LIA DEVELOPING YOUR FUTURE IN FINANCE

QFA Financial Advice

LEVEL 7

Certificate in Professional Financial Advice

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Your textbook is the single most important study resource for your exam.

All sections of the textbook are examinable so it's essential that you study it thoroughly.

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Recommended Study: 130 hours

Steps to Success

Step 1

Getting Started

- Familiarise yourself with the e-learning resources provided in your Study Hub.
- Attend your Online Induction.
- Create a personalised study plan based on the recommended study time.

Step 2

Textbook

- Your textbook is the single most important study resource for your exam.
- All sections of the textbook are examinable so it's essential that you study it thoroughly.

Step 3

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- After reading a chapter, watch the corresponding pre-recorded lecture to reinforce your understanding.
- Listen to the pre-recorded lectures while on the go, allowing yourself every opportunity to study.

Step 4

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Step 5

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Step 6

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- Read the Online Exam User Guide and watch the corresponding webinars which will show you what to expect on the day of your exam.
- Ensure your laptop or desktop is set up correctly ahead of the exam.

The Education Team are with you every step of the journey and we wish you every success in your exam.

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QFA Financial Advice

2024 / 2025 Textbook

Disclaimer

This textbook has been prepared and provided solely as an educational aid for LIA students taking the Certificate in Professional Financial Advice programme. The objective of the textbook is to support students in preparing for their examinations in conjunction with all other module materials. The textbook is not intended as an industry reference guide and should not be used as such.

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Financial Planning: Fact-Finding

Chapter 1 includes an introduction to financial advice together with an overview of the five-stage financial planning advisory process and the benefits to consumers. This chapter covers the first stage of the financial planning process, that is, determining the consumer's circumstances or 'knowing the consumer' through fact-finding. The Consumer Protection Code details the adviser's requirements before recommending a product or service to a consumer. Other topics include how to deal with errors and inconsistencies and the refusal of a client to provide the information you request.

Learning Outcomes – after studying this chapter you should be able to:
identify consumers' financial needs;
explain the five-stage financial advisory process;
understand the four different life cycle stages;
demonstrate the benefits of the financial planning process;
describe when the Consumer Protection Code (CPC) applies and to whom;
identify when a MiFID Investment firm must comply with MiFID conduct of business rules and the CPC;
be very familiar with the fact-finding process and structure;
recognise vulnerable customers; understand the definitions and be able to follow the process of how best to deal with the various categories;
be able to identify gaps, errors and inconsistencies and understand the importance of a complete fact-find; and
understand the Insurance Distribution Directive (IDD).

1.1 Introduction to Financial Advice

Personal financial planning is the systematic process by which a consumer is helped:

- By a competent personal Financial Adviser;
- To identify and achieve, as far as possible, their financial objectives through the efficient management and use of:
    - Their available financial resources

      and

    - Suitable financial products.

The financial adviser may be proficient in the areas of protection, pensions, investments, and loans but the advice may be very poor if the adviser has not gone through the full financial planning process. The adviser must seek out the consumer's objectives in the short, medium and long term and then attempt to achieve these objectives with a sound financial plan. The adviser must take into consideration the consumer's relevant personal and financial information. The financial planning process enables the adviser to see the overall circumstances of the consumer in order to provide suitable financial advice.

1.2 Financial Planning to Meet Financial Needs

Most consumers in their lifetime will have one or more of the following financial needs:

Savings	• A need to accumulate a capital lump sum from regular surplus income either to meet some anticipated financial objective in the future, or to build up a general 'rainy day' fund.
Investment	A need to invest a lump sum over a period of time to earn an investment return, either in the form of income or capital growth or a combination of both.
Protection	• A need to provide financially for certain unpredictable events, such as ill health or death, which will cause the interruption or total cessation of earned income for the consumer and/or their dependants. There is therefore a need to provide replacement income or capital or both.
Retirement funding	A need to accumulate funds or benefits to provide a replacement income in retirement, when the consumer will no longer be working and earning an income.
Mortgages	• A need to borrow a capital sum to fund the purchase of a property, usually an apartment or house, to be used as the individual's principal private residence.

1.2.1 Financial Planning: The Process

There are **five stages** to the financial planning advisory process:

Determine the consumer's circumstances

↓

Identify, quantify and prioritise financial needs and objectives

↓

Devise a strategy

↓

Make a suitable recommendation

↓

Monitor and review

1. **Determine the consumer's current personal and financial circumstances,** principally their current income and expenses, financial assets and liabilities, details of dependants, their investment knowledge and experience, and attitude to and capacity for investment risk. This step is sometimes called ***fact-finding*** or ***knowing the consumer.***

2. **Identify, quantify and prioritise, in conjunction and in agreement with the consumer, their financial needs and objectives**.

3. **Devise a strategy to meet the consumer's financial needs and objectives, as far as is practically possible,** taking account of the consumer's available financial resources, attitude to and capacity for investment risk, investment time horizon, the nature of their financial needs and objectives, and the proper use of suitable financial products.

4. **Make suitable recommendations to the consumer on a strategy to best meet their financial needs and objectives**, setting out, in the case of each recommendation:

   - The reason for that recommendation, that is, *how* it is likely to help achieve their financial needs and objectives, and

   - *Why* that recommendation, in terms of a recommended financial product or service, is suitable to the consumer at that time.

   This step is referred to as ***suitability***.

5. **Regularly monitor and review the consumer's circumstances,** to determine:

   - Any change in their financial circumstances, needs and objectives, or personal circumstances.

   - Any change in the tax or regulatory legislation which may impact on the consumer's current strategy or on his or her need or objectives.

   - The extent to which the consumer's financial strategy and financial products are meeting their current financial needs and objectives, and

   - The changes, if any, required in the consumer's current financial strategy in order to best meet their revised financial needs and objectives.

1.2.2 Life Cycle

Consumers will have different financial needs and objectives at different stages of their life. In very broad terms there may be four different life cycle stages:

Young (20s – 30s)	Financial needs at this stage may be dominated by a need to fund home purchase, through a combination of savings and borrowing. Savings needs tend to be short term. Little surplus income.
Middle (30s – 40s)	At this stage a consumer's income may steadily increase as their career advances, etc. Family responsibilities may also increase, demanding more protection. Savings and investment needs may start to lengthen, for example, provision for retirement may start. Surplus income starts to increase. Significant appetite for investment risk.
Older (50s – 60s)	Earned income may have peaked or begin to decline. Borrowing commitments may have been paid off, and increasing focus is on retirement provision. Client may inherit funds from their parents. Surplus income is at its peak. Investment and retirement planning needs tend to dominate. Appetite for investment risk reduces significantly. Capital preservation starts to dominate. Estate and succession planning may start.
Retired	Earned income ceases, substantially. Replacement pension income(s) commence. There is usually a significant reduction in income. Capital accumulation has peaked, and the consumer may need to draw on accumulated capital at regular intervals. Health may gradually deteriorate, necessitating increased medical expenditure. Estate planning will be important.

Of course, not every consumer will fit neatly into one of these groups above.

However, in broad terms the financial planning life cycle can be represented by a capital *accumulation* phase, which may peak in the 50s or early 60s, followed by a gradual capital *decumulation* or drawdown/rundown phase as earned income tapers off and accumulated capital is drawn on in retirement.

Decumulation is therefore the opposite of accumulation.

1.3 The Benefits of Financial Planning

Benefits of the financial planning process for consumers:

- **Holistic approach**. It takes the focus away from one product that the consumer may require at a given time and instead guides the consumer into assessing their current and future financial requirements as a whole.

- **Greater understanding of direction**. It provides direction and meaning to the consumer's financial decisions by allowing them to see how each decision made will affect another area of their finances, now or in the future. It helps focus their minds on what they want to achieve rather than focusing on a short-term need.

- **Priorities**. Consumers can then identify and prioritise their needs and objectives and maximize the efficiency of their affordability at the same time.

- **Risk suitability**. For consumers with savings, investments or pension requirements, they will be guided through a risk assessment process which will help to assess their ability to tolerate risk and aids the Financial Planner to assess their suitability to a product.

- **Needs suitability**. For all consumers, the process will ensure that the products and services identified are suitable to their needs, not just in the short term but in line with their goals and aspirations.

- **Reviews**. Through regular reviews, the consumer's changing financial needs and objectives are identified, and appropriate changes recommended to the consumer. Reviews help the consumer to stay on track to meet their ongoing financial needs and objectives.

1.4 Conduct of Business Rules

In providing financial advice to customers, firms are regulated by either the Central Bank's Consumer Protection Code or by MiFID Regulations.

1.4.1 Consumer Protection Code

The Central Bank's Consumer Protection Code (the "Code") applies to all intermediaries, including banks and MiFID investment firms, when providing advice on and arranging any of the following for consumers:

- Life assurance policies;

- PRSAs and pension policies;

- Deposits;

- Tracker bonds and structured products; and

- Mortgages.

The Code applies to Credit Unions when providing advice and offering services in relation to insurance activities.

The Code also applies to intermediaries (but not MiFID investment firms, as they are covered instead by MiFID Regulations (see below)) when providing advice on and arranging any of the following for consumers:

- Listed shares and bonds;
- Collective investment funds, such as exchange traded funds and UCITS.

1.4.2 MiFID Regulations

A MiFID (Market in Financial Instruments Directive) investment firm is authorised by the Central Bank to provide investment advice on and arrange a wider range of investments.

A MiFID investment firm must comply with MiFID conduct of business rules when it is providing to a customer *investment advice* or *arranging*:

- Shares or bonds, **not** listed on a stock exchange;
- Contracts for Difference (CFDs); and
- A discretionary portfolio management service (i.e. buying and selling investments for a client, without needing to seek the client's permission each time);

However, as pointed out above, a MiFID investment firm must follow the Consumer Protection Code when providing advice on and arranging any of the following for consumers:

- Life assurance and pension policies;
- PRSAs;
- Deposits;
- Tracker bonds and Structured Retail Products; and
- Mortgages.

1.4.3 The Insurance Distribution Directive (IDD)

Introduced in 2018, the IDD sets out standards in relation to the provision of advice, based on the information provided by the customer, in deciding what their needs are, providing objective information about the insurance products and making a personalized recommendation. Overriding requirement to act in customers' 'best interests' include:

- Should act 'honestly, fairly, and professionally in accordance with the best interests of its customers'.
- That all information must be "fair, clear and not misleading".

Any contracts proposed must be consistent with the customer's needs as identified from the fact-find (full details should be recorded on the Statement of Suitability).

1.4.3.1 Pre-Contract Disclosures

Where a product is offered with another service or as part of a package, the distributor must inform the customer whether it is possible to buy the different components separately and if so, they must provide an adequate description of the different components as well as separate evidence of costs and charges. This is called cross-selling disclosures.

The IDD includes additional specific and stricter requirements in relation to packaged retail insurance-based investment products (PRIIPs). The protection of insurance policyholders must be brought to a similar level as that of clients of investment products.

Information which should be provided pre-sale (this should be largely covered off by a firm's Terms of Business);

- How information is provided (paper or another durable medium e.g., PDF)
- The cost of advice (how the firm charges it's fees)
- Where advice is provided, whether the intermediary will provide a periodic assessment of the suitability of the product chosen, (and how those reviews are managed)
- Information on risks associated with the product
- Information on costs and charges (KID)

1.4.3.2 Provision of Information

Information should be provided on paper, in a clear and accurate manner, in local language and free of charge **OR** information can be provided via a durable medium or a website if:

- The customer has been given a choice and agreed
- This medium is considered to be appropriate if the customer provides an email address.

Information must be kept available for as long as the customer is likely to need it. Even if the customer has received information via a durable medium, they can subsequently request a paper copy and it must be provided free of charge.

1.4.3.3 Intermediary Inducements

Benefits to intermediaries are termed either "inducements" or "minor non-monetary benefits". "Inducements" includes both commission and supports. Inducements must be **shown** to enhance the quality of the service provided to consumers, should be transparent and should not impair the intermediary's obligation to act honestly, fairly, and professionally.

This also means that firms are required to ensure that they do not remunerate or assess the performance of their employees in a way that conflicts with the duty to act in the best interests of customers, e.g., Inducements shouldn't be of such a scale that it encourages individuals to fail to act in line with the best interests of the customer.

Independent intermediaries will no longer be able to receive inducements "fees, commissions or non-monetary benefits" from insurers in relation to investment products.

1.4.3.4 Fact Finding

Where relevant, the following shall be gathered:

- Information about the types of financial instruments with which the customer is familiar
- Information on past transactions
- The level of education and profession (or former profession) of the customer

Advice should not be provided if this information can't be gathered. Intermediaries should take reasonable steps to ensure that the information provided is accurate. If a suitable product isn't available, a recommendation should not be made. If relevant, business replacement analysis should be carried out. Intermediaries should clearly explain to customers that the reason for assessing suitability is to enable them to act in the customer's best interests. The use of an automated tool (e.g., risk profile questionnaire) does not reduce the responsibility of the intermediary.

1.4.3.5 Assessment of Suitability for Insurance Based Investment Products (IBIPs)

Sufficient information should be gathered so the intermediary can assess whether a product:

- Meets the investment ***objectives*** of a customer, including risk tolerance (length of investment, risk profile, risk preference, purpose of investment)

- Meets the customer's financial ***situation***, including the ability to bear losses (income, assets, investments, property, financial commitments)

- Is ***appropriate*** for the customer's level of knowledge and experience.

1.4.3.6 General Customer Communications

Complaints Handling

Under IDD Intermediaries are required to issue a confirmation letter to the customer each time a concern or issue has been resolved, even if it did not require a Complaint to be investigated or formally recorded.

Annual Customer Communication – Service & Transactional Record

Under IDD, Intermediaries are required to issue a confirmation letter to the customer each year outlining an itemised list of requested services they provided and transactions they completed on their behalf.

1.5 The Fact-Finding Process

The first step in the financial planning process with a consumer is to gather sufficient and relevant information about the consumer's income, financial assets, benefits and liabilities. This is sometimes referred to as **knowing the consumer**.

Without this information, the financial adviser would not be in a position to accurately identify and quantify fully a consumer's financial needs or make appropriate recommendations suitable to the consumer's needs.

The process of collecting and assembling relevant information about a consumer is generally referred to as **fact-finding**, as it involves finding or determining relevant *facts* about the consumer's financial circumstances, as a prelude to making recommendations that are suitable to the client and their circumstances, that is, **suitability**.

It is important, before seeking to obtain the appropriate information from the consumer, that you clearly communicate to the consumer the approach that you will be taking in providing financial advice and the stages involved in the process of providing this advice.

You should therefore communicate to the consumer **why** you may be seeking various items of information, some of which the consumer may consider to be private and confidential and may be reluctant to disclose. You are required to seek such information in order that you can give advice and make recommendations that are suitable and appropriate to the consumer's needs and resources, a process you are required to follow under the Central Bank's Consumer Protection Code or MiFID Regulations, as the case may be.

GDPR (General Data Protection Regulation) is an EU regulation on data protection which came into force across the EU in May 2018. It provides for higher standards of data protection regarding the processing and transfer of personal data, how data is stored, and allows the consumer to access this data. Personal data obtained from a consumer must be strictly limited to the specific purpose but should be adequate to be able to provide a professional service. The consumer must consent to providing the data for the specific purpose.

