Finance Act 2013: An Overview of the Taxation of Pensions and Related Rules for Investments

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Introduction

The first part of this article considers the provisions of Finance Act 2013 insofar as they affect pensions. There are no major surprises. The widely reported innovation is the pre-retirement access option, allowing members to access 30% of their additional voluntary contributions (AVCs). The second part of this article considers the tax rules governing pension investment.

Pre-Retirement Access Options

As announced in the Budget speech, Finance Act 2013 provides for limited pre-retirement access to pension money.[1] During the three years following the passing of the Finance Act, individuals will be able to make a once-off withdrawal of up to 30% of their AVCs from their pensions. The amount withdrawn will be taxed at the individual's marginal rate. Undoubtedly, this will provide welcome, but limited, relief for some cash-strapped individuals.

The pre-retirement access option ("PRA option") is to be governed by a new s782A in the Taxes Consolidation Act 1997 (TCA 1997). A PRA option is exercisable at any time up to the third anniversary of the passing of Finance Act 2013 (*27 March* 2016). A PRA option can be exercised only once. The amount of the withdrawal can be up to 30% of the value, at the date of exercise, of an individual's AVC fund.

The AVC fund is that portion of the realisable value of the pension scheme or AVC PRSA[2] that represents relevant AVCs less any

1 Section 17 Finance Act 2013.

2 An AVC PRSA (personal retirement savings account) is a PRSA established by an employee who is already a member an occupational pension scheme and into which the employee makes additional voluntary contributions.

expenses of the scheme attributable to that portion. Relevant AVCs must be voluntary and do not include employer contributions, nor contributions that a member or contributor is obliged to make (i.e. under contract), nor contributions made under a purchase of notional service scheme. It is important to note that personal contributions to normal PRSAs or retirement annuity contracts (RACs) are not AVCs and, therefore, certain employees and the self-employed cannot currently benefit from the PRA option.

The value of the AVC fund is to be determined at the date on which the PRA option is exercised. This may give rise to problems where asset values are not easily ascertained or where valuations may be wide-ranging. A PRA option cannot be exercised in respect of a vested PRSA (i.e. post-retirement). Where a pension has been divided between spouses or civil partners under a pension adjustment order, either party can exercise a PRA option in respect of his or her share of the AVC element of the pension.

A payment to an individual on the exercise of the PRA option is taxable under Schedule E, and the pension/PRSA administrator is obliged to deduct tax at the individual's marginal rate unless a Tax Credits and Standard Rate Cut-Off Point Certificate is provided by the Revenue Commissioners. The USC[3] and PRSI[4] will not apply to PRA option payments.

Within 15 working days of the end of each quarter, administrators must file electronic returns detailing the number of PRA option payments made, their aggregate value and the total tax deducted[5]. Administrators must retain records for six years and produce them to the Revenue Commissioners when requested.

Interestingly, the exercise of a PRA option will not give rise to a benefit crystallisation event, which would otherwise trigger onerous taxes for pension schemes that exceed the maximum tax-relieved fund thresholds.[6]

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ARF Access

Finance Act 2013 also introduced some temporary changes to the provisions governing access to approved retirement funds (ARFs).

To be permitted to access to an ARF on retirement, an individual must be in receipt of a minimum annual income or hold a minimum fund (an AMRF) until the age of 75. To ensure that there is no disparity between ARFs and vested PRSAs, unless an individual has a certain minimum annual income, a minimum fund must be retained within a vested PRSA or an AMRF until the age of 75.

Under Finance Act 2011, the amounts were increased from a minimum annual income of €12,700 and a minimum fund of €63,500 to amounts determined by a formula linked to the State contributory pension. In 2012, the figures were an annual income of €18,000 and a fund of €119,800. However, Finance Act 2013 temporarily rescinds the increases with the intention that they will be reintroduced in 2016. There are specific provisions to deal with those who were subject to the increased amounts since Finance Act 2011.

