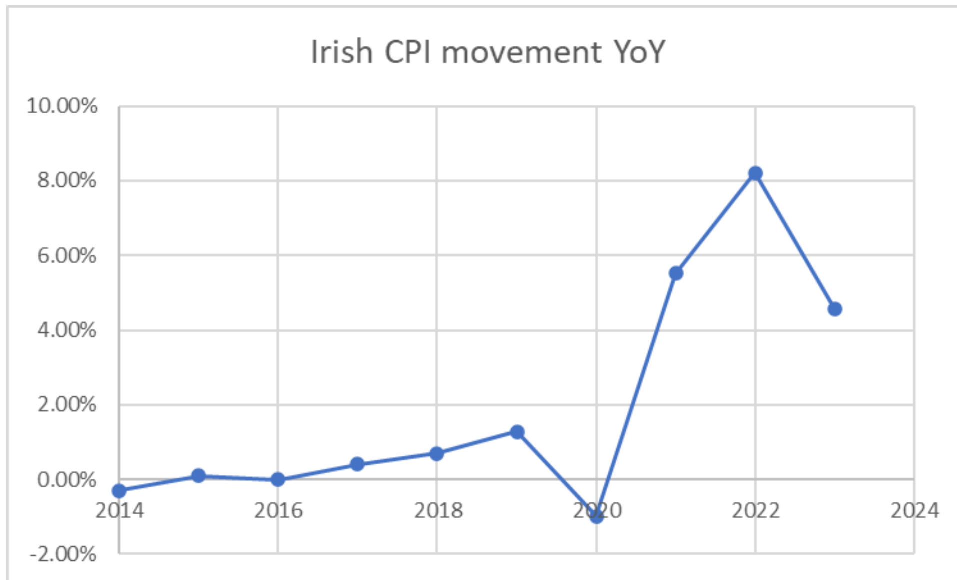
We expect that these would be employees in relatively senior positions and/or with long service, and the failure to retain them in employment may have a disproportionate impact on the employer. We would point to the current difficulties in securing a Garda Deputy Commissioner due, in part, to concerns over taxation of pension entitlements.

In general, the public sector arrangements for managing the SFT tax (i.e. ability to pay it by pension deduction over a 20 year period) should lessen the incentive to leave such employment once the limit is breached whereas private sector employees in a similar situation may be more likely to retire. We believe that the Society's proposal to increase the SFT as well as lessen the excess tax rate on breaching the limit will go some way to addressing these concerns.

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.

We propose that some form of indexation of the SFT is appropriate. The SFT has not changed since being reduced to €2m in 2014. This has completely ignored the impact of inflation on the purchasing power of pension savings over this period. While inflation was muted during the

period 2014-2020, the last number of years has seen significant inflation exacerbated by the energy crisis following the war in Ukraine. Overall inflation as measured by the benchmark CPI index has increased by 21% over the last 10 years. In other words, in order to have the same purchasing power, an individual who had accumulated a lump sum of €2m in 2014, would need to have accumulated €2.42m by January 2024.



In many cases investment returns have been keeping pace with inflation and some cases exceeding inflation, thus it does not make sense that the SFT limit remains constant while savings increase.

If the SFT is to be benchmarked to an appropriate and fair level of estimated retirement income, it is reasonable to expect that this level of income should be protected against erosion due to increases in the cost of living. There are many options which can be used to index the SFT, each with its own merits and drawbacks:

- The Consumer Price Index (CPI);
- The Harmonised Index of Consumer Prices (HICP);
- A capped version of one of the indices above, such as the index of statutory revaluation for DB pensions;
- Increases in average national earnings
- Increases to the State pension;
- Increases to the Single Scheme pension;
- Increases or an appropriate subset of increases in public-sector salaries or pensions

The Society's preferred option is to link the increase in the SFT to CPI with upward only adjustments. Our rationale for this approach is that it:

- Provides an objective, transparent and easily accessible measure of inflation
- Provides general protection against the increase in price levels
- Is probably the best understood measure of inflation amongst the public
- Avoids many practical downfalls with a SFT that reduces.

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

The Society believes it is important that there is broad equity between public sector pensions, private sector DB and DC pensions. Taking a long-term approach to setting the valuation factors is also important to facilitate financial planning and ensure individuals are not impacted by short-term changes.

Some relevant key differences between public sector and private sector pensions are (a) the level of increases applied to pensions in payment and (b) the options available for settling any excess tax liability should it arise. Public sector pensions remain linked to public sector pay increases while most private sector pensions do not increase in payment. Private sector pensioners cannot avail of the tax deferral options available to public service pensioners. In an attempt to improve equity consideration could be given to the following:

- Reverting to the original capitalisation factor of 20 in circumstances where a DB scheme can confirm that no form of pension indexation will ever be provided to the person impacted by the SFT.
- Reducing the excess tax rate below its current level of 40% to apply to those who exceed the limit.

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

We recognise that a Chargeable Excess Tax liability may be difficult to fund for individuals with a private sector DB pension (and little or no DC pension benefits). We believe it would be beneficial to highlight, and encourage trustee facilitation of, the option to allow an individual to finance the tax by a reduction in their pension over a long-term period, with no clawback on death. Currently this option is available to public sector employees but is not always available in the private sector. One way of encouraging a more equal system would be to change Revenue rules by allowing trustees of private sector pension schemes the option of spreading any excess tax liability over a

20 year period – thus facilitating an equivalent adjustment to a member's pension as applies in the public sector.

We note that Chapter 29 of the Revenue Pension Manual (Dual Private/Public Pension Scheme Encashment Option) is available only where an individual has a combination of private and public sector benefits and is an active member of a public sector scheme. This option may be helpful for some individuals as it could bring their pension pot below the SFT through a refund of their own contributions, subject to 40% income tax only. Consideration could be given to extending this option to individuals who have private sector DB pension but no public sector pension.

Pensions Manual - Chapter 29 - Dual Private/Public Pension Scheme Encashment Option (revenue.ie)

The encashment option allows people encash pension above SFT and avoid the excess tax. Extending this option to the private sector would reduce tax take.

8. Options for simplifying the SFT regime.

The Society supports the continuation of the SFT regime. There is a level of complexity involved in any such regime but understanding and administration of the regime can be helped by consistent and clear rules over time.

At the moment, there are some areas which need to be excluded from the SFT calculation. The exact treatment in these scenarios is not well defined and often relies on individual interpretations from Revenue. We would recommend that the treatment of these areas is more clearly defined and set out to provide a consistent treatment in all cases. In particular:

- Periods where an individual has been on secondment overseas
- Where an individual has had a transfer in from an overseas pension scheme

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