1.5.1 Consumer Protection Code Requirements

Under the heading of '*Knowing the Consumer'* the Code specifies the information that the adviser should obtain when completing a fact-find, under various headings:

a. *'**Needs and objectives** including, where relevant:*

   i. *The length of time for which the consumer wishes to hold a product;*

   ii. *Need for access to funds (including emergency funds);*

   iii. *Need for accumulation of funds.*

b. ***Personal circumstances** including, where relevant:*

   i. *Age;*

   ii. *Health;*

   iii. *Knowledge and experience of financial products;*

   iv. *Dependents;*

   v. *Employment status;*

   vi. *Known future changes to his/her circumstances.*

c. ***Financial situation** including, where relevant:*

   i. *Income;*

   ii. *Savings;*

   iii. *Financial products and other assets;*

   iv. *Debts and financial commitments.*

d. *Where relevant, **attitude to risk**, particularly the importance of capital security to the consumer.*

The financial adviser is only required to seek the information set out at a) to d) above where it is relevant to the assessment of suitability to be carried out.'

The Code also requires that, at any review with an existing consumer, it is important to seek to gather and record sufficient information to detect any *material* changes in the consumer's circumstances, since the previous assessment of the consumer's financial circumstances. If there are no material changes, this should be recorded.

1.5.2 MiFID Requirements

Under MiFID rules, the firm must obtain sufficient information from the consumer to be able to recommend the services and investments that are *suitable* for that consumer given:

- The consumer's knowledge and experience in investments, relevant to the specific investment product or service being offered to the consumer by the firm;
- The consumer's financial situation; and,
- The consumer's investment objectives.

1.5.2.1 MiFID II

From 3rd January 2018, MiFID firms must identify their target market for each product or service and also identify their negative-target market (that is, the market for which the product will definitely not be suitable). MiFID investment intermediaries who distribute their products or services must take account of these as part of their fact-finding and assessment of suitability for each consumer. MiFID II attempts to protect the consumer even further by ensuring that the MiFID investment firm has full and accurate information pertaining to the appropriateness of the product or service.

1.5.3 Fact-Find Structure

A *fact-find* form is a questionnaire designed to gather all relevant facts and information on a consumer which you feel are necessary to be able to accurately identify and quantify your consumer's financial needs and make suitable recommendations to satisfy these needs.

There is no one common fact-find used by all financial advisers. Instead, most advisers design the format of a fact-find to meet their own business approach, requirements, and typical consumers. Increasingly fact-find information is recorded electronically by the adviser.

A fact-find form may also be tailored to a particular type of product or service being provided to a consumer.

A typical generic fact-find will usually have five main sections:

- **Personal information**. This secion will cover all the initial and basic information required by the adviser at the outset of the fact-finding exercise, such as the consumer's age, gender, family and employment status, occupation or profession, etc.
- **Financial information**. This section will record all the appropriate information in respect of the consumer's current financial situation, including the consumer's regular income and expenses, their assets and liabilities, and regular financial commitments.
- **Financial plans and objectives**. While the personal and financial information sections record details of the consumer's current circumstances, this section is concerned with identifying and understanding the consumer's financial objectives and future plans, including how long the consumer may wish to hold new investments.

- **Investment knowledge and experience.** This will attempt to determine the consumer's previous investment knowledge and experience, relevant to the products and services that may be discussed or recommended to the consumer.

- **Investment risk profile**. This will attempt to categorise the consumer's risk profile, in order that any investment recommendations made to the consumer, including investing in particular financial products, is appropriate to the consumer's attitude to and capacity for investment risk, so that the overall risk profile of the consumer's investment portfolio will match, as far as possible, their attitude to and capacity for investment risk.

1.5.4 Client's Investment Risk Profile

This section of the fact-find attempts to establish the consumer's attitude to and capacity for investment risk, that is, determine the scale of volatility of investment returns the consumer is prepared to accept and can afford in respect of their savings and investments. Online risk profiling tools or questionnaires can be used with many investment firms and life assurance companies providing template online risk profiling tools.

It is important to establish the consumer's attitude to investment risk to:

- Determine whether the consumer's current investment portfolio is appropriate to his or her attitude to and capacity for investment risk; and to,

- Only recommend an investment portfolio that is appropriate to the consumer's risk profile.

Where there is a mismatch between the risk profile of a consumer's investment portfolio and that of his or her current attitude to investment risk:

- The investment portfolio may be too high risk for the consumer.

  In this case there is a risk that the consumer may suffer a financial loss larger than he or she is prepared or financially able to accept.

  OR

- The investment portfolio may be too low risk for the consumer.

  In this case there is a risk that the consumer may obtain, over the longer term, a lower investment return than he or she anticipated or needed to obtain to meet some financial need or objective.

You therefore need to determine the consumer's attitude to and capacity for investment risk, in order to ensure that any advice given, following the fact-finding process, is suitable to the consumer, and that the consumer's investment portfolio is closely aligned in terms of exposure to investment risk, with the consumer's attitude to and capacity for investment risk.

One of the Consumer Protection Code requirements in relation to investment advice suitability is that the consumer should be *financially able to bear any risks attaching to the recommended product.*

It is therefore important to determine what level of capital loss on a proposed investment would have a serious negative impact on the consumer's standard of living, in order to determine whether the consumer is financially able for the potential risks attached to the investment product recommended.

The Central Bank has, on a number of occasions, highlighted the importance of firms correctly identifying the consumer's attitude to investment risk.

Following an examination by the Central Bank of selected credit institutions, life assurance firms and investment firms in relation to the suitability of investment products sold to older consumers, a mystery shopping exercise was also carried out by the Central Bank to assess how credit institutions interact with older customers regarding the sales process for investment products. In relation to risk rating consumers, the Central Bank commented:

> *"A number of incidents were also found where firms selected a default risk rating, which was not the lowest risk rating of the firm, for consumers that had failed to complete a section of the Know Your Client documentation. This means that a consumer may have been allocated an inaccurate risk profile."*

Again, in September 2010, the Central Bank commented:

> *"We strongly encouraged firms to look at how they classify investment risk profiles to ensure that the customer's attitude to risk corresponds with their individual circumstances and that customers are guided toward a suitable risk category of product.*
>
> *Firms should be careful that terms for investment risk are well understood and are not subject to misinterpretation. In particular, firms should be careful about the designation 'low risk' as some customers may interpret this to mean 'no risk'."*

1.5.5 How Financial Advisors Must Deal with Sustainability Preferences

Since August 2022, all financial advisors, when providing advice on Packaged Retail insurance Based Investment Products (PRIIPs) are required to consider and factor in their clients' sustainability preferences in their advisory processes.

Specifically, financial advisors must establish whether a client wants a certain minimum proportion of sustainable investments to be included in any product recommendation.

The advisor must also establish specifically, whether the client wants the possible impact on people, the environment or society of the investment to be considered in their investment product. This could be focussed on carbon emissions, biodiversity & ecosystems and pollution prevention control and are known as sustainability preferences.

Sustainability preferences establishes a customer's choice as to whether, and if so, to what extent one or more sustainability investment products should be integrated into their investment.

Where a client confirms they do not have a preference for sustainable investments, the advisor may consider the customer as sustainability neutral and recommend products with and without sustainability related features. However, this must be documented clearly as part of the fact find process.

Where a client confirms they do have a preference, the advisor must establish the amount which the investor would like to invest in such an investment.

1.5.6 Scaling the Information Sought

The Consumer Protection Code specifies that in relation to obtaining relevant information from the consumer:

> *"The level of information gathered should be appropriate to the nature and complexity of the product or service being sought by the consumer, but must be to a level that allows the financial adviser to provide a professional service ..."*

You should only seek information from the consumer that is relevant to the '*nature and complexity of the product or service being sought by the consumer'.* You therefore should not 'fish' for consumer information for other sales and marketing purposes unrelated to the specific product or service being sought by the consumer, unless you have sought and obtained permission from the consumer to conduct a full financial review.

If a consumer does not wish to give relevant information, the adviser is unable to progress to the next stage which is assessing suitability and making recommendations.

What Should be Recorded?

Fact-finds and Statements of Suitability need to demonstrate / record:

- Knowledge and Experience of the customer with regards to investments
- Willingness to take risk
- Capacity for Loss – Time Horizon – Age to retirement
- Accuracy of Disposable Income recorded – ensuring that the customer is aware of the importance of same
- Future Liabilities for the next six years
- Emergency Funding
- Accessible assets
- Conflicts of Interests fully documented
- Ongoing Reviews of Suitability – how they are recorded and managed.

1.5.7 Identifying Vulnerable Customers

The Consumer Protection Code requires that, as part of the 'knowing the consumer' fact-finding process, any 'vulnerable consumers' are identified.

The term *vulnerable consumer* is defined in the Code as an individual who:

> - *Has the capacity to make his or her own decisions but who, because of individual circumstances, may require assistance to do so (for example, hearing impaired or visually impaired persons); and/or*
> - *Has limited capacity to make his or her own decisions and who requires assistance to do so (for example, persons with intellectual disabilities or mental health difficulties).*

The Central Bank have further clarified that:

> *"Identification of a consumer's vulnerability or otherwise will require the exercise of judgement and common sense and should be based on a consumer's ability to make a particular decision at a point in time."*

Advisers must identify vulnerable consumers during the fact-find and, depending on the level of vulnerability, must take their circumstances into account before assessing suitability, and provide reasonable arrangements or assistance to facilitate their dealings, perhaps with a family member present.

1.6 Errors and Inconsistencies

We do not live in a perfect world, where all the information you seek from a consumer will be immediately provided by the consumer to you, when and as you want it, in order for you to give appropriate financial advice.

The vast majority of consumers:

- Do not know all the details of their financial affairs**,** off the top of their head. Very few consumers, for example, will know off hand the level of life assurance cover they currently have.
- Do not necessarily know the full range of financial products and benefits they currently hold or have held in the past. Clients typically confuse financial product brand names and terms.
- Do not fully understand the financial products they currently hold or have held.

Therefore, some consumers will, unintentionally, give inaccurate or incomplete information about their financial affairs. Getting inaccurate, inconsistent, and incomplete information is part and parcel of dealing with consumers.

It is necessary to try to get information that is as accurate as possible, if that information is directly relevant to the advice that you may give the consumer. Therefore, you should try to clear up any errors and inconsistencies with the consumer, by:

- Asking the consumer questions about the suspect information. It may be a case of just rephrasing the question to get the right information; the consumer may simply have misunderstood the original question.
- Seeking corroborating information or documentation from the consumer themselves, or from another professional adviser they use, for example, their accountant, or from financial institutions with whom the consumer deals.

Example

A consumer says that they are 'standard rate' taxpayers, but their combined income appears to be over €90,000 per annum.

By asking to see a copy of their latest payslip, or *Certificate of Tax Credits and Standard Rate Cut-Off Point*, you should be able to confirm the actual situation.

In the case of life assurance and pension arrangements, a consumer's off-the-cuff opinion on the level of cover, benefits, etc, they have is frequently incorrect. Asking to see a copy of policy documents, pension scheme benefit statements, etc., will inevitably give a more accurate view of their benefits etc.

It may often be necessary to seek information about a consumer's existing financial products held with different institutions. To get this information from these institutions, you will need to get a signed *letter of authority* from the consumer addressed to each such institution, which will authorise the institution to give you whatever information they may have in relation to financial products held by that consumer with that institution.

The MiFID Regulations provide that a MiFID investment firm is entitled to rely on the information provided by the consumer "*unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete."*

1.7 Existing Clients

As your relationship with a consumer develops and grows over time, you will build up a considerable amount of information about the consumer, for example:

- Copies of previously completed fact-finds, conducted at different times.
- Copies of all regulatory documents related to that consumer, for example, *terms of business* letter given to new consumer at the outset, previous *reason why statements* provided to the consumer, etc.
- Copies of document(s) used to establish the identity of the consumer, where that was required. For example, copies of passport, driving license, utility bills, etc.
- Letters and emails to and from the consumer, and/or to or from their taxation and legal advisers.
- Notes or recordings of phone calls with the consumer, and/or with their taxation and legal advisers.
- Notes of meetings with the consumer, and/or with their taxation and legal advisers.
- Copies of completed consumer application forms for various financial products and services.
- Copies and details of financial products held by the consumer with financial institutions, for example, a copy of a life assurance policy or unit trust investment certificate held by the consumer.
- Correspondence to and from financial institutions in relation to any product the consumer holds with those institutions.
- Correspondence with the consumer and possibly with the consumer's accountant and/or solicitor. You may have details of the consumer's earnings, etc.
- Personal documents and information that a consumer may have given to you at some stage, for example, consumer's payslip, copy of consumer's will, pension scheme booklet or annual benefit statement, etc.
- Publicly available sources of information, particularly in relation to business consumers, for example, information available from the Companies Registration Office, trade publications, the internet, consumer's business website etc.

Of course, you can only use such information if allowed under the Data Protection Acts, that is, the data must have been fairly obtained for this purpose and the consumer has given consent for its use for this purpose.

This is particularly relevant to larger financial institutions where information about a consumer may have been collected for one specific purpose, for example, application for a mortgage, and cannot be used for another purpose (for example, insurance) without the specific permission of the consumer, obtained either at the outset or subsequently.

It is more likely that each time you deal with an existing consumer, it will only be in relation to a limited aspect of the consumer's financial affairs, rather than undertaking a complete fact-find each time.

Example #1

An existing self-employed consumer of yours has contacted you about topping up his existing personal pension plan contributions, coming up to 31st October pay and file tax deadline.

You already have considerable information about this consumer. The consumer, at this stage, is only seeking your advice and services in relation to topping up his personal pension plan contributions.

Example #2

A consumer of yours has a tracker bond, which is maturing in one months' time. You contact the consumer and the consumer is anxious to reinvest the proceeds in some similar guaranteed investment product.

The consumer, at this stage, is only seeking your advice and services in relation to the investment of the proceeds of the maturing bond.

In each example, the fact-finding might be confined to those areas of information directly relevant to the particular need being addressed at that time, for example:

- In relation to the personal pension plan top up, for example:
  - Client's current net relevant earnings, in the previous and current years.
  - Details of all personal pension plan, PRSA, and pension term assurance contributions paid in the previous and current tax years, and any carry forward of tax relief to the current year.
  - A re-assessment of the consumer's attitude to risk, to check that there is no change since the last time investment advice was given to the consumer.
- In relation to the tracker bond reinvestment, for example:
  - Has the consumer made any new investment or changed investments since you last dealt with him or her, of which you may not have been aware to date.
  - A re-assessment of the consumer's attitude to and capacity for investment risk, to check that there is no change since the last time investment advice was given to the consumer.

- An up-to-date valuation of all the consumer's investments, of which you are aware, to see the current make up of their investment portfolio.

