Lump sum benefits and commutation

Chapter 7

This document should be read in conjunction with section 781 Taxes Consolidation Act 1997 (TCA)

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Revenue
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7.1 General

This chapter sets out the maximum lump sum benefits and the commutation of retirement benefits that may be provided under an occupational pension scheme. The level of lump sum benefits that is approvable is calculated by reference to an employee's length of service and final remuneration with the relevant employer.

Lump sum benefits must only be paid once, normally at the time of retirement (that is, the date on which the pension becomes payable). Lump sum benefits are subject to a lifetime tax free lump sum allowance of €200,000. Where lump sum benefits are greater than this allowance, the excess is subject to tax.

Please refer to Pensions Manual Chapter 25: Limit on Tax Relieved Pension Funds for further information on the taxation pension benefits.

7.2 Maximum Lump Sum Benefits

A scheme member accumulates 3/80ths of final remuneration for each year of service. This is subject to a limit of 40 years, providing a maximum allowable lump sum benefit of 120/80ths, or 1.5 times final remuneration. Lump sum benefits greater than 3/80ths of final remuneration for each year of service may be given on retirement at normal retirement age (NRA) in accordance with the table set out below, provided that the aggregate of the value of non-pension retirement benefits in respect of service with the current employer and any retained benefits does not exceed 1.5 times final remuneration.

Years of Service	Eightieths (80ths) of Final Remuneration
9	30
10	36
11	42
12	48
13	54
14	63
15	72
16	81
17	90
18	99
19	108
20 or more	120

Please refer to Pensions Manual Chapter 23.6 for details of the calculation of lump sum benefits for retiring employees taking "ARF options".

7.3 Commutation Factors

Occupational pension schemes may permit a retiring employee to commute part of their pension to provide a lump sum within the permitted maximum. The pension must then be reduced in proportion to the amount of the lump sum commuted.

The relationship between the lump sum and the reduced pension may be calculated using one of the following bases:

- The fixed rate – Schemes may use a fixed commutation rate that is applied to all scheme members regardless of age, gender or any other considerations. See Pension Manual Chapter 6.4 which provides that €1 of annual pension payment may be commuted for a lump sum of €9.

- Actuarial tables - Schemes may use specifically designed tables that provide commutation factors varying with age and other considerations. Continued approval of the scheme will be dependent on the table being changed if any of the assumptions on which it is based are varied.

- Individual calculators - Schemes may allow for individual calculations by a qualified actuary for each commutation, taking into account the individual's relevant circumstances. These calculations must be consistent with other calculations made for the same individual and for other purposes of the scheme having regard to changing financial conditions.

A uniform basis should apply to all members (subject to variations of age) of one scheme and to all schemes that have a substantial common membership.

Commutation factors fall into two categories:

- Standard factors, which are used by schemes that do not provide for post-retirement increases; and

- Enhanced factors, which apply to schemes that provide regular reviews and discretionary increases tied to cost of living.

Enhanced factors should reflect the expected rate of future pension increases and require actuarial certification. However, please see comment below on schemes which provide for regular reviews and an expectation of resultant increases.

For schemes not using enhanced factors, commutation factors in the range 10.2 to 11.0 at age 60 and 9.0 to 9.8 at age 65 may be used for members. Values for other ages within the acceptable range for normal retirement may be calculated by adding or subtracting 0.02 per month of age difference. The factors are acceptable whether pensions are guaranteed for 5 or 10 years or not guaranteed at all, irrespective of whether payments are in advance or in arrears and regardless of the frequency of payments.

If the rules of the scheme provide for pensions to be reviewed regularly and increased (within the limit of the rise in the cost of living) at the discretion of the employer or trustees if funds permit, enhanced commutation factors may be used, provided that a certificate by an actuary is furnished which states the anticipated percentage rate of future increases on the basis of the current annual contributions without taking into account any future special contributions which the employer might make.

The pension equivalent of a lump sum taken from a defined contribution scheme is determined by application of the annuity rate used to determine the balance of the pension.

Where scheme rules permit the application of enhanced commutation factors and where post-retirement increases are not applicable on commuted pensions, the commutation factor may be calculated by reference to current open market annuity rates despite the amount of pension prior to commutation not being dependent on open market annuity rates.

7.4 Trivial Pensions

An approved scheme may permit full commutation of a pension if the aggregate benefits payable to an employee under that scheme and any other scheme relating to the same employment, do not exceed the value of a pension of €330 per annum. Pensions for spouses, civil partners and dependants may also be commuted at the same time as commutation of the member's pension if they are independently trivial. If commutation of part of a greater pension than €330 per annum leaves a residual pension within the "trivial" limits, this residual pension may not be commuted on triviality grounds.

In a defined contribution context, for the purposes of establishing whether benefits come within the "trivial" limit, the calculation should be based on the cost of a single life annuity with no escalation.

Where an individual fully commutes their pension in this manner, the scheme Administrator should deduct tax under Case IV of Schedule D at a rate of 10%[1]. The chargeable part of the payment may be calculated in the same manner as indicated for lump sum payments under the section dealing with serious ill-health (see paragraph 7.6). However, when calculating the maximum commutation (in the context of triviality), potential service should not be taken into account.

Where a trivial pension is a deferred pension, it may not be commuted until it begins to be payable. Furthermore, if such a pension is secured by an annuity contract or a policy which has been bought in the name of the employee, or assigned to the employee, because the scheme has been wound up or the employee has left service, commutation will be possible only if satisfactory arrangements have been made with the life office or pension provider concerned for payment of any tax due out of the policy proceeds. For the purposes of the €330 limit, a deferred pension will be that pension as increased by virtue of the preservation requirements of the Pensions Act 1990.

