Examination of the Standard Fund Threshold

February 2024

Overview

Review of the SFT

The SFT was introduced in December 2005. It was intended to place a lifetime limit on the total capital value of pension benefits that an individual could draw from tax relieved pension products where those benefits are taken, or come into payment, for the first time on or after 7 December 2005 (benefits which came into payment prior to that date are ignored). This limit, known as the SFT, was initially set at a level of €5 million. In certain circumstances, a higher threshold called the personal fund threshold (PFT) could apply.

On each occasion on or after 7 December 2005 (referred to as a "benefit crystallisation event" or "BCE") that an affected individual becomes entitled to receive or, in the case of vested RACs, vested PRSAs or vested Pan-European Personal Pension Products (PEPPs) are treated as having received, a benefit (for example, a pension or a retirement lump sum) under a pension arrangement, an individual uses up part of their SFT or PFT equal to the capital value of that benefit.

When the capital value of a BCE (either on its own or when added to BCEs that have been taken since 7 December 2005) exceeds an individual's SFT or PFT, a "chargeable excess" arises which is subject to an upfront income tax charge levied at a rate of 40%. This is additional to any income tax that would ordinarily arise on the draw down of pension benefits. In the case of a marginal rate taxpayer, this may lead to an effective income tax rate (including USC) of 68.8% in respect of the chargeable excess.

When the SFT was initially set at a level of €5 million, it was intended that it would be indexed at regular intervals in line with an earnings factor[1]. The SFT was increased in 2007 and 2008 and reached a level of €5,418,085. However, the financial crisis intervened resulting in the reduction of the SFT to €2.3 million in 2010. The SFT was further reduced to €2 million in 2014. The threshold has remained at that level for a decade, with no adjustments to reflect subsequent economic, social or demographic changes or the subsequent improvement in the State's financial health.

The SFT is a very significant feature of the Irish pension regime which has a profound behavioural impact on the level of provision made for private pensions. As discussed further below, it is important for the wellbeing of the country that individuals are encouraged to make adequate financial provision for their retirements. Given that the SFT has remained unchanged since 2014, it is time for the SFT to be reviewed and adjusted to take account of:

- changes in the standard of living;
- changes in the national average wage;
- changes in life expectancy;
- the impact of inflation; and
- changes in interest rates

We have made a number of recommendations below on how best to reform the SFT. In framing those recommendations, we have not revisited the basis for the reductions made to the SFT in 2010 and 2014. While there is an argument that those reductions were too deep and there is a correction required, we have focussed on a rebasing of the €2 million SFT set in 2014 to take account of the matters set out above only.

[1] Explanatory memo to Finance Bill 2006: https://data.oireachtas.ie/ie/oireachtas/bill/2006/1/eng/memo/b0106-memo.pdf

Key recommendations

- ✓ Rebase the SFT to 2024 levels to take account of:
    - increases in inflation / wage levels
    - changes in interest and annuity rates
    - changes in life expectancy and mortality rates
    - socio-economic developments

  Depending on whether CPI or wage inflation is used, this would necessitate an increased SFT of between **€3,158,100** and **€3,475,600.** This would incorporate an increased retirement lump sum amount between **€460,800** and **€500,800.**
- ✓ Provide an effective mechanism for the future indexation of the SFT
- ✓ The opportunities afforded to public sector taxpayers to avoid a chargeable excess though partial encashment and the spreading of the BCE charge should be extended to all taxpayers

Other consequential changes

An increase of the SFT should also necessitate a re-assessment of the pension contribution rules for individuals. Currently, the pension contribution limits for individuals are based on a percentage of annual earnings, capped at an annual earnings limit of €115,000. If the SFT is increased, it will be necessary to increase the annual earnings limit by the percentage increase applied to the SFT. Depending on whether CPI or wage inflation is used, this would necessitate an increased annual earnings limit of between €182,000 and €200,000.

