Society of Actuaries in Ireland

Information and Assistance Note PEN-3:

Calculating the present value of tax-free lump sums

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Disclaimer

This Information and Assistance Note ("Note") is intended as an aid to actuaries who calculate the present value of tax-free lump sums payable from pension schemes, for the purpose of determining the maximum allowable income tax relief on severance payments.

The Society does not accept responsibility or liability for any loss to any person or body as a result of any decision or action taken on foot of information, opinions or suggestions set out in this Note.

1 Introduction

The purpose of the Note is to promote consistency in the calculation of the present values of lump sums payable from pension schemes, where such present values are used for the purposes of both the Standard Capital Superannuation Benefit (SCSB) and the increased basic exemption calculation.

In sections 2 and 3 of this document, the word "should" is used to indicate the steps that should be taken by an actuary who wishes to follow this approach. It does not imply that this document has any regulatory status, either professional or legal.

2 Determining what lump sum should be valued

Effective 24 February 2023, Revenue issued guidelines in respect of the calculation of the present value of pension lump sum for the purposes of the Relevant Capital Sum calculation. These guidelines are set out in the Revenue Pensions Manual - Appendix V and should be read in conjunction with Section 3.5 of TDM Part 05-05-19 (Payments on Termination of an Office or Employment or Removal from an Office or Employment)
https://www.revenue.ie/en/tax-professionals/tdm/pensions/d-appendix5.pdf

Actuaries should follow these guidelines when determining the net present value of the lump sum to be valued.

3 Assumptions used to value the lump sum

The Revenue guidelines as referred to above do not set out what assumptions should be used when placing a present value on the pension lump sum receivable in the future.

In general, all lump sums payable from a pension scheme should be valued using the standard transfer value basis as set out in ASP PEN-2 and in the Prescribed Guidance in relation to Section 34 of the Pensions Act, 1990, as issued by the Pensions Authority. The standard transfer value basis should also be used to calculate the present value of any amounts that are specified in monetary terms (for example, the €200,000 limit on tax-free lump sums).

Points to note:

1. Unless the member is taking immediate early retirement on leaving service (in which case the assumptions set out here are not relevant) it should be assumed that the member will retire at the normal retirement age under the rules of the scheme.

2. Mortality before normal retirement age should be allowed for, using the pre-retirement mortality table specified in the Prescribed Guidance in relation to Section 34 of the Pensions Act, 1990, as issued by the Pensions Authority. This applies to both Defined Benefit (DB) and Defined Contribution (DC) lump sums.

3. As of September 2024 there is no stated policy for indexation of the €200,000 limit on tax-free lump sums. On that basis, it should be assumed to remain fixed. If a policy of indexation is announced in future, this assumption may need to be revised.

4. Where a lump sum has been calculated based on the 'salary and service' approach, indexation of the lump sum should be assumed in line with the rate of increase in the price inflation.

4 Examples

An actuary is asked to calculate the present value, at date of leaving service, of the tax-free lump sum that an employee aged 47 may receive from the employer's DC pension scheme. The employee has no retained benefits.

The Revenue guidelines allow a taxpayer to choose the lower of 3/80 ths of salary per year of service or 25% of pension fund option. (A lower "present value" will give a higher tax-free amount from the SCSB calculation.) These examples assume that the taxpayer has opted for the lower amount.

<u>Example 1</u>

The value of the employee's DC fund is €120,000 at date of leaving service and the maximum lump sum payable under the 'salary and service' option, according to the rules of the scheme, is €81,800.

The actuary calculates the following using the standard transfer value basis:

- The pre-retirement mortality factor is 0.93.
- The present value of the maximum lump sum payable under the 'salary and service' option, allowing for indexation as allowed under the scheme rules, is **€37,800**.

- The present value of a lump sum of €200,000, without assuming indexation, is **€70,800**.
- The present value of a lump sum of 25% of the fund is €120,000 x 25% x 0.93 = **€27,900**.

The present value of the tax-free lump sum that may be received from the pension scheme is the lowest of the three present values shown above, i.e. it is **€27,900**.

Example 2

The value of the employee's DC fund is €320,000 at date of leaving service and the maximum lump sum payable under the 'salary and service' option, according to the rules of the scheme, is €81,800.

The actuary calculates the following using the standard transfer value basis:

- The pre-retirement mortality factor is 0.93.
- The present value of the maximum lump sum payable under the 'salary and service' option, allowing for indexation as allowed under the scheme rules, is **€37,800**.
- The present value of a lump sum of €200,000, without assuming indexation, is **€70,800**.
- The present value of a lump sum of 25% of the fund is €320,000 x 25% x 0.93 = **€74,400**.

The present value of the tax-free lump sum that may be received from the pension scheme is the lowest of the three present values shown above, i.e. it is **€37,800**.

Example 3

The value of the employee's DC fund is €320,000 at date of leaving service and the maximum lump sum (not necessarily tax-free) payable under the 'salary and service' option is €245,400 at date of leaving service.

The actuary calculates the following using the standard transfer value basis:

- The pre-retirement mortality factor is 0.93.
- The present value of the maximum lump sum payable under the 'salary and service' option, allowing for indexation as allowed under the scheme rules, is **€113,500**.
- The present value of a lump sum of €200,000, without assuming indexation, is **€70,800**.
- The present value of a lump sum of 25% of the fund is €320,000 x 25% x 0.93 = **€74,400**.

The present value of the tax-free lump sum that may be received from the pension scheme is the lowest of the three present values shown above, i.e. it is **€70,800**.