60 – it's a magic number!

Senior Manager in the PricewaterhouseCoopers Pension Solutions Group, Emmet Gibson offers IVJ readers advice on the ever-evolving area of pensions.

Retirement planning for the self employed has changed over the years in response to external factors like changes in legislation and the increasing costs of securing an income in retirement. In addition, people are living longer and continuing to work later in life, often reducing hours or working on a part-time basis well into their 60s and 70s. Unfortunately for many, having to work later in life is necessity rather than choice.

Carefully planning for eventual retirement during your working life and exercising the best options for you at retirement will have a major impact on quality of life in retirement. Independent financial advice should always be taken to help you make the best decisions. The following gives a brief overview of options for the 'self employed' at retirement, as well as highlighting some important considerations in relation to retirement planning. Please note that the retirement options for 'employees' are quite different.

Emmet Gibson, Senior Manager in the PricewaterhouseCoopers Pension Solutions Group.

The importance of age 60 for planning purposes

Under Irish pensions legislation, age 60 has special significance for the self employed. It is the age at which you can first retire from your pension plans and access your pension fund. It is important to note that here 'retire' does not mean to stop working, but rather accessing pension benefits. Therefore, it is feasible for a self employed vet at age 60 to access their pension funds/policies, to continue working and make pension contributions in respect of those ongoing earnings.

Significantly, while legally entitled to access pension benefits at 60, the terms of individual pension policies vary and should be investigated before accessing benefits. For example, if your pension policy stipulates a retirement age of 65 and you wish to retire at 60 your policy provider may penalise you. Therefore, it makes most sense to choose a pension plan that offers the flexibility to retire at any age from 60-75 without penalty.

Your options at retirement

As a self employed vet who has reached the magic age of 60, what are your retirement options?

i) Take a tax free lump sum of 25% of the accumulated value of your pension funds and with the balance of your funds:

a. Purchase a pension for life.
b. Purchase an Approved Retirement Fund (ARF).*
c. Take the balance as a taxable lump sum.*

ii)Continue working.

*Options b. and c. were Finance Act 1999 introductions, with the conditions that to avail of them you must have guaranteed pension income in your own right of at least €12,700 pa or use the first €63,500 of your fund (after taking your tax free cash) to purchase a pension for life, or to purchase an Approved Minimum Retirement Fund (AMRF).

Tax free cash

The tax free cash released can be used to fund one-off purchases like cars or holidays or used to augment your income. Sometimes individuals don't wish to take the tax free lump sum and would rather take this as additional pension or put it in their ARF. This isn't really tax efficient as you are electing to place funds which can be taken tax free into a taxable regime.

Purchase a pension for life

The balance of pension funds can be used to buy a guaranteed income for the rest of your life. This has the attraction of income certainty regardless of how long you live. However, there are some factors to bear in mind.

Purchasing such a guaranteed income is currently very expensive and there is no flexibility going forward - you are stuck with your decision. For example a 60 year old male vet wishing to buy an income for himself of €22,500 pa increasing at 3% pa would need a fund of €500,000 based on current annuity rates. Another important consideration is what happens on death. In the above example if the 60 year old vet died at 63, nothing remains for his estate (i.e. he received c. €70,000 in total up to his death with the other €430,000 lost to the insurance company providing the annuity). Income tax is of course payable on retirement income.

ARF/AMRF

ARF and AMRF's are essentially investment vehicles in your name that offer a high degree of control and investment flexibility with income tax payable on drawdowns. An ARF is designed to house the remainder of your pension fund after taking your tax free cash. You decide what investment strategy to follow, and whether to take a regular income or dip occasionally into your ARF.

An AMRF houses the first €63,500 of the balance of your pension funds after taking your tax free cash if you do not satisfy the minimum guaranteed pension income requirement. You only have to satisfy the AMRF requirement once. You decide what investment strategy to follow. A balance of at least €63,500 must be maintained in your AMRF until age 75, at which time the AMRF is converted into an ARF and is accessed in the normal way.

The main difference between the pension for life and ARF/AMRF route is treatment on death. Unlike the pension, on the ARF/AMRF holder's death, the assets pass to the deceased's estate. This is a significant advantage over the pension option. In such cases taxes may be payable. With an ARF/AMRF you are bearing the investment risk so the possibility exists that under certain circumstances the ARF/AMRF can run out.