The treatment described above in relation to the commutation of trivial pensions may also be offered in the same circumstances to holders of RACs, PRSAs and PEPPs.

[1] Section 781(3) Taxes Consolidation Act 1997.

As an alternative to the above, and with the agreement of the scheme beneficiary and trustees, a single once-off pension may be paid to a beneficiary where the total of all funds available for pension benefits, following payment of any lump sum benefit, is less than €30,000. The quantum of retirement benefits from all sources must be taken into account for the purpose of calculating the €30,000 limit. In a defined benefit context, the pension benefit needs to be converted to a fund value to determine if the benefits are within the €30,000 limit. This should be done by reference to the scheme commutation factors. The rates of tax, USC and PRSI to be applied are those that apply to any other pension payment. Prior Revenue approval is not required.

The above option may be offered to all scheme members, including buy out bond holders, RAC, PRSA or PEPP holders, and may also be applied to residual funds available to secure pensions for spouses, civil partners and dependants.

7.5 Pension adjustment orders

Where benefits are payable under a pension arrangement in respect of which a pension adjustment order (PAO) has been made in favour of a non-member spouse or civil partner, the requirements described above may be applied to the separate entitlements of each party under the arrangement (having regard to the PAO) to determine if they independently satisfy the trivial "once-off pension" options.

7.6 Serious ill-health

An approved scheme may include a rule that permits for commutation of a pension if at the time it becomes payable the recipient is in exceptional circumstances of ill-health. This phrase is interpreted strictly and narrowly. It does not mean the kind of ill-health which prevents somebody from working but cases where the expectation of life is unquestionably very short. Commutation on these grounds should not take place unless the administrator has been satisfied by receipt of adequate medical evidence that terminal illness is in point and that the expectation of life is measured in months rather than years. Whether an individual is in this position is a matter for decision by the pension administrator (with the exception of cases involving "20% directors" and members of small self-administered schemes, which should be referred to Pensions Branch, High Wealth & Financial Services Division) but the inclusion of a rule on these lines in an approved scheme is accepted on condition that it will be interpreted invariably in this sense.

Where a deferred member of a scheme suffers from serious ill-health, their deferred benefits are subject to the deferred benefits rules on lump sums as set out in Pension Manual Chapter 12.5. The rules of this Chapter are not applicable to a deferred member's benefits.

To arrive at the taxable part of the payment, there may normally be deducted an amount (inclusive of the aggregate of any lump sums already permitted) not exceeding 3/80ths of the employee's final remuneration multiplied by the number of years of service with the relevant employer. In this context final remuneration will, irrespective of any definition in the rules, be taken as the average annual remuneration of the last three years' service. (This deduction will frequently eliminate any tax liability where a trivial pension is commuted.) The tax rate to be applied is 10%, by virtue of section 781(3) TCA.

An alternative deduction in arriving at the taxable part of the payment is the largest amount which could have been received apart from the special circumstances – that is, the triviality of the pension or the employee's exceptionally serious ill-health. In calculating the largest amount, one must look at the rules of the scheme; if the scheme does not permit commutation except on serious ill-health grounds for the category of employee concerned, or ordinarily restricts the lump sum to 3/80th of salary per year of service or some lower amount, then no alternative deduction can be made. Where the rules leave the trustees or the employer discretion to determine (within approvable limits) to what extent an employee may normally commute their pension, or to increase the lump sum part of the benefits, it may be assumed for the purpose of calculating the tax charge that they would have exercised their discretion to permit the maximum lump sum.

Example

An employee with 40 years' potential service retires 10 years early because of serious illness which has made their life expectancy extremely short. Their final salary is €12,000, and the average salary for the last 3 years' service is €10,800. The actuarial value of the amount of their pension is €54,000, and payment of this sum is, in the circumstances, permitted under the rules of the scheme. The general rule of the scheme permitting commutation specifies that every employee may have a lump sum of 3/80ths of final remuneration (defined in the scheme rules to include remuneration for the final 12 months' service) for each year of service.

Section 781(1)(i) permits a lump sum calculation of:

30 x 3/80 x €10,800 = €12,150

However, Section 781(1)(ii), which applies in this case, increases the calculation to:

30 x 3/80 x €12,000 = €13,500

Tax at 10% will therefore be charged on €40,500 (€54,000 less €13,500); tax due at 10% is €4,050.

If the general rule of the scheme had given the scheme trustees discretion to approve, in normal circumstances, commutation of a greater amount, (see paragraph 7.2) the deduction under Section 781(1)(ii) could have been increased to

120/80 x €12,000 = €18,000

This leaves tax to be charged on €36,000 of the commutation payment (actuarial value of €54,000 minus €18,000 lump sum). It is appropriate to take account of the fact that the employee is retiring on grounds of incapacity, and that the maximum lump sum would have been based on their 40 years potential service (see paragraph 9.4) rather than their 30 years actual service.

7.7 Normal lump sum plus lump sum from commutation of pension

Where the scheme provides for a lump sum of 3/80ths of final remuneration per year of service separately from the pension and not in commutation of the pension, and the pension itself is commuted – for example, because the employee is seriously ill - the whole of the commutation payment will be chargeable to tax.

Lump sums receivable by way of commutation in special circumstances of pensions under two or more separate schemes relating to the same employment are to be aggregated for the purposes of determining the taxable part.