PRSAs Passing on Death

Section 85 of the Capital Acquisitions Tax Consolidation Act 2003 provides that where a child over the age of 21 inherits an ARF, that disposition will not be subject to inheritance tax. Again, to eliminate any disparities between ARFs and vested PRSAs, Finance Act 2013 extends this exemption to PRSAs passing on death.[7]

Proposed Reduction in Maximum Tax-Relieved Pension

One measure that does not feature in Finance Act 2013 but was included in the Budget speech is the proposed introduction in 2014 of a cap on tax-relieved pension funds of an amount that will produce a pension of €60,000 per annum. On a rough calculation, this would equate to a tax-relieved pension fund cap of *c.* €1.5m, a reduction from the current cap of €2.3m. It remains to be seen how the proposed cap will be implemented.

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3 Section 2 Finance Act 2013.
4 To be included in the next Social Welfare and Pensions Bill.
5 Paragraph 2C, Schedule 23, TCA 1997, and Schedule 23C TCA 1997.
6 Section 787R TCA 1997.
7 Section 90 Finance Act 2013.

Current Tax Regime

Importantly, pensions still present benefits for taxpayers:

- Individual contributions to a pension continue to enjoy tax relief at marginal rates, limited by reference to a percentage of earnings based on the employee's age.[8]
- Employer contributions to a pension are not subject to those limits. Employers are permitted to contribute amounts up to those that would produce the maximum tax-relieved pension on retirement.
- Income and gains within a pension are not subject to tax.
- Members can avail of a tax-free lump sum on retirement.

Using Pensions to Invest

Understanding how pensions can be used for investment purposes is important. The low participation in the Employment and Investment Incentive Scheme suggests that individuals are currently keen to hold on to cash deposits. They are more inclined to invest using pension funds, which are (for the most part) locked away until retirement. This article will now focus on the rules governing investments by small self-administered occupational pension schemes. Similar rules apply to investments by self-directed PRSAs[9] and ARFs.[10]

In order to ensure that a self-administered scheme maintains its favourable tax treatment, investments must comply with two sets of rules, one statutory and the other extra-statutory. Please note that, aside from the tax rules, any investment must be permitted by the terms of the scheme. Also, pension providers are under an obligation to ensure that, in choosing an investment, a member is duly advised and fully informed.[11]

Statutory Rules

The statutory rules are found in s784A(1B) TCA 1997.[12] The provision sets out the different types of transaction that would give rise to a "pension in payment". In other words, the member would be deemed to have received income from the scheme to the value of the assets used in the transaction and would be taxed accordingly. In exceptional circumstances, the Revenue Commissioners could withdraw approval for the entire scheme.

The types of transaction proscribed include:

- making a loan to the member or using the assets of the scheme as security for such a loan,
- acquiring an asset from the member,
- selling an asset to the member,
- acquiring a holiday home or residence for use by the member,
- acquiring an interest in a close company in which the member is a participator,
- acquiring tangible moveable property (i.e. goods) and
- acquiring assets for use in the member's business.

In the foregoing paragraphs, "member" should be taken to include a person "connected" with the member within the meaning ascribed to that term by s10 TCA 1997.

In short, the statutory rules mean that, in order for the scheme to maintain its tax exemptions, there must be no unauthorised flow of value between the member and the scheme before retirement. When contemplating any investment, it should be scrutinised to ensure that it does not comprise a proscribed transaction.

UK Exception

It is noteworthy that, in the UK, investments in the member's employer by way of a loan are permitted in certain circumstances.[13] The loan must be:

- for less than five years,
- at an interest rate greater than the average base rate plus 1%,
- secured by a first fixed charge,
- for no more than 50% of scheme assets and
- repaid in equal annual instalments.

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8 See s774(7)(c) and s787E(1) TCA 1997. Note that for the purposes of calculating the limit, earnings may not exceed €115,000 (s790A TCA 1997).
9 Section 779G TCA 1997.
10 Section 784A TCA 1997.
11 Section 59 Pensions Acts 1990 to 2012.
12 Section 784A(1B) is concerned with ARFs but is applied to small self-administered schemes by s779A TCA 1997.
13 See s179 and Schedule 30 of UK Finance Act 2004.