Taxable cash

If after taking your tax free cash you satisfy the minimum guaranteed pension income requirement or have an AMRF, you can take the balance of pension funds as a taxable lump sum. This provides an immediate amount of cash and is subject to a once-off income tax hit at your marginal rate of income tax.

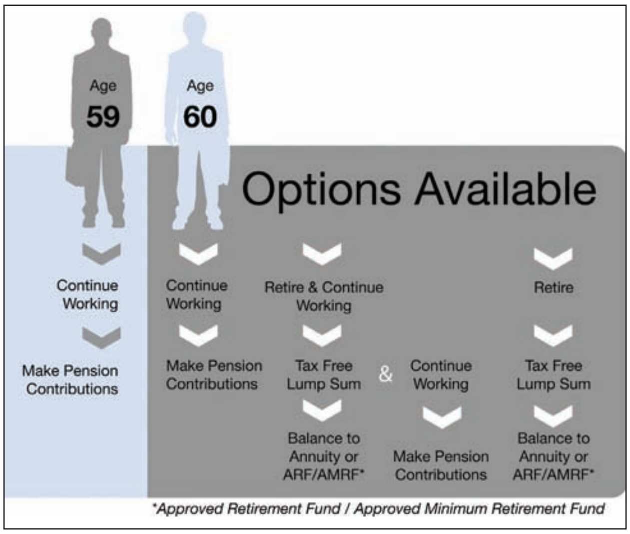
Continue working

Before you turn 60 you are limited to just the one pension option of continue working and contributing to a pension. However, once you reach 60 you can exercise your retirement options as outlined above but also have two other options available. You can retire and cease working, take your tax free lump sum, purchase either an annuity or ARF/AMRF or take the balance as a taxable lump sum and enjoy your retirement years.

The other option, which many people do not appreciate, is to retire (access your retirement funds), continue working and make ongoing pension contributions in respect of earnings. This way, you could release tax free cash, buy an annuity or ARF to supplement earnings, continue working and making pension contributions thereby saving tax and building up an additional retirement fund which can be accessed when you eventually stop work altogether.

The importance of diversifying assets

The main asset classes are cash, bonds, property and equities. When deciding how to invest in pension contributions or an ARF, placing a high proportion of funds in one particular asset class in one market is considered a high risk investment strategy that ignores a key investment principle of reducing investment risk through diversification across asset classes, industries and markets. Most of the world's equity markets have performed badly over the last year, having a knock on effect to the equity holdings of pension funds.



The additional retirement options available to the self employed once they have reached 60 years of age.

A well diversified pension portfolio made up of all four asset classes is less volatile than a portfolio based entirely on equities. While it is important to be aware of falls in equity markets, such falls should be taken in the context of some of the features of pension funds.

Tax relief

In terms of income tax saved, pension contributions offer an immediate return of 41% for a higher rate tax payer, and 20% for a standard rate tax payer. This tax relief should be taken into account when assessing falls in pension funds.

Cash funds

Many people within five to ten years of retirement take a phased approach to switching their assets into lower risk investments like cash or bond funds to protect against volatility in equity markets. The thinking is it is sensible to invest in higher risk assets when younger so that you can benefit from the superior long term returns and then to protect capital as you approach retirement using lower risk funds.

A strategy for the risk averse pension investor?

It is possible to completely immunise against falls in equity markets yet still benefit from the substantial income tax relief available on pension contributions. This could be achieved by making annual pension contributions to a pension policy that offers a cash fund. In this way, you benefit from the income tax relief on each contribution and your pension fund will never decrease in value. Of course there are other risks associated with such a low risk investment strategy, that your investment fails to keep pace with inflation or underperforms other riskier assets – some people consider this high risk!

Looking at your options

Reaching age 60 is a key milestone in relation to your pension options and there is a high degree of retirement planning flexibility available.

The options available at retirement are varied and each has advantages and disadvantages. Independent financial advice which takes account of your financial aims and objectives and your attitude to risk will assist in making the best decision for yourself.

A pension or an ARF provides an opportunity to create a well diversified investment portfolio in a very tax efficient and flexible way. You can decide how much or how little risk you wish to take. As with any major financial decision, it is advisable to take the appropriate advice around this complex area.

Emmet Gibson is a Senior Manager in the PricewaterhouseCoopers Pension Solutions Group. He can be contacted at 01 792 6202.