Key recommendations

- ✓ Increase the pension contribution earnings limit by the percentage increase applied to the SFT
- ✓ Adopt a “whole of life approach” to the pension contribution limit
- ✓ Introduce tax relief for spousal contributions

Rebasing of the Standard Fund Threshold

Our recommendations for reform of the SFT are as follows:

Rebasing of the SFT

As set out in the overview, provision was made in Finance Act 2006 for the Minister for Finance to amend the SFT in line with an earnings adjustment factor[1]. The intention of that provision was to enable the real economic value of the SFT to be maintained for all generations of taxpayers. While that review process resulted in the initial SFT of €5 million being increased to €5,418,085 in 2008, it was dramatically reduced to €2.3 million in 2010 and then to €2 million in 2014[2]. No adjustments have since been made.

When the SFT was reset in 2014 at €2 million, it appears that a view was formed at that time that the provision of tax support to fund defined benefit pensions above €60,000 for those retiring at age 60 should be discouraged. This can be inferred from the fact that the €2 million threshold is the aggregate of:

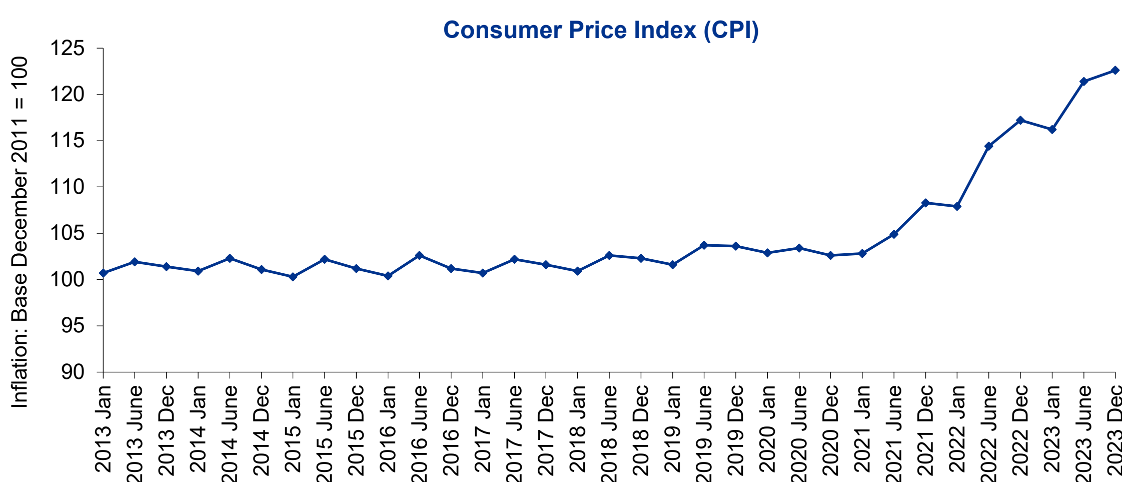
(i) an annual pension of €60,000 capitalised using the post-2014 capitalisation factor of 30 in the SFT rules, and
(ii) the maximum tax-exempt retirement lump sum of €200,000.

As the SFT has been fixed at €2 million for a decade, it needs to be reviewed and adjusted to take account of:

- inflation / average wage growth;
- changes in interest and annuity rates;
- changes in life expectancy and mortality rates;
- socio-economic developments;
- changes in the standard of living;

These are addressed in turn below:

- *Inflation / increases in price levels / average wage growth*: According to the CSO, the Consumer Price Index (CPI) over the period between January 2014 and December 2023 reflected an increase of 21.5 percent[3], illustrated in the graph below:



Source: Central Statistics Office, January 2024

[1] This is provided for in section 787O, TCA 1997 and has occurred twice; in 2007 (adjustment factor: 1.033, SFT: €5.165 million) and 2008 (adjustment factor: 1.049, SFT: €5.418 million).
[2] https://www.revenue.ie/en/tax-professionals/tdm/pensions/chapter-25.pdf
[3] Central Statistics Office: https://visual.cso.ie/?body=entity/cpicalculator