However, this is always subject to complying with the Central Bank's Consumer Protection Code requirements that:

- The information sought "*must be to a level that allows the financial adviser to provide a professional service";* and,

- A financial adviser must *"gather and maintain a record of any material changes to a consumer's circumstances prior to offering, recommending, arranging or providing a subsequent product or service to the consumer. Where there is no material change, this must be noted on a consumer's records."*

1.8 Standard PRSAs and Fact-Finding Exception

Employers who do not operate employer pension schemes for their employers or who operate such schemes but impose eligibility conditions, such as requiring employees to wait more than six months to join the scheme for retirement benefits, are required by law to provide employees excluded from the employer pension scheme with access to at least one standard PRSA at work to which they can contribute by deduction from salary operated by the employer.

In the case of a standard PRSA, where an employer has chosen a PRSA provider and the PRSA provider makes a presentation to employees, the Consumer Protection Code specifies that the *minimum* relevant fact-finding information required by an adviser is to establish that the consumer:

- Is an employee of the firm;

- Has no other form of pension provision; and

- Intends to select the PRSA's default investment strategy.

In such circumstances, therefore, the adviser is *not* required to seek any additional information from the employee, in order to give that employee advice on the employer nominated standard PRSA. But note that all three requirements above must be met in order for the reduced fact-finding obligations to apply.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] The concept of a personal financial need
- [ ] The five main steps in the financial planning process
- [ ] The life cycle of financial needs
- [ ] The benefits of good financial planning for the consumer
- [ ] Conduct of business *knowing the consumer* requirements
- [ ] The *fact-find* process
- [ ] Refusal to provide information requested
- [ ] Errors and inconsistencies
- [ ] Existing clients
- [ ] Standard PRSAs

02

Taxation

This chapter features many elements of taxation in Ireland. The various tax schedules are set out and how to compute an income tax calculation is dealt with in detail, including exemptions and common reliefs. The basics of capital taxes CGT and CAT are included.

Learning Outcomes – after studying this chapter you should be able to:
demonstrate an understanding of the main tax schedules and cases;
calculate a basic income tax computation showing knowledge of the key reliefs and credits available to individuals; and
identify and apply the basics of capital taxes; capital gains tax and capital acquisitions tax, including any reliefs available.

2.1 Introduction

Taxation needs to be considered, when providing financial advice, in a number of different ways:

- Taxation on income impacts on the level of a consumer's surplus income available to meet various financial needs and objectives.

- Taxation may affect the level of funds available for investment, following the occurrence of a specific event. Examples include:

    - A consumer who has sold an investment property; capital gains tax may reduce the level of funds realised by the sale and hence available for investment.

    - A consumer who is receiving a large termination payment, on being made redundant. Part of this payment may be liable to income tax, and so reduce the level of funds available for investment.

Taxation often influences investment decisions:

- Tax efficiency of investment returns; some financial products may be liable to tax on the returns differently than others, i.e. DIRT, exit tax, income tax or capital gains tax.

    - Individuals over age 65, whose income is under the exemption limit[1] will be exempt from, or can reclaim, DIRT but are liable to exit tax on investment funds. This may have an impact on their decision to invest in a deposit versus an insured tracker bond, for example.

    - Many investment firms provide investment options whose returns are taxed as income tax, exit tax or capital gains tax, depending on how they are structured. This may influence a consumer's decision regarding where to invest. An individual who has not used their tax reliefs and credits may prefer an income tax liability. Capital gains tax being lower than exit tax may influence other investors.

- Various tax reliefs and exemptions may make some products more suitable for consumers than others. For example, tax relief at marginal rate on pension and PRSA contributions, tax-free growth of these products, and tax-free lump sums from them in retirement.[2] These tax reliefs make such products very attractive for long term retirement savings.

2.2 Income Tax

For the purposes of this exam, please assume that all questions relate to individuals who are fully liable to tax in Ireland.

2.2.1 Schedules

Income is assessed for income tax under different *schedules*. Within some schedules, income is further split into different *cases* or subcategories.

[1] €36,000 for a married couple/civil partners; €18,000 for a single person.

[2] Subject to a personal limit on tax-free pension lump sums of €200,000 in respect of all pension lump sums taken on or after 7th December 2005. From 1st January 2011 lump sums taken in excess of this €200,000 limit are liable to income tax; the next €300,000 of lump sums is taxed at standard rate, the balance at marginal rate.

The main schedules and cases are:

Schedule D – Case I & II	Income from a self-employed trade or profession.
Schedule D – Case III	Interest and dividends, not subject to Irish income tax by deduction, including rental income from foreign properties.
Schedule D – Case IV	Interest from which DIRT has already been deducted, income received from UCITS and unit trusts, and other miscellaneous income.
Schedule D – Case V	Rental income from Irish property.
Schedule E	Income and benefits in kind from an employment in the State. Income under Schedule E is usually subject to PAYE at source.
Schedule F	Dividends from Irish resident companies, which are usually subject to dividend withholding tax.

2.2.2 Standard Rate Tax Band and Personal Tax Credits

Each consumer has a standard rate tax band, that is, a level of taxable income subject to standard rate income tax at 20%, and personal tax credits to be offset against their income tax liability. Any income above this level is taxed at the higher rate; in 2024 this is at 40%.

The main tax credits are as follows:

	Standard Rate Tax Band 2024	Personal Tax Credit 2024
Single/widowed	€42,000	€1,875 / €2,415
Married couple/civil partners, one income	€51,000	€3,750
Married couple/civil partners, two incomes	€84,000 (€51,000 for highest earner + the lower of €33,000 or the income of lowest earner)	€3,750
One-parent family	€46,000	€1,750 (additional)
Age tax credit – 65 and over		€245 (€490 for married couple)
Employee tax credit*		€1,875 (max)
Earned income (self employed) tax credit		€1,875 (max)

* The Employee Tax Credit can be claimed by anybody in receipt of income that is taxable under the PAYE system. This includes wages, benefit in kind, occupational pensions and Department of Social Protection (DSP) income.

2.2.2.1 Universal Social Charge

A universal social charge (USC) is payable on an individual's income from all sources, that is, on income ***before*** deduction of any tax reliefs, covenants etc.

The standard rate of USC payable in 2024 is as follows:

Total income subject to USC	USC rate
The first €12,012	0.50%
The next €13,748	2.0%
The next €44,284	4.0%
Balance over €69,774	8.0%

In the case of a married couple/civil partners, the USC rates and thresholds apply to each person individually. So, for example, if both are earning less than €70,044, the 8% rate will not apply, despite the fact that their combined income may be over €70,044.

Other USC Rates

- There is an **additional USC of 3% payable by the self-employed** (non-PAYE) on income over €100,000, that is, **11%.**

- A **special reduced maximum rate of 2%** applies to:

  - The over 70s with income less than €60,000 per annum.

  - All those holding a full medical card with income less than €60,000 per annum.

Exemptions from USC

- Individuals with total income less than €13,000 do not pay USC.

In addition, the following types of income are not subject to USC:

- Social Protection benefits, pensions, and similar payments.

- Deposit interest.

- Dividends paid by credit unions to their members.

- Returns from life assurance and collective investment fund investments.

- The tax-free part of ex-gratia redundancy payments paid by employers.

Where income is taxed under the PAYE system, the USC is applied to the gross income, *before* deduction of pension contributions, reliefs, tax credits, etc.

2.2.3 Income Tax Calculation Example

The general outline of how income tax is charged is as follows. The example is assumed to refer to a married couple who are assessed for income tax under joint assessment, with one income, and both are under age 65:

Total gross income from all sources, earnings, taxable investment income, etc.	*Salary:* Schedule E: Schedule F: *Gross dividends from an Irish resident company* [3] **Total:**	 €95,000 €5,000 **€100,000**
LESS		
Reliefs, such as personal pension plan contributions, PRSA contributions, personal contributions to employer pension schemes, PHI premiums.	*Gross personal pension plan contribution*	€3,000
Taxable income		**€97,000**
Standard rate tax band	€51,000(married couple, one income) at 20% =	€10,200
Balance taxable at 40%	€46,000 at 40% =	€18,400
Total income tax		**€28,600**
LESS		
Tax credits:	Married tax credit: PAYE tax credit: Dividend withholding tax on dividends: Medical expenses (€2,000 at 20%) Total credits	€3,750 €1,875 €1,250 €400 **€7,275**
Total income tax liability for 2024	**€28,600 - €7,275 =**	**€21,325**
PLUS USC** First €12,012 at 0.5% Next €13,748 at 2% Next €44,284 at 4.0% Balance of €29,956 at 8%	 €60.06 €274.96 €1,771.36 €2,396.48	 €4,502.86
Total income tax and USC liability for 2024		**€25,828***

*The tax liability in total was €27,078 but 25% x €5,000, i.e. €1,250 would have been paid through Dividend Withholding Tax deducted from the €5,000 dividend payment before payment, leaving a balance of €25,828 to be paid though the PAYE system.

**Note that the USC liability is calculated on the gross income before deducting the pension contributions.

[3] *Dividends paid by an Irish resident company are subject to withholding tax at 25% rate, before payment to individual investors. The €5,000 shown is before deduction of 25% tax.*

The standard rate band is important in relation to investment planning for consumers who need investment income from their investment portfolio; generally, it would be advisable to only create taxable income, including any other pensions or sources of income the individual has, up to the level of the standard rate tax band.

Any income requirement in excess of this level might be best generated from an investment where the individual does not have any marginal tax rate liability in respect of returns, for example, income distribution from an authorised collective investment fund established in the State, which is subject only to exit tax at 41%, with no liability to income tax or USC, and no further personal tax liability.

2.2.4 Paying Income Tax

There are two main ways in which income tax is paid:

- Under *PAYE system* in respect of income and benefits arising from an employment and taxed under Schedule E.

  Employers receive a *Certificate of Tax Credits and Standard Rate Cut-Off Point* from Revenue in respect of each employee; this certificate tells the employer, when operating PAYE:

  - The amount of income during the payroll period, for example, a week or month, to be taxed at standard rate, this is the *standard rate cut-off point*. Any income received in the period above this amount is subject to income tax at the higher rate of 40%.

  - The amount of tax credit to be allowed against this tax liability during this period; the balance is the amount of tax to be deducted for that period.

  Example

  For the 2024 tax year, the weekly standard rate cut-off point, for Mary, a single taxpayer, might be certified by Revenue at €700 per week.

  Let's say the weekly tax credit for 2024 for Mary is certified by Revenue at, say, €70 per week.

  Her gross earnings for a week in June 2024 are €800.

  Income tax liability for this period would be: €700 at 20% + €100 at 40%= €180 less €70 (tax credit) = €110 which would be deducted from earnings under the PAYE system.

  Based on an annual income of €41,744 (€800 x 52.18) the annual USC charge is €974 for 2024 or €18.67 per week.

  Mary's net pay for the week in June is €671.

- Under the *self-assessment system*, where the taxpayer is obliged to calculate their own income tax and USC liability and pay over the tax due (allowing for any tax already deducted at source, for example, PAYE) in one lump sum to Revenue each year no later than 31st October of that year (or typically mid-November if paying AND filing tax using the ROS[4] system).

[4] *Revenue Online Service.*

Everyone is subject to self-assessment for income tax, with the following *exceptions*:

- Persons whose total income for the year of assessment is dealt with under the PAYE system, or, where there is other non-PAYE income of less than €5,000 per annum which is fully coded into their *Certificate of Tax Credits and Standard Rate Cut-Off Point* and tax on such income is recovered though the PAYE system.

- Anyone who has received a notice from Revenue exempting him/her from making a return.

- A person who is only liable to income tax in respect of tax withheld on annual payments.

The main groups liable to self-assessment are therefore:

- Most proprietary directors.

- The self-employed.

- Employees who have non-PAYE gross investment income of more than €5,000 per annum, for example, rental and/or gross investment income.

A self-employed person will usually make up their accounts for a 12-month period, called an *accounting period*, which is usually any continuous 12-month period.

A self-employed individual is usually assessed for income tax in a year on the profits of the accounting period ending in that tax year. For example, if a doctor's accounting period ends on 31st May, then his accounts for the year ending 31st May 2024 would form the basis for calculating his/her taxable income for the 2023 tax year.

Individuals subject to self-assessment pay a lump sum income tax payment each year before 31st October of that year**;** this payment is referred to as *preliminary income tax*, as it is an advance or, *preliminary* payment of income tax due for the tax year in question under the self-assessment system. The final liability may not be known until after the end of the tax year in question. At the same time, they make a *final tax (balance of tax) payment* for the previous year and file a *return of income.*

- Preliminary income tax and USC for the 2024 tax year must be paid by 31st October 2024 (or later on a date specified by Revenue in November 2024 if paying and filing using ROS) **[Pay].**

- The return of income for the 2023 tax year must be made by 31st October 2024(or on the ROS deadline date in November 2024 if paying and filing using ROS) **[File].**

- The balance of any income tax and USC due for 2023 tax year must be paid by 31st October 2024(or later in November 2024 if paying and filing using ROS) **[Pay].**

- The return of income for the 2024 tax year must be made to Revenue by 31st October 2025 (or on the ROS deadline date in November, if paying and filing using ROS) **[File].**

In order to avoid interest and penalties subsequently becoming payable if the final tax liability owed for the year turns out to be more than the preliminary tax paid, the taxpayer must normally pay preliminary income tax of at least:

- 90% of the actual final tax liability for the current tax year, as ascertained when the year has finished;

  OR,

- 100% of the tax liability of the previous tax year;

  OR,

- 105% of pre-preceding tax year, where preliminary income tax is paid in instalments by regular direct debit.

For example, the *minimum* preliminary income tax options for the 2024 tax year are either of the following:

Option	2024 tax year
90% of current year	90% x 2024 tax liability
100% of preceding year	100% x 2023 tax liability
Direct debit	105% x 2022 tax liability

Under the *self-assessment* system, the onus is on the taxpayer to estimate his own tax liability and pay it to Revenue each year. Revenue perform ‘spot checks’ on such returns. They can impose heavy penalties and interest on underpaid tax if they find that a self-employed person has not declared his true income or has paid inadequate tax.

2.2.5 Income Tax Exemption Limit

A very important relief is the *income tax exemption relief*, which completely exempts individuals age 65 years and over from income tax (but not from USC) where their total income, that is, before reliefs and allowances, in the 2024 tax year does not exceed €18,000. This limit is doubled in the case of a married couple/civil partners, that is, €36,000.

The limits are further increased by €575 for each of the first two dependent children and €830 for each subsequent dependent child.

The importance of the income exemption limit lies in the opportunity it may offer certain older consumers to obtain a return not liable to income tax, where the consumers have little or no other taxable income. However, note that the USC will apply to certain taxable income greater than €13,000 per annum.

Example

John and Mary are in their late 60s. Their only income is the State Pension (Contributory). During 2024, this will amount to, say, €26,300 of taxable income. They have €100,000 to invest and have no other taxable income.

Their income tax exemption limit is €36,000.

They can therefore receive another €9,700 of gross taxable investment income, that is, €36,000 less €26,300, in the 2024 tax year, before becoming liable to income tax.

To benefit from this available €9,700 tax-free income:

- They could invest a sufficient amount in a treasury bond and obtain a gross tax-free income return not subject to DIRT. However, the income would be subject to the USC.

  AND/OR

- They could invest a sufficient amount in a deposit which would not be liable to DIRT[5] or USC, as they are not otherwise liable to income tax on the deposit interest and are over age 65.

