Approved Retirement Funds

As many readers will be aware one of the most significant changes in the structure of pension arrangements in many years came with the introduction by Charlie McCreevey of the Approved Retirement Funds (ARFs) in Finance Act 1999. This was and remains the only alternative to purchasing an annuity (an annual income) with the proceeds of a pension fund at retirement.

WHAT IS AN ARF?

An ARF is a tax free investment vehicle structured for pension investors during the period of retirement. Where the funds remain invested in an ARF the tax treatment of the ARF is the same as that of a pension fund, i.e. the funds grow free of income and capital gains tax.

An ARF investment can effectively be anything – a bank account, a stock portfolio, units in a managed fund with an insurance company, an investment in a tracker bond, a residential or commercial property held within a self directed ARF and so on. The ARF investor is the beneficial owner of the assets within the ARF investment, so effectively an ARF is an administrative layer that allows an investment to grow tax free and it is only when funds are drawn down from an ARF that a tax liability will crystallise. The draw down of benefits from an ARF is liable to income tax in the normal manner and the ARF provider (known as a Qualifying Fund Manager) has an obligation to deduct income tax on such draw downs under the PAYE system.

Note:

There was a period between the introduction of ARFs in Finance Act 1999 and amendments made in Finance Act 2000 where an ARF established during that period can attract an income tax and/or CGT charge within the fund but discussion of same is outside the scope of this article.

ACCESS TO ARFS

The ARF option was initially only available to personal pension investors (typically the self employed) and members of employer sponsored pension scheme who owned greater than 20% of the voting rights in the company sponsoring the scheme.

Finance Act 2000 reduced the 20% requirement to a greater than 5% shareholding requirement.

The ARF options are now available to:

- an employer sponsored pension scheme member (holding less than 5% of the voting rights of the company) who has made Additional Voluntary Contributions (AVCs) to the employer's main scheme or to a separate AVC scheme. However, this option is only available on the proportion of the benefits secured by the AVC. Note the 25% tax free lump sum entitlement is not available under the ARF AVC rules.
- the spouse of an ARF holder on the death of that individual. The ARF can pass intact to the surviving spouse.
- the spouse or former spouse of a 5% director where that spouse is entitled to a benefit under a pension adjustment order.
- the holder of a Personal Retirement Savings Account (PRSA).

DEATH

Along with the innovative means by which you could retain control and ownership of your pension fund in retirement through an ARF came the slightly peculiar tax treatment of the proceeds of an ARF on the death of an ARF investor.

Up until the introduction of the ARF provisions the passing of assets on death by an individual beneficially entitled to them would fall within the scope of capital acquisitions tax. CAT is, broadly speaking, determined by

- the tax residence of the disponer or the beneficiary
- where the asset(s) were situated (Irish situated assets will always be liable to CAT regardless of the residence of the disponer or beneficiary)
- the value of the asset(s) passing
- previous gifts or inheritances from the same disponer
- the relationship between the disponer and the beneficiary.

The new ARF provisions introduced circumstances where an income tax charge could be levied in place of a potential CAT liability in the death of an ARF investor:

ARF passing to	Income Tax	CAT
A spouse	Exempt*	Exempt
A child – under 21	Exempt	Liable
A child – 21 or over	Income tax at 20%	Exempt
Other	Income tax in year of death**	Liable

A spouse can 'step in to the shoes' of the ARF investor and retain the ARF investment intact. Subsequent draw downs from the ARF by the surviving spouse will be liable to income tax under the PAYE regime in the normal manner. The passing of the ARF to the surviving spouse is free from CAT under the spousal exemption rules. This is the only circumstance where an ARF can pass intact after the death of the ARF investor; in every other circumstance the assets of the ARF investment will cease and the assets of the ARF distributed.

Curiously (and to provide the Exchequer with a level of income tax from these types of investments, I would suspect) an ARF passing to a child who has attained the age of 21 at the date of the death of the ARF investor creates an income tax liability at the standard rate, currently 20%. There is an obligation on the ARF provider, i.e. the QFM, to deduct this tax at source under Section 784A TCA 1997.

The introduction of this particular income tax charge had the effect of creating a tax liability on a death that, although for all intents and purposes an 'inheritance tax', could not be defrayed by the use of a 'Section 60 policy'.

Where the assets of an ARF pass to anyone other than a surviving spouse or a child a distribution will be deemed to have occurred in the year of death of the ARF investor (this income tax liability falls upon the ARF investor) and an income tax liability will arise. There is an obligation on the ARF provider, i.e. the QFM, to deduct this tax at source (again under Section 784A TCA 1997). The proceeds received by the beneficiary will be liable to CAT in the normal manner.

WHAT IS A SECTION 60 POLICY?

A Section 60 policy is an assurance policy introduced by Section 60 Finance Act 1985 and is described in the Revenue's statement of practice (SP-CAT-1/04) as:

"Section 60 Finance Act, 1985 grants a concession in relation to the proceeds of life insurance policies which would otherwise be liable to inheritance tax on the death of the insured person. The section provides that the proceeds of any qualifying policy taken out under this section by an insured person on his or her life will be exempt from inheritance tax insofar as such proceeds are used to pay the inheritance tax arising on the insured persons death, or within a year of his death, under dispositions made by him (for example, under his will). Any part of the proceeds not so used are liable to inheritance tax."

Section 72 Capital Acquisitions Tax Consolidation Act 2003 (dealing with these types of policy) refers to "relevant tax" as meaning inheritance tax payable in respect of an inheritance. As the liability arising where the proceeds of an ARF passed to a child of 21 was income tax rather than CAT the proceeds of a Section 60 policy could not be used to meet such a tax burden.

However, representations made by Independent Trustee Company Ltd to Revenue late last year led to an improvement in the financial planning opportunities available.

Section 133 Finance Act 2005 introduces an amendment to Section 72 of the Capital Acquisitions Tax Consolidation Act 2003 to ensure that the income tax liability arising on the assets of an ARF passing to a child 21 or over now comes within the definition of relevant tax.

This means that assets held within an ARF structure (for example a residential or commercial property) can be protected and passed on to the next generation intact by the use of a Section 60 policy, i.e. the assets of the ARF will not have to be disposed of to pay this income tax liability.

This change in the legislation provides a real opportunity to structure a client's strategy in relation to the passing of assets after death in a more tax efficient manner. Now is the time to bring this to a client's attention to review their existing Section 60 policies arrangements or to consider the use of these policies to mitigate future tax liabilities. ■

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