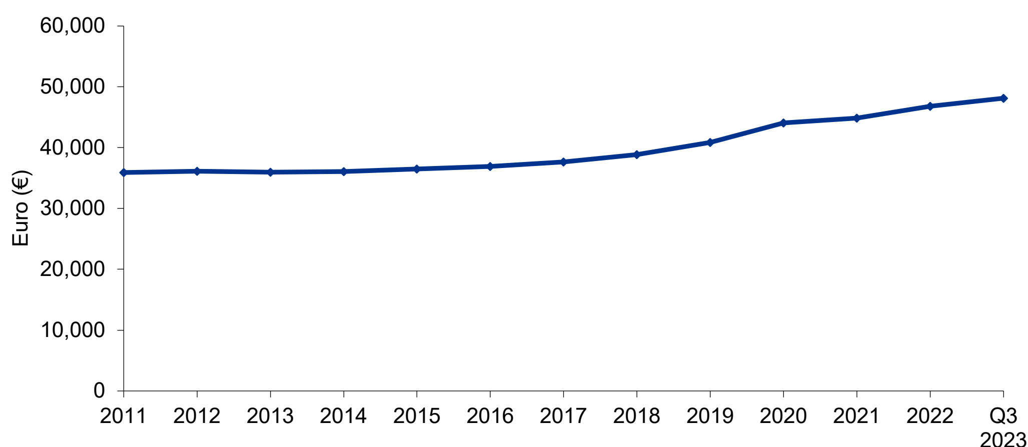
Inflation has caused a very material erosion of the real value of the €2 million SFT that was reset in 2014. To restore the real value of the 2014 SFT amount to take account of CPI (ignoring the other matters discussed below, which should also be taken into account), the SFT should be increased to €2.43 million.

As noted earlier, the SFT is derived from an aggregation of a capitalised pension annuity (€60,000 x 30) plus the maximum tax-free pension lump sum. An adjustment of the SFT for CPI would essentially involve the adjustment of both the annuity assumption (to €72,900) and the retirement lump sum amount (to €243,000).

While an adjustment of the SFT to reverse the impact of inflation since 2014 would be a positive step, it would in our view be more appropriate to adjust the SFT to take account of wage inflation. Given that the SFT was re-configured in 2014 by reference to a pension annuity of €60,000, a strong argument can be made that the real value of that annuity, and therefore the SFT, would be better achieved by adjusting the SFT for wage inflation.

According, to the CSO, average wages increased between 2014 and 2023 by 34%[4]. To restore the real value of the 2014 SFT amount to take account of wage inflation (ignoring the other matters discussed below, which should also be taken into account), the SFT should be increased to €2.68 million.

Adjusting the SFT for wage inflation would essentially involve the adjustment of both the annuity assumption (to €80,400) and the retirement lump sum amount (to €268,000).



Source: Central Statistics Office

- *Interest and annuity rates*: Annuity rates are significantly impacted by interest rates. As prevailing long term interest rates have increased significantly since 2014, it would be appropriate to adjust the capitalisation factor. For example, the open market annuity rate for an individual aged 60 with (i) 50% spouse's reversion; and (ii) indexing in line with CPI capped at 3% is 2.677%, which translates into a capitalisation factor of 37[5].

  Increasing the capitalisation factor used in the determination of the SFT from 30 to 37, based on a CPI adjusted pension annuity of €72,900, would increase the CPI adjusted SFT from €2.43 million to €2.94 million.

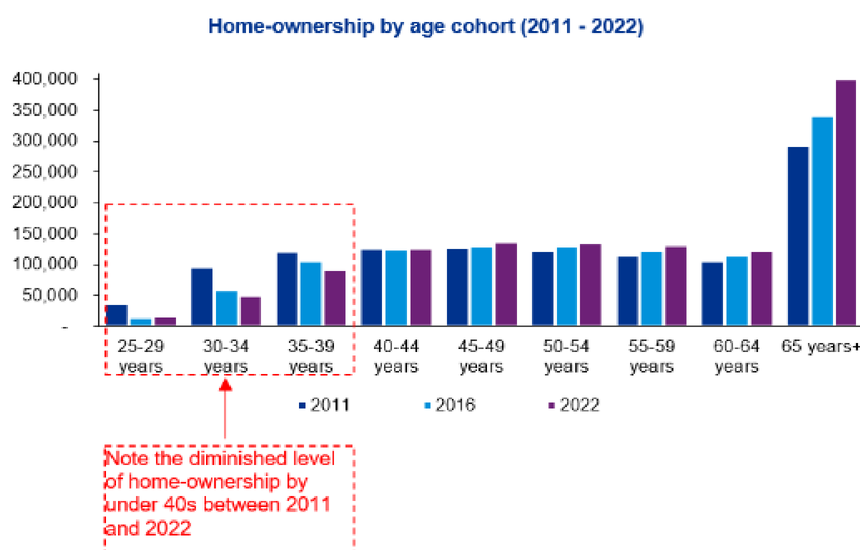
[4] Average wage of €35,915 in 2011 and €48,134 in Q3 2023 (Source: Central Statistics office)
[5] Market derived annuity quotation