  AND/OR

- They could invest a sufficient amount directly in Irish shares and be able to reclaim the dividend withholding tax deducted on the dividend payments. However, the income would be subject to the USC. Gain on the sale of such shares would result in a capital gains tax at 33%, after the CGT annual exemption of €1,270.
- Some MiFID firms may occasionally produce investment bonds subject to income tax on their sale/encashment.

Investment in a life assurance investment bond or unit trust would not normally be recommended in such a case as the exit tax deducted within the fund could not be reclaimed by John and Mary, even though they are non-income tax payers.

[5] Subject to completing an appropriate declaration.

2.2.5.1 Marginal Relief

It is important to realise that once an individual's income exceeds the income tax exemption limit the full amount of income is then subject to income tax but with due allowance given for allowances and reliefs etc. However, there is marginal relief where the consumer's total income exceeds the relevant exemption limit but is less than twice the limit; the relief provided is that the income tax liable will not exceed 40% of the excess of income over the limit.

Example – Marginal Relief

John and Mary are in their late 60s. They receive the State Pension (Contributory). During 2024, this will amount to, say, €26,300 of taxable income. John is also in receipt of a pension from his former employer's pension scheme of €14,700 per annum, so that their total taxable income for 2024 is €41,000, that is, it exceeds the income tax exemption limit by €5,000.

They are therefore liable to income tax on this €41,000 income, with due allowance for tax credits and standard rate bands.

Their income tax liability on this €41,000 taxable income is:

	€
€41,000 at 20%	€8,200
Less tax credits	
Personal	-€3,750
Age	-€490
PAYE (employer pension)	-€1,875
Income tax Payable	€2,185
Marginal relief	Income tax limited to 40% x (€41,000 - €36,000) = €2,000

In this example, the couple's income tax liability is restricted to €2,000 due to the income exemption limit marginal relief. However, John is liable to USC on the private pension income.

2.2.6 Paying for Care of Incapacitated Relatives

Where a consumer is financially maintaining an incapacitated relative, for example, an elderly parent, there are three possible tax reliefs which can be used to subsidise the cost of such financial support:

- Claiming tax relief on medical expenses
- Making a covenant payment within certain limits.
- Claiming tax relief on cost of carers.

2.2.7 Medical Expenses Relief

At a certain stage in a consumer's life, medical expenses may become more prevalent and a drain on disposable income and/or capital.

Where a consumer has medical expense insurance, this will deal with part of the cost of medical treatment.

However, consumers may, at certain times, have substantial *unreimbursed* medical expenses either because:

- They become ill and need medical treatment, but don't have medical expense insurance.

- They have medical expense insurance, but it does not cover all of the costs, for example, specialist treatment or 'home' care.

- The illness may be of a permanent nature and require ongoing medical treatment, not covered fully by medical expense insurance.

- An individual can claim tax relief on *unreimbursed* qualifying medical expenses incurred in respect of the individual himself or any other individual on whose behalf he or she pays medical expenses.

Therefore, any medical expenses not reimbursed by, say, VHI or the local health board, may be claimed under this particular provision.

Tax relief for medical expenses is generally given at standard rate, currently at 20%.

Payments in respect of maintenance and treatment in an approved **nursing home** qualify for tax relief at the individual's marginal rate of income tax.

Relief is normally given by way of a refund at the end of the tax year in which the expenses are claimed.

Example

In the 2024 tax year, Mary had medical expenses of €2,870. However, she recovered €1,670 from her insurer and another €380 from the HSE. She is single and pays income tax at 40% marginal rate and USC.

Let's assume that all of the expenses qualify for income tax relief.

Medical expenses:	€2,870
Less	
Recovered from her insurer:	- €1,670
Recovered from HSE:	- €380
Unreimbursed medical expenses:	€820
Tax deductible expenses:	€820

If none of the expenses relate to nursing home care, Mary will be entitled to an income tax rebate of €820 x 20% = €164.

If all of the expenses related to nursing home care, Mary will be entitled to an income tax rebate of €820 x 40% = €328.

The significance of this relief and investment planning is that for someone with substantial medical expenses it may be more tax efficient to generate investment income liable to income tax, against which the tax deductible medical expenses can then be offset, particularly where the individual's total income is such that they do not pay income tax at the higher rate. Such individuals could then obtain a gross investment income return, as compared to investing in certain collective investment products, for example, life assurance investment bonds, unit trusts, etc., where exit tax deducted cannot be reclaimed by such individuals.

2.2.8 Employing a Carer

Income tax relief can be claimed at marginal rate, up to an annual limit of €75,000, on the cost of employing a person (including a person whose services are provided by or through an agency) to take care of either:

- A family member (including the claimant themselves, their spouse or civil partner) who is totally incapacitated by reason of physical or mental infirmity;

  OR,

- A relative who is totally incapacitated by reason of physical or mental infirmity; ‘relative’ in this regard includes a relation by marriage or civil partnership and includes an individual in respect of whom the claimant is or was the legal guardian.

2.2.9 Investment of Compensation Awards

Exemption from Income and capital gains tax is allowed in the case of investment income and gains from compensation lump sum investments, if certain conditions are satisfied.

2.2.9.1 Conditions Which Must be Satisfied

The compensation award must be for *personal injury* and:

- It must have been received arising from the institution of a civil action for damages in the courts; where such an action is initiated but settled *‘out of court’* the compensation will still qualify. Payments awarded by the Criminal Injuries Compensation Tribunal and the Personal Injuries Assessment Board can also qualify.

- The person receiving the compensation must, as a result of the injury which gave rise to the action, be permanently AND totally incapacitated either physically or mentally from maintaining himself or herself.

- The relief will apply in a tax year where the total investment income and capital gains arising in that tax year from the investment and reinvestment of the compensation award exceeds 50% of the individual’s total income and chargeable gains for that tax year. The state invalidity pension, while taxable, is ignored in the 50% test.

Example #1

Joe, who is single, was involved in a serious accident at work. Following legal action, he received a lump sum compensation payment of €250,000 which was invested and produced taxable income of €8,000 and capital gains of €15,000 in the current tax year.

He also has other rental income, not arising from the investment of the compensation award, of €6,000 per annum, and a State invalidity pension of, say, €11,140 in the current tax year.

Joe is deemed to be permanently and totally incapacitated. and unable to maintain himself.

For the purposes of determining entitlement to tax exemption in the current tax year in respect of the investment income and capital gains arising from the investment of the €250,000 payment the test is as follows:

- Arising from investment and reinvestment of compensation award: €8,000 income and chargeable gains of €15,000 = €23,000 in total.
- Other income and gains to be included for the 50% test: rental income of €6,000
- Total income and gains included for that year = €23,000 + €6,000 = €29,000
- Proportion arising from investment and reinvestment of compensation award = €23,000/€29,000, that is, 79% of total applicable income and gains for that tax year.

In this case, in the current tax year, the investment income of €8,000 and capital gains of €15,000 arising from the investment and reinvestment of the compensation award would be tax free. Note that the other rental income and State invalidity pension are still taxable.

Note that the *'greater than 50%'* test is applied each year separately and so if investment income and capital gains is exempted from tax in one tax year, it is no guarantee that such exemption will apply again the following year. For the exemption to apply in any tax year, the greater than 50% test must be complied with in that tax year.

Example #2

Take the same Joe example as above.

Let's say that in the following tax year Joe sells the other investment property which he owned already before the accident and realises a gain of €50,000 on it.

Let's say his figures for that tax year are:

- Arising from investment and reinvestment of compensation award: €8,670 income and chargeable gains of €3,000 = €11,670 in total.
- Other applicable income and gains (i.e. excluding the state pension): rental income of say €3,000 and capital gains of €50,000 = €53,000
- Total income and gains included for that year = €11,670 + €53,000 = €64,670

Proportion arising from investment and reinvestment of compensation award = €11,670/€64,670, that is, 18% of total income and gains for that tax year.

In this case, in the current tax year, the investment income of €8,670 and capital gains of €3,000 would be fully taxable as the greater than 50% test is not fulfilled.

2.2.9.2 Exit Tax

Where compensation funds are invested in life assurance investment bonds or other collective investment schemes which are subject to exit tax, any gain subject to exit tax deduction is treated as being investment income of the individual or fund involved for that tax year, from which income tax (at the level of exit tax deducted) has been deducted.

The net result may be an ability to reclaim the exit tax deducted, in the same circumstances in which the investment of those funds would be entitled to exemption from income tax and capital gains tax, as outlined already.

2.2.10 Restriction on Tax Reliefs for High Earners

Individuals with income in excess of an Income Threshold and who claim certain specified tax reliefs (mainly property related capital allowances, EII investments, royalties, etc.) over €80,000, are restricted in the level of such reliefs they can offset against their taxable income, in order to ensure a minimum effective income tax rate of 30%.

The restriction normally applies in circumstances where:

- An individual's income is €125,000 or over – but it can be less in some cases,
- The total specified reliefs claimed are greater than €80,000, and
- The aggregate of specified reliefs used are greater than 20% of 'adjusted' income (generally income before deduction of these specified reliefs).

Note that pension tax reliefs are *not* restricted or impacted by this restriction.

2.2.11 Case Study – Income Tax Calculation

- *Michael* is aged 49 and is a Widower with dependents.
- He is a self-employed professional with gross income of €80,000 in 2024.
- *Michael* also has rental income of €20,000 pa.
- He has an income protection policy at a cost of €1,000 pa.
- He has a pension term assurance which costs €500 per annum and has contributed €20,000 into his personal pension for this tax year.
- He has medical expenses of €2,000 but €1,000 of these were claimed back from the VHI.
- *Michael's* social insurance benefit in relation to his widower with dependents status is €14,150 pa.

Calculate his income tax and USC liability for 2024. For the purposes of this calculation, ignore PRSI.

Income Tax Calculation		
Gross income from profession Gross income from rental income Gross income from Social Welfare widower payments	*INCOME* Schedule D case II Schedule D case V Schedule E	 €80,000 €20,000 €14,150
TOTAL GROSS INCOME		€114,150
LESS		
Pension term assurance premium €500 Pension contribution €20,000 (note 1) Income Protection premium (note 2)		€ 500 €19,500 €1,000
Taxable income		**€93,150**
Standard rate tax band	€46,000@20%	€9,200
Balance taxable at 40%	€47,150 at 40% =	€18,860
Total income tax payable before credits		**€28,060**
LESS		
Tax credits: Qualifying medical expenses (€2,000 less private health care claim €1,000)	Surviving partner credit One parent family credit Earned income credit Medical expenses (€1,000 at 20%) **Total Credits**	€2,415 €1,750 €1,875 €200 €6,240
Total income tax liability for 2024	€28,060 - €6,240	€21,820
PLUS USC on €100,000 First €12,012 at 0.5% Next €13,748 at 2% Next €44,284 at 4% Balance of €29,956 at 8%	 €60.06 €274.96 €1771.36 €2,396.48	 €**4,503**
Total income tax and USC liability for 2024		**€26,323**

Notes:

1. The maximum he can contribute in relation to his pension is 25% of his earned income at age 49, i.e. €20,000. Rental income is not allowed as pensionable income. Social welfare payments are not earned income and are therefore not included in net relevant earnings for pension purposes.
   The pension term assurance is allowable but only within his overall maximum limit of €20,000 (25% max earnings at age 49 i.e. €80,000 x 25%).
2. Income protection premiums are fully allowable against tax at the marginal rate.
3. Qualifying medical expenses are allowable against tax at 20%.
4. USC is paid on gross income excluding social welfare payments.

2.3 Capital Gains Tax

2.3.1 Introduction

Capital gains tax (CGT) is a tax on the growth in the capital value of assets, with certain exceptions.

Individuals or companies who are resident or ordinarily resident in the State for a year of assessment are chargeable to CGT on *chargeable gains* made on disposal of assets wherever located.

2.3.2 Calculation of Capital Gains Tax Liability

2.3.2.1 A Disposal

Liability to CGT may arise when an individual or company makes a *disposal* of an asset. A disposal can take place by the individual selling the asset. An exposure to CGT can also occur even if no cash is received for disposing of the assets, for example, where there is a *deemed disposal*.

For example, if a parent signs over an asset to, say, a son or daughter, there is a deemed disposal for CGT purposes at the estimated open market value of the asset at the time of transfer.

A similar situation would apply if the asset were sold to the son or daughter at a ‘knock down’ price; for CGT purposes the full open market value would be substituted for the ‘knock down’ price.

2.3.2.2 Calculation of Chargeable Gain

The chargeable gain is the consideration for disposal of the asset less allowable expenditure on the asset.

For example, if an individual acquired an asset, at say, €5,000 and sold that asset some years later at, say, €9,000 then the:

- *Consideration* for disposal is €9,000; and,
- The *allowable expenditure* is €5,000

As indicated above where an asset is disposed of, for example, by way of transfer by gift, at no value or a value below the market value, a *deemed* consideration, at the estimated full market value, is substituted for the actual consideration, for the purposes of calculating CGT.

2.3.2.3 Allowable Expenditure

The acquisition cost of an asset, for example, the purchase price of the asset, is an allowable item of expenditure, in calculating the chargeable gain that may arise on subsequent disposal of the asset. So too is any enhancement capital expenditure, that would *not* be an allowable deduction for income tax purposes.

Example

Joe buys an investment property for €178,000. Two years later he spends €45,000 on extending the premises. One year later he spent €5,000 on redecorating the premises.

Three years later he sells the property for €398,000.

The allowable expenditure includes the original acquisition cost of €178,000 and the subsequent €45,000 of capital expenditure.

The €5,000 redecorating expenditure is not deductible as allowable expenditure for CGT, as it is a 'revenue' or 'income' item of expenditure, deductible from rental income for income tax purposes.

So therefore, an item of expenditure that is deductible for income tax purposes is NOT deductible for CGT purposes, and vice versa.

'Incidental' items of expenditure related to the acquisition and disposal of the asset are deductible for CGT purposes, for example:

- Fees paid to acquire or dispose of the asset, for example, auctioneer's fees, solicitor's fees, valuation fees, etc.
- Stamp duty paid to acquire the asset.
- Costs of advertising the asset for sale.

2.3.2.4 Indexation Relief

Any allowable expenditure incurred on the asset prior to 2003 is first indexed in line with inflation, before calculating the chargeable gain.

This has the effect of increasing the expenditure or buying cost of the asset in line with the rise in *Consumer Price Index* since the asset was acquired.

The indexation factors which apply for disposal of assets are as follows:

Tax year in which expenditure on asset was incurred	Indexation factor where asset disposed of in 2003 or later tax years
1990/1991	1.442
1991/1992	1.406
1992/1993	1.356
1993/1994	1.331
1994/1995	1.309
1995/1996	1.277
1996/1997	1.251
1997/1998	1.232
1998/1999	1.212
1999/2000	1.193
2000/2001	1.144
2001	1.087
2002	1.049
2003 and subsequent years	1.000

Up to 2001 the tax year in which expenditure on an asset occurred commenced on 6th April and ended on 5th April each year. For example, a capital gain on the disposal of an asset purchased in January 1994 will give rise to an indexation factor of 1.331. From 2001 onwards, the tax year changed to a calendar year basis.