The possibility of mirroring this arrangement in Ireland (through legislative amendment) was suggested by the Association of Pensioneer Trustees in Ireland in the context of the Jobs Initiative as a way of providing much-needed finance for businesses. It did not, however, feature in Finance Act 2013.

Revenue Rules

In approving most self-administered schemes, the Revenue Commissioners are authorised by statute to attach such conditions as they deem proper to the approval.[14] The general conditions, known as the Revenue Rules, have been embodied in the Revenue Pensions Manual.[15] Chapter 19 relates to small self-administered schemes.

Every small self-administered scheme must have a pensioneer trustee, that is, an independent professional trustee with particular responsibilities. The trust document must provide that the pensioneer trustee is a co-signatory on all financial transactions, and the pensioneer trustee must not consent to any action that is contrary to any Revenue regulations. This function cannot be delegated. When approval is being applied for, the scheme's investment policy must be outlined. This usually takes the form of a general statement of investment objectives.

Chapter 19.4 sets out rules governing self-administered pension investments. It begins:

> *"All scheme investments must be on an arm's length basis. The investment powers of Trustees are circumscribed in a number of areas which are detailed below. This list is not exhaustive and is merely intended as a guide. A ruling on any specific proposal can be requested."*

The requirement that investments be on an arm's-length basis actually means that the parties must not be connected. It is not sufficient that the terms are equivalent to those that would have been agreed by parties acting at arm's length. This is a logical extension of the prerequisite for Revenue approval that the scheme be established solely for the purposes of providing benefits in retirement.

For the most part, the rules set out in Chapter 19 reflect those in s784A(1B) TCA 1997. The Revenue Rules had existed for some time before the statutory rules were applied to self-administered schemes in 2006.[16] Whereas the Revenue Rules prohibit the acquisition of "pride in possession" articles such as jewellery, yachts and artwork, the statutory rules simply prohibit the acquisition of "tangible moveable property".

Notably, investments in foreign property must be structured in such a way that the pensioneer trustee has control over the property to ensure that the Revenue Rules are complied with. Investments must be capable of being realised within two years of death or early retirement due to ill health. In the case of an investment "locked in" for a specific term, it is important to ensure that an exception will be made permitting the investment to be sold in the event of death or ill health.

The 5%/10% Rule

One particular rule that deserves closer scrutiny is known as the "5%/10% Rule". It provides:

> "[Chapter 19.4] *(v) Private Companies*
> *Investments must be limited to 5% of scheme assets and to 10% of the private company's share capital."*

In practice, this rule has served to block bona fide investments.

Where a statutory body is granted power to attach conditions to an approval, that power must be exercised within the objects of the Act granting the power. Otherwise, the conditions are *ultra vires*.[17] The 5%/10% rule goes beyond the objects of ensuring that an investment is for the sole purpose of providing benefits in retirement and preventing tax avoidance. The percentages chosen are arbitrary. It is arguably *ultra vires*. The Pensions Manual is currently being updated, and it is hoped that this particular rule will be reviewed.

Conclusion

The pre-retirement access option introduced by Finance Act 2013 may offer some limited relief to cash-strapped individuals. Apart from this and the other, mainly technical, amendments, the Bill left pension taxation largely unchanged. Self-administered pensions afford their members significant autonomy over what their pensions invest in. However, care should be taken to ensure that investments comply with the tax rules governing them.

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14 Section 772(4) TCA 1997.
15 See http://www.revenue.ie/en/about/foi/s16/templates/pensions.
16 Section 14(1)(a)(iv) Finance Act 2006.
17 See *East Donegal Co-operative v Attorney General* [1970] 1 IR 336, recently approved in *Dellway Investments v NAMA* [2011] IESC 14.