Increasing the capitalisation factor used in the determination of the SFT from 30 to 37, based on a wage inflation adjusted pension annuity of €80,400, would increase the wage inflation adjusted SFT from €2.68 million to €3.24 million.

- *Life expectancy and mortality rates*: Average life expectancy in Ireland has increased from 81 years in 2014 to 83 years in 2024. Increasing life expectancy is expected to remain a trend in future years[6]. In practical terms, this means that an individual's pension pot will need to stretch over a longer period than was assumed in 2014. A failure to adjust the assumptions underlying the calculation of the SFT to take this into account may leave pensioners short funded at a vulnerable time in their lives. Further adjustments may be required in the future if the increasing life expectancy trend continues.

  On a simplified basis, this would suggest that the SFT should be increased by an additional €145,800 based on a CPI adjusted pension annuity of €72,900, or by €160,800 based on a wage inflation adjusted pension annuity of €80,400. This would cover the funding of two additional years of the adjusted pension annuity assumption.

- *Socio-economic developments*: The Economic and Social Research Institute ("ESRI") has projected that future retirees are likely to face substantially lower rates of home-ownership than current retirees. The ESRI estimates that only 65 per cent of those currently aged 35-44 are likely to become homeowners by retirement given current trends, as compared to 90 per cent of those currently aged 65 and over[7]. In 2011, 69 per cent of those aged 34-44 and 86 percent of those aged 65+ owned their homes[8]. This compares to 17 per cent of individuals aged 34-44 that owned their homes in 2023[9]. The graph below illustrates that individuals are purchasing their homes at a later stage in life[10]:



This means that future cohorts of retirees may have to fund their housing costs (either a mortgage or rent) using their pensions. Consideration should therefore be given to increasing the SFT to offset the increased housing burden that will be borne by future retirees in retirement[11].

[6] Male life expectancy in 2051 is projected to be 85.6, a gain of 6.3 years over the 36-year period (2015 – 2051). For females there is a projected gain of 5 years to 88.3: https://www.cso.ie/en/releasesandpublications/ep/p-plfp/populationandlabourforceprojections2017-2051/mortalityassumptions/

[7] ESRI: Future Trends In Housing Tenure And The Adequacy Of Retirement Income (July 2022)

[8] Homeownership and Rental: What Road is Ireland On? (National Economic and Social Council, November 2014)

[9] According to a survey conducted on behalf of Aviva Group in August 2023 Survey – Homeowners in Ireland

[10] Central Statistics Office: Census of Population 2022 Profile 2 - Housing in Ireland (July 2023).

[11] One in 10 homeowners face mortgage payments past 70, survey finds – The Irish Times - https://www.irishtimes.com/

Based on the Banking & Payments Federation Ireland Mortgage Market Profile Report for H1 2023[12], the average age of a first time buyer is 35 years and the average loan amount was €270,000, with a loan term of 30 years. Assuming an interest rate of 4.25%[13], approximately €72,000 (rounding to the nearest thousand) will be outstanding when an individual is aged 60[14]. This would suggest that the SFT should be increased by an additional €72,000. We would recommend that this be implemented by way of an increase to the tax-free pension lump sum amount (and a resulting increase in the SFT).

The cumulative effect of these issues on the SFT is illustrated in the tables below.

As outlined above, the SFT and tax-free retirement lump sum could be rebased by reference to CPI or wage inflation. In Table 1, we have illustrated the impact of rebasing by reference to CPI and adjusting for the other matters set out above. This would result in an increase in the SFT to approximately €3.15 million.