Example #1

Mary bought 1,000 ordinary shares in XYZ Ltd for €2 per share in 1998/1999 tax year, plus stamp duty of 1% and stockbrokers commission of 1%. The total acquisition cost is therefore (1,000 x €2) x 1.02 = €2,040.

Mary sold 1,000 ordinary shares in XYZ Ltd for €3.50 per share in the 2024 tax year, less stockbrokers commission of 1%. The total disposal proceeds are: 1,000 x €3.50 x 99% = €3,465.

For an asset acquired in 1998/99 tax year and disposed of in the 2024 tax year, the indexation factor is 1.212, so that the chargeable gain is:

€3,465 – [€2,040 x 1.212] = €992.

Of course, a loss could arise instead of a gain on the disposal of an asset. A loss may usually be offset against chargeable gains arising from the disposal of other assets.

Where a loss arises on the disposal of an asset, the use of indexation relief is restricted:

- Where there is an actual or real loss on the disposal of an asset, then indexation cannot be used to increase that loss, the loss is simply the actual loss incurred *without* indexing the acquisition costs.

Example #2

Tom bought 1,000 ordinary shares in XYZ Ltd for €2 per share in 1998/1999 tax year, plus stamp duty of 1% and stockbrokers commission of 1%. The total acquisition cost is therefore (1,000 x €2) x 1.02 = €2,040.

Tom sold 1,000 ordinary shares in XYZ Ltd for €1.50 per share in the 2024 tax year, less stockbrokers commission of 1%. The total disposal proceeds are:
1,000 x €1.50 x 99% = €1,485.

A 'real' loss therefore arises of €2,040 - €1,485 = €555. (Note that, indexation is not allowed to be applied to the acquisition cost in this case, so that no greater loss than that actually incurred can be claimed).

If Tom has no other chargeable gains in the 2024 tax year, this loss can be carried forward to future tax years to be offset against any chargeable gains that might arise in any year

If, however, Tom had other chargeable gains in the 2024 tax year, the loss of €555 could first be offset against these gains, before any CGT would become due.

- Where a gain arises on the disposal of an asset and the application of indexation relief converts that gain into a '*paper'* loss, the disposal is treated as if neither a gain nor a loss occurred:

Example #3

Peter bought 1,000 ordinary shares in XYZ Ltd for €2 per share in 1998/1999 tax year, plus stamp duty of 1% and stockbrokers commission of 1%. The total acquisition cost is therefore: (1,000 x €2) x 1.02 = €2,040.

Peter sold 1,000 ordinary shares in XYZ Ltd for €2.30 per share in the 2024 tax year, less stockbrokers commission of 1%. The total disposal proceeds are:
1,000 x €2.30 x 99% = €2,277.

A 'real' gain therefore arises of €2,277 - €2,040 = €237.

If indexation was applied to the acquisitions cost, this would have resulted in a potential loss of €195 that is, €2,277 – (€2,040 x 1.212).

(Where the use of indexation relief converts a real gain into a loss, then the disposal is treated as if no gain or loss arose.)

As there is no gain, no liability to CGT arises and there is no loss available to be potentially offset against other gains in the period.

So, indexation relief cannot be used, to increase a real monetary loss, or, to turn a real or actual gain into a loss.

2.3.2.5 Rate of Capital Gains Tax

The general rate of CGT in 2024 is 33%. This is reduced to 10% for gains on disposal of business assets for up to €1 million, in certain circumstances (so called *entrepreneur's relief*).

2.3.2.6 Offsetting Losses Against Gains

An individual can offset allowable losses for CGT purposes against chargeable gains within the same tax year; any unused losses can be carried forward and set against gains arising in later years.

Example

Mr A has a chargeable gain on the disposal of a property of €10,000. He also has an allowable loss on the disposal of another property of, say, €6,000, in the same tax year.

His overall chargeable gain for the year is therefore €4,000.

Losses which are not fully relieved in a tax year can be carried forward to the next tax year to be offset against any chargeable gains arising.

2.3.3 Exemptions and Reliefs

There are a number of significant exemptions and reliefs for CGT purposes, in addition to the indexation relief outlined earlier.

2.3.3.1 Annual Allowance

Individuals, but not companies, are entitled to an annual CGT exemption of €1,270 of chargeable gains in a tax year.

This annual exemption is related to chargeable gains, ***after*** allowance has been made for indexation relief. The annual allowance is taken from the gain and not the tax on the gain.

Example

Mr A disposes of an asset during the 2024 tax year, giving rise to a chargeable gain of, say, €5,000 (after indexation relief). He has no other gains in the same tax year.

Chargeable gain	€5,000
Less annual allowance	€1,270
Chargeable gain	€3,730
Capital gains tax (€3,730 at 33%)	€1,231

If the annual exemption is not used in a particular year, it *cannot* be carried forward. Unused annual allowance cannot be transferred from one spouse/civil partner to the other.

2.3.3.2 Spouses/Civil Partners

A married couple or registered civil partnership living together are taxed for capital gains tax purposes as one unit unless separate assessment has been chosen.

This means that the allowable losses of one spouse may be set against the allowable gains of the other spouse.

For CGT purposes, a sale or transfer of assets between spouses/civil partners is deemed to occur at a price at which no gain or loss arises, provided the spouse/civil partner to whom the asset is transferred is resident in the State in the year of transfer.

If an asset is transferred from, say, the husband to his wife then on subsequent disposal by his wife, she is deemed to have acquired it, at the same price and acquisition date as her husband had acquired it.

In other words, the period of ownership is treated as one unit in the case of a husband and wife.

Example

John buys shares in 1997/1998 tax year for €20,000, plus allowable acquisition costs of €400.

In 1999/2000 tax year, John transferred these shares to his wife Mary, who lives with him. They are both resident in the State. The transfer is deemed to occur at a price at which no gain or loss arises.

Mary sells the shares in the 2024 tax year for €30,000 less allowable disposal costs of €300.

For the purposes of calculating Mary's chargeable gain:

- Mary is deemed to have acquired the shares in the 1997/98 tax year for €20,000 plus allowable acquisition costs of €400 with indexation; and,
- Disposed of the shares in the 2024 tax year for €30,000, less allowable disposal costs of €300.

A married/civil partnership couple's CGT position changes to that of two unconnected single people, if they divorce/dissolve the civil partnership.

However, any transfer of assets from one to the other by virtue or in consequence of a court order made on or following the granting of the divorce/dissolution of civil partnership decree, is treated as would normally apply to a married couple/civil partners.

2.3.3.3 Death

When an individual dies, any person who acquires assets under his will or intestacy is deemed to have acquired them at the date of death and at the market value at the date of death.

However, the deceased person is not deemed to have disposed of the assets and hence no capital gains tax arises on death. Of course, it may be that inheritance tax could arise as a result of the transfer of assets on death.

In the case of spouses/civil partners, if one dies and leaves assets to the surviving spouse/civil partner, he or she is deemed to have acquired them from the other spouse/civil partner at the date of his or her death and at the market value at that date thus eliminating any gain made up to the date of death.

On subsequent disposal indexation applies from the date of acquisition by the surviving spouse/civil partner, that is, from the date of death of the spouse/civil partner.

2.3.3.4 Principal Private Residence

An individual is not liable to CGT on any gain made on the sale of his or her principal private residence, subject to certain conditions.

For the purposes of the relief, an individual can generally only claim to have one principal private residence at any one time.

A principal private residence is deemed to include land in connection with the occupation and enjoyment of the residence up to an area not exceeding one acre.

Where a house is used partly for private and partly for business purposes - for example a doctor with a surgery, then part of the gain made on the disposal of the property may be liable to CGT.

2.3.3.5 Treasury Bonds

Individuals are not liable to CGT on any gains made on the sale of treasury bonds issued by the Irish Government. However, note that as gains are not liable to CGT, any losses arising on the disposal of such investments are not allowable for CGT purposes either.

2.3.4 Case Study - Capital Gains

- James is married to Kate. They have two children.
- James sells a holiday home to Kate’s brother in 2024 for €200,000 (market value €350,000 and original cost €100,000, when it was bought in 2010).
- James has capital losses carried forward of €20,000 on the sale of shares in 2015.
- James sells an investment property in 2024 for €750,000. The original cost was €380,000 when it was bought in 2009. There were legal fees of €10,000 relating to the purchase and James built an extension to the property costing €90,000. Selling fees amount to €6,000.
- James disposed of €80,000 in Irish government securities in 2024, making a profit of €10,000.

Calculate the capital gain/loss for James.

Solution

1. Disposal of Holiday Home to brother in law:

Market Value	€350,000	
Cost	€100,000	
Chargeable gain		€250,000

2. Capital losses carried forward (€20,000)

3. Sale of investment property:

Proceeds	€750,000	
Costs (€380k+€10k+€90k+€6k)	€486,000	
Chargeable gain		€264,000

4. Government securities are exempt from capital gains

5.

Total Net Chargeable Gains	€494,000
Less annual exemption	(€1,270)
	€492,730
CGT @ 33%	**€162,601**

2.4 Capital Acquisitions Tax

2.4.1 Introduction

Capital acquisitions tax (CAT) is a tax levied on the recipient of a taxable:

- Inheritance, that is, a benefit taken on a death; and,
- Gift, that is, a benefit taken otherwise than on a death.

Both inheritance tax and gift tax are taxes levied on the acquisition of a benefit received by way of gift, from a living person, or by an inheritance on the death of a person whom has left it to them in their estate or by succession laws, if they die intestate.

The CAT rate for gifts and inheritances in 2024 is 33%.

2.4.2 Exemptions and Reliefs

There are certain important exemptions and reliefs from inheritance tax:

- The first €3,000 small gifts exemption from any individual to any individual.
- Spouse/civil partner exemption.
- ARF payments.

2.4.2.1 Small Gift Exemption

The first €3,000 gift received from any individual to any individual in a year is exempt from gift tax. For inheritance tax planning, it is therefore possible for a mother and father to gift €3,000 per annum each to a child, that is, €6,000 per annum without it being part of a gift or inheritance.

2.4.2.2 Spouse/Civil Partner Exemption

One of the most important exemptions is the *spouse/civil partner exemption*, where any benefit, taken either as a gift or inheritance by a person from their spouse or civil partner is totally exempt from CAT, regardless of the amount.

So, for example, the following would be exempt from inheritance tax:

- The proceeds of a life assurance policy owned by the deceased and received by his or her spouse on death.
- The proceeds of a personal pension plan or PRSA owned by the deceased and received by his or her civil partner on death through his estate.
- Payments from an employer pension scheme, either as a lump sum benefit or as a pension, received by a spouse of a deceased pension scheme member.
- A distribution from an ARF owned by the deceased and inherited by his or her civil partner on death.

It is important to note that the exemption only applies between persons who are recognised in law as being spouses or registered civil partners to each other at the time of the gift or inheritance.

2.4.2.3 ARF and Vested PRSA Payments Inherited by Children

Distributions from an ARF or vested PRSA after the death of an ARF/ vested PRSA holder received by a child of the deceased ARF/ vested PRSA owner, are exempt from inheritance tax provided:

- The child is over age 21 at the date of the ARF/vested PRSA holder’s death; and,
- The payment is received from the deceased parent’s estate.

2.4.3 How is Inheritance Tax Calculated?

The inheritance tax rate is 33% and is levied on the excess of the value of the total benefits received by a beneficiary from all sources since 5th December 1991, over a certain *threshold amount.* The value of all gifts and inheritances received by an individual are taken into account for the purpose of the threshold.

The threshold amount varies according to the degree of relationship between the person from whom the gift or inheritance is taken (usually referred to as the *disponer*), and the beneficiary. The threshold amounts in respect of benefits taken in 2024 are:

Threshold class	Beneficiary	Threshold amount
A	Where the beneficiary is a child, including adopted, foster and stepchild, of the person providing the benefit, or the minor child of a deceased child (grandchild)	**€335,000**
B	Where the beneficiary is a brother or sister, a niece or nephew that is, a child of a brother or sister, or other lineal ancestor or descendant of the person providing the benefit for example, a grandchild. Includes relationships an individual has by virtue of being a foster child.	**€32,500**
C	All other cases	**€16,250**

Note that Class B only applies to relatives related in blood to each other and the Class C threshold, applies to benefits received from ‘in laws’.

All benefits received, since 5th December 1991, from all persons within a particular threshold class are added together for the purposes of determining whether an inheritance exceeds the relevant threshold class amount.

All benefits received from parents, therefore, are added together for the purpose of the Class A, **€335,000** threshold amount.

Benefits from other blood related family members (brother, sister, grandparent, etc) will be added together for the Class B, **€32,500** threshold amount, and all benefits from others (strangers) are taken into account for the purpose of the Class C, **€16,250** threshold amount.

So, in effect a beneficiary can potentially receive €383,750 tax-free, if benefits are received from people in the different classes.

Example #1

Mary receives a taxable cash inheritance of €200,000 from her mother in January 2024. She has received no other gifts or inheritances before that date.

Class A threshold amount applies, that is, €335,000.

Her inheritance tax liability is nil as her total benefits received from her parents since 1991 does not exceed the relevant threshold class amount of €335,000.

Example #2

Susan receives a gift valued at €700,000 from her mother in February 2024. She has received no other gifts or inheritances before that date.

The first €3,000 is exempt from gift tax. Therefore, her taxable gift is €697,000.

Class A threshold amount applies, that is, €335,000.

Her gift tax liability is calculated as:

33% x (€697,000 - €335,000) = €119,460.

Tax is levied according to the *cumulative* value of benefits received from parents since 5th December 1991.

Example #3

Mary receives a taxable cash gift of €700,000 from her mother in January 2024. She has received no prior gifts or inheritances from her parents before that date. The €3,000 small gift exemption applies.

Class A threshold amount applies, that is, €335,000.

Her gift tax liability is calculated as: 33% x (€697,000 - €335,000) = €119,460

In February 2024 she receives an inheritance of €250,000 from her father. This also falls under the Class A (parent to child) threshold amount.

Total inheritances/gifts received to date:	€947,000	(that is, €697,000 + €250,000)
Less relevant threshold:	€335,000	
Taxable:	€612,000	
Tax at 33%:	€201,960	
Less gift tax already paid on previous benefit:	- €119,460	
Inheritance tax on latest benefit:	€82,500	

Example #4

Taking the same details as in *Example #3* above, that is, Mary received a gift of €700,000 from her mother in January 2024 and an inheritance of €250,000 from her father in February 2024, on which the total gift/inheritance tax liability was €201,960

Later in March 2024 she receives an inheritance of €70,000 from her aunt. Class B threshold applies to this inheritance.

She has not received any prior gifts or inheritances other than those from her parents.

Mary's Class B threshold amount in relation to the inheritance from her aunt is €32,500, so her inheritance tax liability on this latest benefit is calculated as:

33% x (€70,000 - €32,500) = €12,375.

If Mary were to receive any further gifts or inheritances from, say, another uncle, the full amount would be taxable as Mary has now used up her entire Class B threshold amount in relation to benefits from such gifts and inheritances.

Mary can still receive a gift or inheritance of up to €16,250 from a Class C relationship, without incurring a tax liability.

Also note that any gifts or inheritances received before 5th December 1991 are not taken into account in calculating the inheritance tax due on a benefit taken since that date.

2.4.4 Who Pays the Tax?

The person who receives the inheritance is primarily liable to pay inheritance tax, if due.

