Pension tax limit to rise gradually following expert report

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The maximum lifetime size of a pension fund that can benefit from tax relief is set to increase by at least 40% over the next five years, following a Government decision this week.

The decision to increase the Standard Fund Threshold (SFT), from the current €2 million it has been for over a decade, to about €2.8 million by 2029, follows an expert review into the threshold and other pension tax rules by Dr Donal de Buitléir.

While the review report recommended an immediate increase to €2.8 million, based on growth in wages since 2014, with annual indexation, Government has decided that this increase would be phased in by €0.2 million per year from 2026 to 2029.

SFT was introduced to prevent the perceived abuse of pension tax relief by very wealthy individuals

The review report recommends that it be index-linked to the CSO's Earnings Hours and Employment Costs Survey (EHECS) on an annual basis. Minister for Finance Jack Chambers, when announcing the Government decision this week, said that when the SFT reaches €2.8 million in 2029 they would converge "the level of SFT with the applicable level of growth at that time".

According to official sources, this means that there will be an adjustment in 2030 for earnings growth up to that point. After that, the adjustment in the SFT each year will be based on changes in earnings since the previous year.

The SFT was introduced in 2005 to prevent the perceived abuse of pension tax relief by very wealthy individuals. It began at €5 million and was cut to €2.3 million in 2010 as a financial retrenchment measure under the Troika, and finally to €2 million in 2014, where it still stands today.

TAX DETERRENT

Pension earnings above the threshold are subject to a special Chargeable Excess Tax (CET) of 40%, with the usual income tax and other deductions also applied after that, giving an effective taxation rate of around 70% (depending on the individual's PRSI rate), providing a strong incentive not to exceed the threshold.

The report recommends a reduction in the CET to 10%, based on the principle that the effective rate of tax should not be greater than the maximum rate of income tax and other levies.

In response to this recommendation, the Government will keep the CET rate at 40% for now and a "specific review" of the CET rate is to take place by 2030. Official sources say this is not a rejection of the recommendation, but "forms part of the staggered and incremental approach taken by the Government in relation to the SFT".

VALUATION FACTORS

Defined benefit (DB) schemes – in the public and private sectors – are given a valuation for SFT purposes, using age-related valuation factors set out in primary legislation. The portion of the pension accrued before 2014 is multiplied by a factor of 20 and the portion accrued after 2014 is multiplied by factors ranging from 37 (if retiring at 50) and 22 (if retiring at 70).

The review recommends a new set of valuation factors for pension accrued after 2014, that would lead to lower valuations and fewer individuals exceeding the SFT.

These new factors range from 25 (if retiring at 50) to 16 (if retiring at 70). The report says these are in line with interest rate market conditions and should be updated every five years, through secondary rather than primary legislation.

In response to these recommendations, the Government has said it will undertake an independent evaluation of the new proposed valuation factors for DB pensions.

CONTRIBUTION LIMITS

Dr de Buitléir's report also recommends abolishing the annual earnings limit of €115,000 for pension tax relief, as well as the age-related limits on employee pension contributions (ranging from 15% of income for under-30s, to 40% of income for those over 60).

The report argues that such limits are not needed when there is an overall SFT limit on the size of a fund that can benefit from pension tax relief. Their purpose has been to protect the Exchequer from irregular pension contributions over time. But abolishing them would benefit the self-employed and others who do not follow 'linear' careers with gradually increasing income.

These recommendations are among those which are to be considered by an implementation group which the Minister for Finance intends to establish. Abolishing all such limits would be a radical change from the pension contribution system which has existed up to now, which pre-dates the SFT but has also existed alongside it for almost 20 years.

RECRUITMENT AND PROMOTIONS

The review, sought by the previous Minister for Finance, Michael McGrath, was prompted in part by reports of difficulty recruiting staff for senior promotional posts in the public service. While the vacant post of Garda Deputy Commissioner posed an urgent challenge, the issue is a live one across both the public service and the private sector.

Most public service pension schemes do not allow employees to stop contributions (a feature that the review was told would be difficult to change for cost and administration reasons), so some are put off going for a promotion if the higher salary would mean going above the threshold. In the private sector, it was seen more as a retention issue, with individuals retiring earlier to avoid CET taxation.

As the SFT has not been indexed since January 2014, the number of senior public and private sector staff affected has increased gradually over the decade (some private sector managers still have defined benefit pensions).

LUMP SUMS

Current retirement lump sums are not taxed up to €200,000, taxed at 20% up to €500,000 and 40% above that. The €500,000 threshold is currently set at 25% of the SFT by legislation, but the review report says there is no clear case for continuing this, noting that the 2021 Commission on Taxation recommended reducing tax breaks on lump sums.

Therefore, the review report recommends that the threshold between 20% and 40% taxation of lump sums should be fixed and not automatically increase with the SFT. This recommendation has been accepted by Government and Minister Chambers said it would be implemented in Budget 2025, remaining at €500,000. No changes were recommended, or are planned, to the €200,000 threshold for full tax exemption of lump sums.

Currently, when 20% tax is paid on a retirement lump sum, this can be written off against any CET paid. The report recommends that if CET is reduced below 20%, this write-off should no longer be available. While the Government had decided to maintain CET at 40% for now, this recommendation may be relevant if the review of the CET rate before 2030 recommends a lower rate.

TAX RELIEF COSTS

Dr de Buitléir's report also examined the costs to the Government of pension tax relief. Three of the costs were quantifiable: individuals' income tax relief on contributions at €1,154 million; corporation tax relief on employer contributions at €254 million; and exemption of employer contributions from benefit-in-kind taxation at €774 million (2020 figures).

However, there was no data on tax relief on retirement lump sums; the exemption of pension fund investment income; the implicit employer contribution to unfunded public service pensions; or income tax paid on pensions in payment (which should be subtracted from the cost of pension tax relief).

The report recommends the following:

- The Department of Finance calculate an estimate for the Government's notional employer contribution to public service pensions on an annual basis.
- The Department of Finance should convene a working group, including Revenue, the Pensions Authority and Central Bank, to estimate the cost of tax-exempting pension funds' investment income.
- Revenue should collect data related to retirement lump sums separate from other lump sum payments.
- The Department of Finance should convene a group to estimate the tax paid on pensions currently in payment.

Dr de Buitléír's report also recommends allowing the payment of CET over 20 years – currently allowed for public service pensions only - to be available also for private sector pensions

In relation to Pension Adjustment Orders (PAOs) in cases of relationship breakdown, the report recommends that application of the SFT system is adjusted to ensure individuals are not unduly constrained in making provision for their own pension when a PAO is in place.

Dr de Buitléir was a senior manager at AIB for 20 years and more recently was chairman of the Low Pay Commission and a member of a review panel on senior public service recruitment. In his earlier career in the 1980s, he worked for the Revenue Commissioners and the Commission on Taxation.