Table 1: Cumulative effect of adjustments to SFT (adjusted in line with CPI)

	Pension capitalised value (€)	Tax-free lump sum (€)	Cumulative impact on SFT (€)
2014 amount	1,800,000	200,000	2,000,000
Inflation adjustment (21.5%)	387,000	43,000	430,000
Long term interest rate adjustment	510,300	-	510,300
Increase in life expectancy rates	-	145,800[15]	145,800
Socio- economic developments	-	72,000[16]	72,000
Rebased amount	2,697,300	460,800	**3,158,100**

[12] Banking & Payments Federation Ireland Mortgage Market Profile Report (November 2023).
[13] Average mortgage rate as at November 2023
[14] Mortgage interest calculator
[15] (72,900 x 2) – to account for a two-year increase in life expectancy between 2014 and 2024
[16] Based on the Banking & Payments Federation Ireland Mortgage Market Profile Report, the average age of a first time buyer is 35 years and the average loan amount was €270,000 with a loan term of 30 years. Assuming an interest rate of 4.25% (average mortgage rate as at November 2023), approximately €72,000 (rounding to the nearest thousand) will be outstanding when the individual is aged 60 (mortgage interest calculator).

However, for the reasons outlined earlier, we consider that it would be more appropriate if the SFT and tax-free retirement lump sum were rebased by reference to wage inflation (and adjusted for the other items noted above).

Table 2: Cumulative effect of adjustments to SFT (adjusted in line with average earnings growth rate)

	Pension capitalised value (€)	Tax-free lump sum (€)	Cumulative impact on SFT (€)
2014 amount	1,800,000	200,000	2,000,000
Increases in average wage adjustment (34%)	612,000	68,000	680,000
Long term interest rate adjustment	562,800	-	562,800
Increase in life expectancy rates	-	160,800[17]	160,800
Socio- economic developments	-	72,000[18]	72,000
Rebased amount	2,974,800	500,800	**3,475,600**

Indexation of SFT

Going forward, it will be important that the SFT is rebased on a regular basis and that an effective process is implemented to achieve this. Section 787O, TCA 1997 already grants the Minister for Finance the power to increase the SFT using an "earnings adjustment factor". However, an earning adjustment has only been applied twice[19].

In addition to the adjustment of the SFT by reference to an earnings factor, it should also be adjusted periodically to take account of other relevant factors including:

- Changes in life expectancy

[17] (72,900 x 2) – to account for 2-year increase in life expectancy between 2014 and 2024
[18] Based on the Banking & Payments Federation Ireland Mortgage Market Profile Report, the average age of a first time buyer is 35 years and the average loan amount was €270,000 with a loan term of 30 years. Assuming an interest rate of 4.25% (average mortgage rate as at November 2023), approximately €72,000 (rounding to the nearest thousand) will be outstanding when the individual is aged 60 (mortgage interest calculator).
[19] In 2007, the earnings adjustment was set at 1.033 (SFT of €5,165,000) and in 2008 the earnings adjustment was set at 1.049 (SFT of €5,418,085): source: https://www.revenue.ie/en/tax-professionals/tdm/pensions/chapter-25.pdf

- Changes in interest and annuity rates
- Other relevant socio-economic factors

Equalisation of the treatment of private sector with public sector taxpayers

Currently, where a benefit crystallisation event gives rise to a chargeable excess, a 40% income tax charge applies to the excess (i.e., the amount above the SFT or the PFT). Individuals with a mix of private and public sector pension benefits can potentially eliminate a prospective chargeable excess tax liability by encashing all or part of their benefits under a private occupational scheme (see section 787TA, TCA 1997) after age 60 but before taking their public sector pension benefits. The amount encashed does not count toward their available threshold limit. This means that public sector employees can enjoy a benefit not available to those in the private sector.

Also, for public service pensions, the chargeable excess tax can be paid in instalments by way of a deduction from the gross pension over 20 years and with no recovery of any undischarged balance upon death. In contrast, for benefits under private sector pension schemes, the residual chargeable excess tax liability is usually recovered by the pension administrator from the pension scheme, reducing the retirement benefits accordingly.

We recommend that the opportunities afforded to public sector taxpayers to avoid a chargeable excess though partial encashment and the spreading of the BCE charge should be extended to all taxpayers.