2.4.5 Pension Benefits

Not all pension payments on death are subject to inheritance tax:

2.4.5.1 Pensions as Favourable Death Benefits

A personal pension plan or PRSA will pay out in full on death of the plan holder. The only tax payable by the recipient is inheritance tax. If it is paid to a spouse or civil partner, it will be exempt from Inheritance tax. If it is paid out to a child, or other individual, inheritance tax is payable, after the lifetime threshold from the appropriate class is accounted for. Tax treatment of current pensions, RACs and PRSAs is different to post pension products, for example, ARFs and vested PRSAs.

Example #1: Current Pensions and Death

Joe has a PRSA valued at €13,000 and a personal pension of €100,000. He dies, and the €113,000 is paid to his estate. His surviving wife takes the benefit tax free.

Example #2: Crystallised Pensions and Death

Joe has a PRSA valued at €13,000 and a personal pension valued at €100,000. He takes 25% of both as a tax-free lump sum and moves the balance to an ARF as per current rules. He dies and is survived by his wife who now owns the ARF. Any subsequent withdrawals are subject to income tax and USC in the normal way.

Example #3: Crystallised Pensions and Death

As in *Example #2* above, values are the same. Joe is not survived by his wife, but by his children only, who are over 21. The ARF will be drawn and subject to a special income tax rate of 30%. If he was not survived by a spouse or children, the ARF would be drawn, subject to income tax and USC to become part of his estate.

Note: If his children were all under 21, the ARF would be drawn and subject to inheritance tax, after the Class A threshold is accounted for.

2.4.5.2 Employer Pension Schemes on Death

On death in service, a lump sum or pension may be payable to next of kin to a maximum of four times final remuneration with the balance being used to purchase an annuity or invest in an ARF in the next of kin's name. The value of the pension fund is added to the death in service life policy, if any, before benefits are determined.

Example

Susan is a member of an employer pension scheme set up by her employer. She dies while in service and her annual remuneration is €50,000 and her death in service benefits amount to €150,000. €100,000 is paid to her civil partner, Alice, and €50,000 is paid to her son, Sam.

The €100,000 received by Alice is exempt from inheritance tax and the €50,000 received by Sam is treated as a taxable inheritance from his mother, under Class A threshold. As this threshold is €335,000, no tax will be payable unless he previously used up this amount.

On death, after retirement, the pay-out is determined by how benefits were taken by the individual. If it was an annuity, it will depend on whether a dependent's annuity was chosen at the outset. If it is an AMRF/ARF, the benefits and tax treatment will be the same as in Example #2 and #3 above.

2.4.6 Life Assurance Policies

The proceeds of a life assurance policy received on death are normally treated as a taxable inheritance in the hands of the beneficiary.

Example #1

Tom has a life policy for €100,000 cover on his own life. He pays the premiums. He dies and, in his will, leaves everything, including the proceeds of the policy, to his daughter.

The €100,000 would be treated as a taxable inheritance received by the daughter from Tom, her father and the Class A threshold would apply.

Of course, where the proceeds are left to a spouse or civil partner, no inheritance tax applies due to the spouse/civil partner exemption.

Example #2

Mr A has a life policy for €100,000 cover on his own life. He pays the premiums. He dies and, in his will, leaves everything, including the proceeds of the policy, to his wife, Mary.

The €100,000 would be exempt from inheritance tax along with the rest of the estate left to Mary, under the inheritance tax spousal exemption.

Inheritance tax will apply to the proceeds of life assurance policies, even if the proceeds do not go through the deceased's estate.

Example #3

Mr A has a life policy for €100,000 cover on his own life, arranged under trust for the benefit of his daughter Susan. He pays the premiums. He dies, and the proceeds are paid to the trustees who then, in accordance with the terms of the trust, pay the €100,000 on to Susan.

The €100,000 would be treated as a taxable inheritance received by Susan from her father, on the basis that her father had funded the cost of the benefit she received, that is, by paying the premiums under the policy.

Example #4

Susan has a *life of another* policy for a sum assured of €100,000 on the life of her father, Tom. Tom pays the premiums.

Tom dies. The life company pay the €100,000 to Susan as the policy holder.

As the premiums were paid by Tom, the €100,000 is treated as a taxable inheritance received by Susan from her father, even though Susan was the policy owner.

Where one individual owns a policy on the life of another individual and pays the premiums on the policy from their own funds, then no inheritance tax arises on death.

Example #5

Susan has a *life of another* policy for a sum assured of €100,000 on the life of her father, Tom. Susan is working and pays the premiums from her own funds.

Tom dies. The life company pay the €100,000 to Susan as the policy holder.

As the premiums were paid by Susan herself, the €100,000 is NOT treated as a taxable inheritance, as she is deemed to have paid for the benefit received.

Where the proceeds of a policy are left to a surviving cohabitant of the deceased (not a spouse or civil partner or other relative of the deceased) and the surviving cohabitant did not contribute to the policy premium, then the full proceeds are a taxable inheritance and Class C threshold applies, that is, the 'strangers' threshold. However, any children of the deceased are entitled to the Class A threshold.

Example #6

Tom and Angie live together but are not married to each other, in a civil partnership or related to each other. They have two children together. Angie does not earn an income.

Tom pays a premium on a policy for €300,000. He dies and, in his Will he directed that €150,000 of the proceeds be paid to Angie and €75,000 to each of his two children.

For inheritance tax purposes, Angie has a tax liability on her €150,000 inheritance as follows:

33% x (€150,000 – €16,250) = €44,137

The children have no inheritance tax liability as their inheritance of €75,000 each is under their Class A threshold of €335,000 each (assuming they had received no other gift or inheritance previously).

However, if Angie had been earning an income and the premiums on Tom's policy were paid from a joint bank account, then if both were earning roughly equal incomes, only 50% of the €150,000 inheritance would be liable to inheritance tax, as Angie can show that she contributed 50% of the premiums. Her inheritance tax liability would reduce to:

33% x (€75,000 - €16,250) = €19,388.

If Angie had been earning an income, sound financial advice would be to arrange the cover as a life of another policy on Tom, that is, Angie *owns* the policy on Tom's life, with the premiums paid from a bank account in Angie's own name. On Tom's death, she would then inherit the full policy proceeds tax free.

2.4.7 The Family Business or Farm Relief

Certain agricultural and business assets are reduced in value by 90%, for inheritance tax purposes (that is, their value for inheritance tax purposes is taken at only 10% of their open market value), if certain conditions are met.

Example

Tom dies and in his will leaves a family business worth €2 million to his son.

If all of the conditions are met, Tom's son, for inheritance tax purposes, is treated as taking a taxable inheritance of €200,000, that is, the €2 million reduced by 90%.

Assuming Tom's son has not fully used his €335,000 threshold amount, the inheritance of the family business would not give rise to an inheritance tax liability.

This relief is usually referred to as *business relief* in relation to business assets, and *agricultural relief* in relation to agricultural assets.

2.4.8 Dwelling House Exemption (Inheritance)

Where a family home is passed on death to the spouse of the deceased, then no inheritance tax applies due to the spousal exemption from inheritance tax.

However, where the home passes to children or others, an inheritance tax liability will arise unless they qualify for the *dwelling house exemption*.

Example

Mary, a widow, dies in March 2024 and leaves the family home worth €880,000 to her daughter, Susan, age 57.

Susan has not received any other gift or inheritance before from any source previously. Class A threshold amount applies.

Susan would be treated as receiving an inheritance of €880,000 which would be liable to inheritance tax as follows:

First €335,000 at nil:	€0
Next €545,000 at 33%:	€179,850
Inheritance tax due:	€179,850

However, the beneficiary, Susan, may be entitled to an exemption from CAT if:

- The house was the only or main home of the person who died, Mary.
- Susan lived in the house as her main home for the three years prior to Mary's death.
- Susan does not own or have an interest in any other home at the date of the inheritance.

Susan must continue to own and occupy the home as her family home for at least six years after the inheritance, unless she was over 65 years of age at the date of the inheritance or is required to live elsewhere due to employment or physical/mental infirmity.

- The above conditions apply in relation to inheritance tax arising on the inheritance of a dwelling house. If the house is received by the beneficiary as a **gift**, not an inheritance, see Chapter 2.4.11 below.

2.4.9 Section 72 Relief

Section 72 of the Capital Acquisitions Tax Consolidation Act, 2003 introduced a relief on the proceeds of certain life assurance policies used to pay inheritance tax. (The relief is sometimes referred to as *Section 60 relief*, after the relevant section of the earlier 1985 Finance Act which originally introduced this relief).

The relief given is that the proceeds of policies effected under Section 72, are exempt from inheritance tax, in certain circumstances, to the extent that they are used to pay inheritance tax arising on the death of the policy holder.

Example #1

Mr Browne effects a policy for €100,000 sum assured, expressed to be effected under Section 72, CAT Consolidation Act, 2003 for the express intention of paying inheritance tax that may arise on his death.

On his death, the inheritance tax liability for his dependants in respect of his estate is €100,000.

His Section 72 policy proceeds may be used to pay inheritance tax arising in respect of bequests made by him, and the payment of the beneficiaries' inheritance tax liabilities will not itself be treated as another taxable inheritance from him.

To benefit from this relief there are four main requirements:

- The policy must be *'expressly'* effected under Section 72.
- Normally such policies are endorsed on the policy face as being issued under Section 72 and are also normally written under a *declaration of trust* which obliges the trustees to use the proceeds initially to pay inheritance tax that may arise following the insured's death.
- The policy must carry life cover of at least eight times annual premium, or six times annual premium if the policy has a loading because of the life assured's health.
- The person who owns the estate that will give rise to the inheritance tax liability must be the policy holder and pay the premiums on the policy.

  Any excess or surplus proceeds of the policy, not used to pay inheritance tax are treated as a separate taxable inheritance in the hands of the beneficiaries.

Example #2

Mr Smyth effected a policy for €150,000, under Section 72 relief.

When Mr Smyth dies, his beneficiaries' inheritance tax liability is €100,000, which is paid by the policy proceeds.

The €50,000 surplus proceeds are divided among certain beneficiaries, as specified in the Section 72 declaration of trust and is then treated as a separate taxable inheritance received by them from Mr Smyth on the day after the initial inheritance is taken.

Section 72 policies are generally issued on *a joint life last survivor* basis, that is, the sum assured becomes payable only on the second death of a married couple or registered civil partners.

This type of policy suits where spouses/civil partners have wills which leave everything to each other on the first death and then onto children on the death of the last survivor. In this case the inheritance tax liability will not arise until both lives assured have died. Premiums can be paid by either or both of the lives assured during their joint lives and by the survivor after the first death.

Any type of protection policy, for example, term assurances, whole of life, unit-linked, etc., can be arranged under Section 72, depending on the life companies' offerings. The minimum requirements to qualify for relief, in addition to those outlined earlier, are:

- Regular premiums must be paid. Therefore, single premium policies do *not* qualify.
- The policy must be set up for a term of at least eight years.
- The premium paid in any year cannot be more than twice the premium paid in any other year of an eight-year period.

Section 72 policies can also fund the income tax deducted from an ARF on the death of the policy holder. Income tax on an ARF is currently set at 30% and must be deducted from a post death transfer from an ARF or vested PRSA to an adult child (over age 21) of the deceased ARF/vested PRSA holder.

The Section 72 relief works by exempting the proceeds of a Section 72 policy from inheritance tax to the extent of income tax deducted from an ARF held by the deceased policy holder.

Example #3

Joe has an ARF worth €400,000. He dies and €200,000 of his ARF is to be paid to his son, then aged 34. €60,000 of income tax, that is, 30%, is deducted from the distribution to be made to Joe's son, so that Joe's son gets €140,000 from the ARF qualifying fund manager.

Joe also had a Section 72 policy on his life for €100,000. As €60,000 of income tax was deducted from an ARF inheritance provided to his son, €60,000 of the Section 72 policy proceeds are exempt from inheritance tax in his son's hands, with the balance being treated as a taxable inheritance unless used to pay separate inheritance tax payable by Joe's son or other beneficiaries on other inheritances received from Joe.

So, Joe's son receives:

- An ARF inheritance, after applicable income tax, of €140,000; plus,
- €60,000 of the Section 72 policy proceeds, that is, €200,000 in total.

Both of the above inheritances are exempt from inheritance tax.

2.4.10 Gift Tax

Gift tax is similar to inheritance tax except that it applies only to benefits received '*otherwise than on a death*', for example, a father makes a gift of property to his son or daughter, while alive. The same tax rate of 33% applies.

Example

Mary receives a taxable inheritance of €200,000 from her mother in January 2024. She has received no other benefit before that date.

Her inheritance tax liability is nil as her total benefits received from her parents since 1991 does not exceed the threshold amount of €335,000.

In March 2024 she received a gift of €300,000 from her father, of which €3,000 is exempt from gift tax. Her taxable gift is therefore €297,000.

She has now received total gifts and inheritances of €497,000, against which the threshold amount of €335,000 can be set.

Therefore, gift tax on the latest gift = 33% x (€497,000 - €335,000) = €53,460

When ascertaining an individual's liability for inheritance tax, any prior gifts received within the same category must be included. The thresholds are for CAT, that is, all property received by an individual whether the disponer was alive or dead, gifts or inheritances. The tax rate is the same for both types of acquisition, that is, 33% and is levied on the excess of the value of the total benefits, that is, both gifts and inheritances, and is levied on the amount received after the threshold amount is taken off.

The first €3,000 received in any one year from any person is exempt from gift tax, that is, the small gift exemption, so an opportunity for inheritance tax planning arises.

2.4.11 Dwelling House Exemption (Gift)

A beneficiary can claim an exemption from CAT on a house received as a gift:

- If they are a dependent relative of the person making the gift. To be a dependant relative you must be:
  - Permanently and totally incapacitated and unable to earn a living; or
  - 65 years or older at date of the gift.
- If they do not own, or have an interest in, or a share in, any other house.
- If the house is their main home for six years after they receive it. This does not apply if they are over 55.

Unlike inheritances, the house being gifted does not have to be the main or sole residence of the disponer.

Therefore, in the earlier example in Chapter 2.4.8, if Mary was still alive and gifted the house to Susan, Susan could not avail of an exemption (unless she was a dependent relative of Mary) and would be subject to full capital acquisitions tax, after her threshold.

2.4.12 Capital Gains Tax Offset

The transfer of an asset as a gift to another person is also treated as a disposal for CGT purposes, and so a potential double tax liability can arise on such a transfer.

Example #1

Martin signs over an investment property worth €750,000 to his son, Tom, as a gift in January 2024.

For tax purposes, two separate events are deemed to have occurred:

- For CGT purposes, Martin is deemed to have made a disposal of the property at its market value of €750,000, even though no cash changed hands for the property. Martin may therefore have some CGT to pay. Let's assume that the CGT liability, after allowing for the deduction of allowable expenditure, is €40,000.
- Tom, the beneficiary, is deemed to have received a gift of €750,000 from his father, which is likely to give rise to a gift tax liability for Tom. Assuming Tom has the full threshold amount of €335,000 available, his gift tax liability would be:
  33% x (€750,000 - €3,000- €335,000) = €135,960.