Other consequential changes

An increase of the SFT should also necessitate a re-assessment of the pension contribution rules for individuals. Currently, the pension contribution limits for individuals are based on a percentage of annual earnings, capped at an annual earnings limit of €115,000. If the SFT is increased, it will be necessary to increase the annual earnings limit.

Furthermore, consideration should be given to increasing the flexibility available to individuals to fund for retirement. In 2022, the CSO reviewed the extent of personal pension coverage in Ireland. They found that 33% of the national workforce had no occupational or personal pension arrangement in place. This is particularly concerning as it suggests that there will be a significant level of dependence on the State pension by our aging population in retirement. There is a need to encourage increased pension coverage and pension saving if we are to meet the objective that 70% of the workforce should have a supplementary pension with an income target of 50% of pre-retirement earnings[20].

Our recommendations are set out below:

Indexation of the pension contribution limit

The maximum amount that an individual can contribute to their combined pension schemes in any one year is determined by the individual's age and an annual earnings cap of €115,000. The original earnings cap of €254,000 introduced in 2006 was reduced to €150,000 in the 2009 emergency budget[21] and further reduced to €115,000 in 2011[22].

Similar to the SFT, it was intended that the pension contribution earnings limit would be indexed to maintain its value[23]. This mechanism was required to ensure that an individual's capacity to

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[20] Report of the Interdepartmental Pensions: Reform & Taxation Group (2020).
[21] Summary of 2009 Budget Measures - Policy Changes
[22] The earnings limit was €254,000 in 2006, €262,382 in 2007, €275,239 in 2008, €150,000 in 2009 and 2010 and €115,000 in 2011.
[23] As stated in the Explanatory Memo to Finance Bill 2006 and confirmed by the then Minister for Finance, Brian Cowen during a Dáil debate on Finance Bill 2006

make pension contributions would adjust in line with the SFT. Otherwise, an increase to the SFT would be of limited benefit.

In our view, the pension contribution earnings limit should be increased by the percentage increase applied to the SFT. Depending on whether CPI or wage inflation is used, this would necessitate an increased annual earnings limit of between €182,000 and €200,000.

Adopt a “whole of life approach” to the pension contribution limit

Currently, the pension contribution limits for individuals operates on a non-cumulative basis (i.e., on a use it or lose it basis annually). The non-cumulative nature of the contribution limits is very inflexible and does not take due account of the diverse working patterns and financial commitments of individuals over their working lives. Individuals are now more likely to transition between a higher number of occupations and periods of training and development over their lifetime, which can result in volatility in an individual’s earnings. Furthermore, for a period of their life, they have to devote their available financial reserves to the purchase of a house, meeting education costs etc. For example, given the increase in the average age of a first-time home buyer to 35 (29 in 2005[24]), individuals are paying off mortgages later in life and the current age-related limits do not take this into account.

As a result of this shift in working dynamics, we advocate that the design of the limits placed on tax relief for funding pensions takes a ‘whole of working life’ approach – supporting provision early in the working life as well as in a ‘lumpy fashion’ throughout the working life as the individual’s financial resources allow. This could be achieved by increasing the tax relief available for contributions and allowing for the carry forward of unused annual tax relief for contributions to accommodate ‘lumpy’ payments. This will allow an individual to make higher contributions at an early stage in their working life if their financial resources allow while also support those with atypical career patterns, including entrepreneurs.

Introduce tax relief for spousal contributions

At present, an individual is only entitled to income tax relief in respect of pension contributions made to their own pension scheme or arrangement. To increase pension coverage, consideration should be given to the introduction of tax relief for contributions made by an individual to the pension scheme or arrangement of their spouse or spousal equivalent. For example, where the annual income of the spouse (or spousal equivalent) does not exceed €33,000[25] (e.g., where a spouse has taken on a role as an unpaid care giver), it should be possible for the other spouse to obtain tax relief for pension contributions made on their behalf.

[24] https://www.independent.ie/business/personal-finance/having-children-now-comes-before-buying-a-home/31472650.html#:~:text=In%202005%2C%20the%20average%20first,a%20key%20barrier%20to%20ownership.

[25] The current amount a married individual that is jointly assessed will have to earn to be entitled to the full standard rate band of €84,000.

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