However, there is a relief in these situations whereby the CGT, if any, paid by the person making the gift is offset against any gift tax due by the beneficiary receiving the gift, in order to remove the impact of double taxation on the same event.

Example #2

Using the same example as above, Tom's gift tax liability of €135,960 would be reduced by the €40,000 CGT already paid by his father Martin, that is, reduced to:

(€135,960- €40,000) = €95,960.

So, the net tax impact on the gifting of the investment property by Martin to Tom would be:

- Martin would have to pay €40,000 CGT; and,
- Tom would have to pay €95,960 in gift tax.

Any CGT credit given in relation to a gift taken will be clawed back if the beneficiary disposes of the property, which was gifted, within two years, for example, if Tom sold the investment property he was gifted, within two years of receiving the gift.

So, in the above example, if Tom sold the investment property shortly after receiving the gift, the €40,000 CGT credit for gift tax is clawed back from Tom and Tom becomes liable for an additional €40,000 gift tax.

2.4.13 Exit Tax Offset

Where an individual holds a life assurance policy or collective investment fund, exit tax at 41% will be deducted from any gain deemed to be realised on encashment on the day before death.

For inheritance tax purposes:

- The bond is deemed to be inherited at its *pre*-exit tax value.
- If the inheritance of the bond gives rise to an inheritance tax liability, the exit tax deducted is offset against this liability.

2.4.14 Section 73 Relief

Section 73 of the Capital Acquisitions Tax Consolidation Act, 2003 provides a relief on the proceeds of certain life assurance savings plans if the proceeds are used to pay gift tax. This relief is therefore usually referred to as Section 73 relief, (or Section 119 relief in reference to the section of the 1991 Finance Act which originally introduced it).

The relief given is that the proceeds of such policies are exempt from gift tax, in certain circumstances, to the extent that they are used to pay gift tax arising in respect of a gift made by the policy holder.

So, a parent, for example, could accumulate funds in a Section 73 life assurance savings plan, to be used to pay gift tax arising on the transfer of, say, the family business or farm to the next generation at some stage in the future.

Any type of savings policy can be arranged under Section 73. In order for the relief to apply:

- Premiums must be payable for at least eight years.
- The proceeds cannot be used to pay gift tax until after eight years.
- The proceeds must be used to pay the gift tax within one year of taking an encashment from the policy.

Example

John plans to sign over certain assets to his daughter, Imelda, in 10 years' time. The estimated gift tax liability for Imelda will be €50,000.

John could effect a life assurance savings plan, expressly effected under Section 73 relief, with a view to accumulating a lump sum of €50,000 after 10 years.

After 10 years if John encashed the savings plan, and within a year uses the proceeds to pay Imelda's gift tax liability, the payment of the gift tax liability by John from the policy proceeds will itself not be another taxable gift from John to Imelda.

There is no requirement to have any minimum level of life cover or savings premiums. Under Section 73, the premiums must have been paid for eight years before proceeds of the plan can be used to offset gift tax. However, under Section 72 for inheritance tax purposes, the life policy must be set up with a term of no less than eight years but will be paid out if the life assured dies within that term and can be used to pay inheritance tax.

The policy holder is not obliged to use the Section 73 policy proceeds to pay gift tax; he or she can retain the policy proceeds for their own use if they wish.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- The main *income tax* reliefs and exemptions which may impact on a consumer's financial planning process ☐
- The main features and exemptions of CGT ☐
- The main features and exemptions of *inheritance and gift tax* ☐

03

Review: Pensions

In Chapter 1, we revisited regulation in relation to the sales advisory process under the Consumer Protection Code (CPC) and the Markets in Financial Instruments Directive (MiFID) and looked at how regulation has shaped the financial planning model. Chapter 2 gave an overview of personal taxation. The next four chapters summarise the other four QFA modules, Pensions, Life Assurance, Loans, and Investments. This chapter reviews pensions.

Learning Outcomes – after studying this chapter you should be able to:
understand and elaborate on the pension tax reliefs available;
explain how and when retirement benefits may be taken and give advice on the possible benefits of postponing benefits in certain circumstances;
understand the options for a member of an employer pension scheme on termination of employment and be able to calculate these options to give your recommendation;
Explain how master trust differs from other employer pension schemes;
understand what is meant by maximum fund thresholds and calculate a consumer's chargeable excess tax;
advise on the various annuity types and the advantages and disadvantages of annuities versus ARF/AMRF;
explain how the beneficiary of a pension adjustment order may take benefits and when; and,
compare certain pension products.

3.1 Introduction: Retirement Planning

Providing for retirement is a key financial need for many consumers. There are many different retirement funding vehicles that may be used, in different circumstances, for this purpose:

- Personal pension plans / RAC
- PRSAs.
- Membership of an employer pension scheme.
- Master Trust
- Executive pension plans.
- AVCs.
- Buy-out bonds, also known as personal retirement bonds.

Different options may be open to the consumer about **how** and **when** to take benefits from these arrangements. Picking the most appropriate combination of benefits for a consumer is a crucial decision, as the consequences of picking an inappropriate option may have a negative material impact on a consumer's financial circumstances for a very long time and may be incapable of being reversed.

3.2 Personal Contracts: RACs and PRSAs

Individuals who have **relevant earnings** liable to income tax, that is, income earned from a self-employed trade of profession or income earned from a non-pensionable employment, can take out a personal pension plan or a *personal retirement savings account* (PRSA).
If an individual is in pensionable employment, that is, they are members of an employer pension scheme through their employment, and they have a secondary income that is non-pensionable, for example, farming or teaching music, they may also take out a personal pension or a PRSA in relation to this secondary income, subject to age related limits.

The personal pension plan contract is between the individual and the life company and is called a *retirement annuity contract* (RAC). Unlike an RAC, you can take out a PRSA without relevant earnings, but will only get tax relief against relevant earnings. In addition, for an individual without relevant earnings who is a member of an employer pension scheme, they may take out an AVC PRSA for additional contributions and therefore would have a personal contract in addition to their employer scheme.

An Employee, who has been an Employee for at least six months and does not have access to an employer pension scheme, can contribute to a PRSA via the Employer's payroll system, i.e. the PRSA contribution is made at source from the gross salary. The Employer is not obliged to contribute to an Employee's PRSA and is only obliged to provide PRSA access to one PRSA provider. These PRSAs are referred to as Employer PRSAs or Group PRSAs but remain Personal Contracts for the Employees.

With effect from 1st January 2024, Revenue Commissioners will not approve any new RAC contracts, however life companies can continue to issue new RAC policies after 1st January 2024 based on existing RAC contracts in place before this date.

3.2.1 Income Tax Relief on Personal Contracts: RACs and PRSAs

- The maximum net relevant earnings that can be taken into account for the purposes of income tax relief on RAC and PRSA contributions is currently €115,000.

- The maximum percentage of *net relevant earnings* (NRE) that can be invested in a personal pension or PRSA contract, for tax relief purposes, is based on the individual's age in that tax year (see table below). This includes any pension term assurance premiums (see Chapter 4).

- Income tax relief is always available on PRSAs for contributions up to €1,525 per annum regardless of these age limits.

- Income tax relief can be claimed on personal contributions to an AVC PRSA for an individual in an employer pension scheme, within the limits of the employer pension scheme benefits and the age-related personal contract earnings limit (inclusive of any normal employee contributions).

Age limits for personal contracts and employee contributions to Employer Pension Schemes	
Age attained during relevant earnings year	**Income relief limit (as a percentage of NRE)**
Less than 30	15%
30 – 39	20%
40 – 49	25%
50 – 54	30%
55 – 59	35%
60 and over	40%

An exception to the limits set out in the above table is made for **certain** professional sportspeople, for example, football and rugby players, who are under age 50. They are allowed a higher limit of 30% of earnings. This is due to the likelihood of retirement age being earlier than other professions.

3.2.2 Retirement Benefits: Personal Pension Plans/PRSAs - Lump Sum Options

In the case of personal pension plans and PRSAs, up to 25% of the accumulated retirement fund can be taken as a lump sum when retirement benefits are being taken. The first €200,000 of such a lump sum taken, in aggregate, from all pension arrangements since 7th December 2005, is tax free. The balance of the lump sum, if any, in excess of €200,000, is taxed at the standard rate of income tax (currently 20%), with any balance over €500,000 taxed at marginal rate.

Retirement benefits can be taken:

- At any time between ages 60 and 75, although some occupations have earlier allowed retirement ages from 50 onwards; OR,

- Earlier on permanent incapacity.

However, an individual may be better advised **not** to take retirement benefits as long as is possible as:

- They receive gross roll up on the full amount invested.

- Death benefits: the full amount is paid to the estate free of income tax. Inheritance tax may be payable depending on the beneficiary and CAT threshold limits.

When it is time to take benefits, or *crystallise* pension benefits, it is almost always good advice to take the maximum lump sum allowed as:

- An immediate lump sum is obtained now, rather than an annuity which would cease on death.

- The immediate lump sum is tax free (within the €200,000 limit), while the annuity alternative would be liable to income tax at marginal rate.

Historically, it would have been possible to use the lump sum to purchase a second annuity called a purchased life annuity. Only part of this annuity would be liable to income tax at marginal rate, rather than a retirement fund annuity where the full annuity is liable to income tax and USC. While it is important to be aware that these products may exist, practically they are no longer available for purchase in the marketplace.

Occasionally, however, an individual may have an older personal pension plan which has a guaranteed minimum annuity rate built into the plan, and it may be of more value to them, if they do not require a lump sum.

Example

Mary is aged 62 and is drawing on her personal pension plan. The accumulated fund is €700,000. Mary took a lump sum of €150,000 from a PRSA last year. She has taken no previous lump sums from any other pension arrangement since 7th December 2005.

Mary can take 25% x €700,000, that is, €175,000, as a lump sum.

As she has already taken a lump sum of €150,000 last year from a PRSA, her available tax-free lump sum limit is now €50,000. Where an individual has exceeded their tax-free lump sum limit, the next €300,000 of lump sum benefits is taxed at a fixed rate of standard rate income tax, that is, no income tax reliefs or tax credits can be set against this tax liability.

So, Mary can take her €175,000 lump sum entitlement under the personal pension plan as:

- €50,000 tax free.
- €125,000 subject to standard rate income tax, 20%.

However, Mary above could alternatively opt to simply take €50,000 as a tax-free lump sum,[6] and use the balance in the plan that is, €650,000, in any other ways outlined below.

[6] *The lump sum entitlement under a personal pension plan is 'up to 25%'; the plan holder can opt to take less than 25% as a lump sum.*

3.2.3 Options for Balance of Fund Not Taken as Lump Sum

- **Invest in an *approved retirement fund* (ARF)**

- The ARF is a personal investment account which can be accumulated and drawn on in retirement as the consumer wishes. The ARF is invested on a tax free basis, with tax only being payable at exit. All lifetime withdrawals are subject to income tax, PRSI (if under age 66) and USC.

  The investor is expected to make a minimum withdrawal each year. There will be an assumed ('imputed') withdrawal each year of 4% rising to 5% at age 71. (There will be an assumed ('imputed') withdrawal each year of 6% in respect of ARF's in excess of €2m). It makes sense to take the actual withdrawal as tax is payable on the imputed amount anyway, and the amount would again be liable to tax on the actual withdrawal later, in effect a double tax hit.

  On death, any balance passing to a spouse/civil partner is liable to tax as for lifetime withdrawals (unless it is transferred to another ARF). Any balance transferred to a child under 21 is exempt from income tax and treated as a taxable inheritance. If the child is over 21, a special tax rate of 30% applies.

- Prior to the implementation of the Finance Act 2021, when investing in an ARF, an individual must first have placed, then or previously, €63,500 in an **approved minimum retirement fund (AMRF)** or have had a guaranteed income of €12,700 per annum, for example, social welfare pension. Funds in an AMRF, up to €63,500, were not permitted to be withdrawn until age 75 (other than an annual optional withdrawal of 4% of the value of the AMRF) or until the individual was in receipt of a guaranteed income of €12,700, at which stage the AMRF would automatically have become an ARF. The requirement to hold an AMRF was abolished by the Finance Act 2021 and all AMRFs in existence at the date of enactment were automatically re-designated as ARFs.

- **Take as a taxable lump sum, subject to income tax, PRSI (if under age 66) and USC**.

- **Purchase an annuity**. Income from an annuity is subject to income tax and USC (but not PRSI at any age).

- **In the case of a PRSA you could leave the balance to accumulate in the PRSA, which is now called a vested PRSA. This is treated for tax purposes as an ARF. It is advisable to transfer a vested PRSA to an ARF before age 75, as from that date no further withdrawals can be made from a vested PRSA (and yet the imputed tax continues to apply).**

Mixing the above options is also possible, for example, part lump sum and annuity.

3.2.3.1 Trivial Pension

A trivial pension is an option available to those who have very small pension funds at the point of retirement. This provides them with their retirement lump sum in the normal way and allows them to take the balance as a once off taxable lump sum. There are two ways a trivial pension can be provided:

Option A:
Revenue will allow an individual to take the full amount of their pension benefits as a taxable lump sum if the total pension benefits from all sources, i.e. RACs, PRSAs, and employer pension schemes, amount to less than €30,000, **after** they take their lump sum entitlement, rather than having to invest it in an ARF or annuity. The benefits are subject to income tax, PRSI (if under age 66) and USC.

Example

Jack has a PRSA, with a maturing fund of €23,000. He has no other retirement benefits.

He opts for 25% x €23,000, that is, €5,750 as a tax-free lump sum, leaving a balance of €17,250 to be invested in an ARF or annuity or retained in the vested PRSA.

However, as the balance is less than €30,000 and he has no other retirement benefits, Revenue practice allows the balance of €17,250 to be paid out as a taxable lump sum, so that the total fund will be paid out as:

- €5,750 as a tax-free lump sum;
- €17,250 as a taxable lump sum, subject to income tax, PRSI (if under age 66) and USC.

If the individual has no other source of income, they may benefit from tax credits against the income tax liability on the lump sum. Financial planning regarding the timing of withdrawal of these pension benefits and an individual's tax position may be required.

Option B:
If the total annual benefits payable to a member from the relevant employment does not exceed €330 per annum then the fund can be paid out as a taxable lump sum. In this case the calculation must be considered **prior** to taking the retirement lump sum and should be based on a standard single life annuity rate. If the trivial pension is calculated in this way, the balance of the fund after the retirement lump sum is subject to income tax at a rate of 10%.

3.3 Employer Pension Schemes

An *employer pension scheme*, sometimes referred to as an occupational pension scheme, is a trust arrangement set up by an employer to provide retirement and/or death benefits for one or more of its employees, who are members of the scheme. The pension assets are held by the trustees of the scheme, separate from the employer's business, to provide benefits for the member.

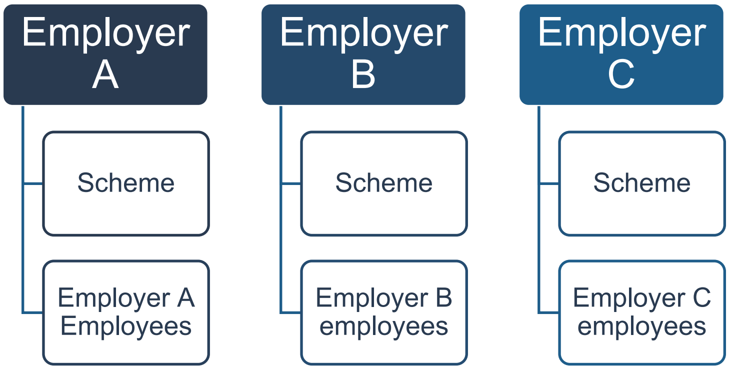
3.3.1 Types of pension schemes

There are two main types of employer pension schemes:

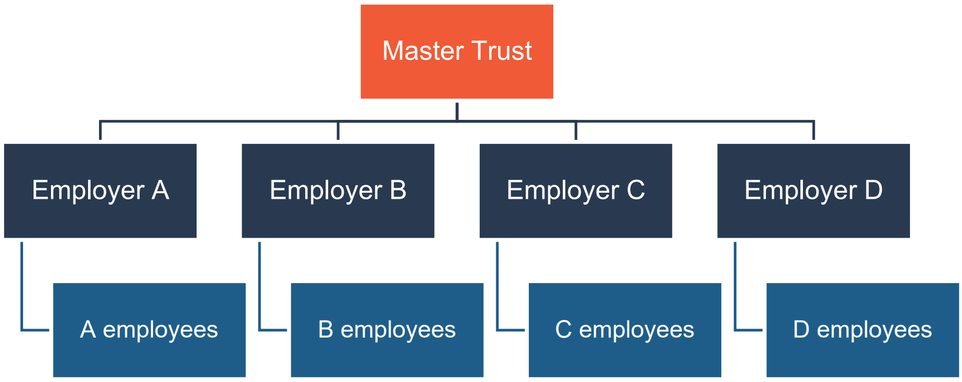
- Defined benefit (DB) which promises a retirement benefit related to the member's earnings and years of service, regardless of the performance of the underlying investments, i.e. it is the benefit which is defined.

- Defined contribution (DC) where a retirement fund is accumulated for each member through regular contributions and investment growth. No promise on the level of retirement benefit is given. It will depend on the value of the fund at retirement, i.e. it is the contribution which is defined.

- Master Trusts - Traditionally most employer pension schemes were set up by an employer to provide benefits for one or more of its own employees, so that each employer has their own scheme:



However, a '**master trust',** on the other hand, is a **single DC scheme** established by a **founder**, which covers a number of different employers (who may not be connected to each other) within the one scheme, with each employer providing separate benefits for their own employees within the single master trust structure:



So instead of each employer operating their own separate DC scheme and trust with separate trustees, the master trust covers the different employers within the **ONE** trust and with **one** independent corporate trustee.

The **Founder** of a Master Trust is typically a financial services company such as a life assurance company, an investment manager or a firm of employee benefit consultants.

The independent corporate trustee of a master trust must:

- Be incorporated as a Designated Activity Company (DAC), with the sole objective of carrying on the business of being a trustee of one, and only one, named master trust; and

- Have a minimum of two directors. The chair must be independent of the Founder and have no interest in the assets of the master trust.

3.3.1.1 Insured or Self-Administered

Defined contribution employer pension schemes are divided into two categories:

- **Insured schemes.** The scheme is set up through a life assurance company, who manage the funds and looks after all the administration of the scheme. These can be group schemes or one person policies, (the latter commonly referred to as Executive Pension Policies). Historically, directors of the sponsoring employer commonly acted as Trustee to such arrangements. However, more recently and particularly following the adoption of the Institution for Occupational Retirement Pension (IORP II) Directive, it is more likely that professional trustees will be appointed.

- **Self-administered.** The scheme is not set up through a life assurance company but is normally set up with a pensioneer trustee company who can provide the services required on such a scheme, for example, actuarial, legal, investment and administration. These schemes are called a *small self-administered scheme* (SSAS) and generally are set up as one-man director schemes where more control and choice of investment is available. Investment choice in these arrangements has been restricted somewhat following the adoption of the IORP II Directive.

Restrictions are in place for Investments in pension schemes, mostly to prevent tax avoidance and to ensure these retirement schemes are used for the purpose of their intention, providing an income in retirement.

3.3.1.2 Funding Limits

Revenue's Pension Manual sets out the calculation of maximum funding allowed. The limits are based on the benefits at retirement, that is, the projected fund at retirement is notionally converted to an annuity which should provide a maximum of two thirds of final remuneration. The fund is also subject to the maximum amount allowed by the standard fund threshold of €2,000,000 or the individual's Personal Fund Threshold if they obtained one. Age-related limits do not apply to employer contributions to these pensions.

Employee contributions, including AVCs, are subject to the normal age-related limits of a personal contract.

3.3.1.3 Retirement Options

A member of an employer pension scheme may retire:

- At the selected *normal retirement age* (NRA), usually between ages 60 and 70; OR,
- On voluntary early retirement from age 50 onwards (subject to certain conditions);[7] OR,
- On earlier ill health retirement.

It is assumed in what follows that the accumulated fund is in a defined contribution scheme and is within revenue maximum revenue limits at date of retirement.

There are two options available to a prospective retiree from an employer pension scheme:

- Traditional benefit option.
- ARF option

[7] *Employees must have left service. If a proprietary director, the director must dispose of all shares in the company and terminate all contact with it.*

Traditional benefit option

Scheme rules may allow pension entitlement at NRA to be commuted for a lump sum within maximum Revenue approvable benefit limits, that is, a lump sum of up to a limit of 1.5 times final remuneration, inclusive of any retained[8] lump sum retirement benefits based on the ‘uplifted’ scale:

Years of service completed by NRA	*Uplifted lump sum* as a fraction of final remuneration
9	30/80ths
10	36/80ths
11	42/80ths
12	48/80ths
13	54/80ths
14	63/80ths
15	72/80ths
16	81/80ths
17	90/80ths
18	99/80ths
19	108/80ths
20+	120/80ths

ARF/AMRF Option

Similar to personal pension plan/ PRSA options, that is:

- Up to 25% of the value of retirement fund can be taken as a lump sum, regardless of the period of completed service or retained benefits. The lump sum is tax free up to a maximum of €200,000 taken from all pension arrangements, in aggregate, since 7th December 2005.
- The balance can be:
  - Invested in an ARF;

    OR
  - Taken as a taxable lump sum;

    OR
  - Used to buy an annuity.

A proprietary director must choose between the traditional route or the ARF route, that is, he cannot choose the tax-free lump sum based on a multiple of salary and then use the balance for an ARF. In that instance, he must use it to purchase an annuity:

[8] *Retained benefits are lump sum entitlements from previous pension arrangements.*

Example

John is a member of his employer's DC employer pension scheme. At normal retirement age he will have completed 22 years' service with the company. He has no retained retirement benefits.

His final remuneration is €125,000, while the accumulated retirement fund is €350,000, which we will assume is not in excess of the fund required to secure the maximum level of approvable benefits at retirement. He has not taken any other retirement benefits from any source since 7th December 2005.

At NRA, John can either opt for:

- Lump sum of 1.5 x €125,000 = €187,500; and,
- An annuity which must be bought with the remaining €162,500 retirement fund.

OR

- Lump sum of 25% x €350,000 = €87,500, and
- Invest the balance of €262,500 in an ARF or take as a taxable lump sum.

What John can't do is to take a lump sum of 1.5 times final remuneration on the traditional option, that is, €187,500, and opt to 'ARF' the balance.

However, for many employee members of DC schemes the level of their retirement fund may be such that their lump sum entitlement under the traditional benefit option may well be considerably higher than the 25% lump sum option under the alternative ARF option.

Example #1

Paula is a member of a DC employer pension scheme. At normal retirement age she will have completed 24 years' service with the company. She has no retained retirement benefits.

Her final remuneration is €45,000 per annum while her accumulated retirement fund is €130,000. She has not taken any other retirement benefits from any source since 7th December 2005.

At NRA, Paula can opt for:

Traditional benefit option		ARF option
Lump sum of 1.5 x €45,000 = €67,500. Balance of €62,500 must be used to buy an annuity.	**OR**	Lump sum of 25% x €130,000 = €32,500. Balance of €97,500 can be transferred to an ARF or taken as a taxable lump sum.

For employees in DC schemes with retirement funds less than six times final remuneration, their lump sum entitlement under the ARF option may be *lower* than the lump sum they can take under the traditional benefit option.

However, the trade-off for a potentially higher lump sum under the traditional benefit option is that the balance of the fund *must* be used to buy an annuity. For employees with a retirement fund less than 150% of their final remuneration, the traditional benefit option may offer the opportunity to take the **full** fund as a lump sum:

Example #2

Joan is an employee member of a DC employer pension scheme. At normal retirement age she will have completed 24 years' service with the company. She has no retained retirement benefits.

Her final remuneration is €70,000 per annum while her accumulated retirement fund is €100,000. She has not taken any other retirement benefits from any source since 7th December 2005.

At NRA, Paula can opt for:

Traditional benefit option		ARF option
Tax-free lump sum = **€100,000** (less than 1.5 x final remuneration). Nil.	**OR**	Tax-free lump sum of 25% x €100,000 = **€25,000**. Balance of €75,000 may be transferred to an ARF or taken as a taxable lump sum.

In *Example #2* above, the traditional benefit option is typically the more attractive to the employee involved, as it can provide 100% of the fund as a tax-free lump sum.

It is therefore important to compare relative tax-free lump sum entitlements between the traditional benefit and alternative ARF options, before rushing to recommend one option over the other.

3.3.2 AVCs

Additional *voluntary* contributions can be made by an employee to an employer pension scheme to which they are a member, or to a PRSA AVC for the purpose of providing retirement benefits for that employee, in addition to their main employer scheme benefits. The sum of the retirement benefits from the employer pension scheme and the AVC cannot exceed the maximum approvable retirement benefits for that employee, that is, a total pension entitlement of two thirds final remuneration at normal retirement age, assuming at least 10 years completed service by normal retirement age applies. The same age limits for personal contracts apply also.

3.3.3 Buy-Out Bonds/Personal Retirement Bonds

A *buy-out bond* (BOB) (also known as a *personal retirement bond* or a PRB) is a single premium defined contribution pension policy which has, normally, been transferred out of an employer pension scheme, either DB or DC. An individual can take benefits from a buy-out bond at any time from age 50 or earlier on ill health grounds. It is not necessary to retire to take the benefits from the bond. The individual can draw on the bond even if he or she is working with a new employer, once they are over age 50.

Traditionally, the default option for retirement benefits from the buy-out bond was to take the lump sum up to the maximum approved and annuity thereafter. On 6th February 2011, the ARF option was extended to benefits arising under DC employer schemes and AVCs of defined benefit schemes. With effect from 22nd June 2016, the rules on the ARF option were extended to allow benefits from a buy-out bond arising from defined benefit employer pension schemes.

Option 1

- A lump sum of the maximum approvable deferred lump sum at the date of leaving service, increased in line with inflation from the date of leaving service.

- The balance, if any, must then be used to buy an annuity.

Option 2

- A once-off lump sum of up to 25% of the value.
- The balance can be transferred to an approved retirement fund.

In many cases the lump sum entitlement under the traditional benefit option will be well in excess of 25%. In some cases, it can be greater than the BOB fund, and hence the full BOB fund can be taken as a lump sum.

Trivial pension rules, as set out earlier, also apply to BOBs.

3.4 Chargeable Excess Tax

Income tax at the higher rate is levied on the excess of the total value of all retirement benefits taken by an individual (referred to as a benefit crystallisation event (BCE)) from the 7th December 2005 over a Threshold limit.

Benefit crystallisation events (BCEs) occur on:

- Taking a lump sum at retirement
- The commencement of a payment of a pension or annuity
- Transfer of funds at retirement to an ARF or to the individual as a taxable lump sum
- Transfer of pension funds to an overseas pension arrangement
- PRSAs at age 75 (if the tax free lump sum was previously taken the crystallisation would already have occurred).

The value of retirement benefits from a BCE over the Threshold limit is referred to as the chargeable excess and is subject to income tax at the higher rate (currently 40%).

3.4.1 Standard Fund Threshold (SFT) and Personal Fund Threshold (PFT)

This is the maximum pension that can be funded without paying an additional tax. The maximum funding threshold applying to an individual will be the higher of:

- **SFT**. This is the minimum threshold amount, set at €2 million with effect from 1st January 2014 although it had been higher before then.
- **PFT**. There are different levels of personal fund thresholds, dependent on the date they were obtained. An individual was allowed to apply for a personal fund threshold when the pension legislation changed, and their fund exceeded the latest standard fund threshold at the time. It allowed individuals who had already exceeded the standard fund threshold to obtain a larger personal threshold.

3.4.2 Chargeable Excess

A *chargeable excess* arising on a BCE is calculated as:

Total cumulative gross value of all retirement benefits taken on a BCE since 7th December 2005 LESS the Standard Fund Threshold or the individual's Personal Fund Threshold, if higher.

Example #1

Frank does not have a PFT and is therefore entitled to the SFT of €2 million.

Frank is retiring on 1st June 2024 and drawing on his small self-administered pension scheme fund of €1.6 million. He has not taken retirement benefits from any other arrangement since 7th December 2005.

Frank's chargeable excess is calculated as:

Total benefits taken on a BCE since 7th December 2005		Less the threshold amount	Chargeable excess
June 2024	€1,600,000		
Total	**€1,600,000**	**€2,000,000**	**Nil**

In this case, the cumulative value of John's benefits taken since 7th December 2005 is less than his available threshold, and hence there is no chargeable excess and therefore no tax on a chargeable excess.

Example #2

Conor does not have a PFT and is therefore entitled to the SFT of €2 million.

Conor is retiring on 1st June 2024 and drawing on his small self-administered pension scheme fund of €1.8 million. He had previously drawn on a personal pension plan valued at €500,000 in May 2015.

Conor's chargeable excess is calculated as:

Total benefits taken on a BCE since 7th December 2005		Less the threshold amount	Chargeable excess
May 2015	€500,000		
June 2024	€1,800,000		
Total	**€2,300,000**	**€2,000,000**	**€300,000**

In this case, Conor has a chargeable excess of €300,000 which attracts a chargeable excess tax liability of 40%, that is, €120,000.

Any standard rate tax deducted from a lump sum can be offset against a chargeable excess tax liability. To place a value on all pension benefits, to assess tax liability, the open market values of all DC schemes are added together. DB schemes must be commuted by 20:1 if they were taken before 1st January 2014 or their age-related factor, if after that date, which ranges between 37:1 up to age 50 to 22:1 after age 70.

See table for illustrative purposes only.

DB pension accrued *before* 1st January 2014	DB pension accrued *after* 1st January 2014	
	Varies by the age attained in the year in which the pension starts:	
20:1 for all ages	Up to and including 50	37:1
	51, 52	36:1
	53	35:1
	54	34:1
	55, 56	33:1
	57	32:1
	58	31:1
	59, 60	30:1
	61	29:1
	62	28:1
	63, 64	27:1
	65	26:1
	66	25:1
	67, 68	24:1
	69	23:1
	70 and over	22:1

Example #3

Brian is crystallising his employer pension scheme at age 67 in 2024. The value of his fund is €1,700,000.

He had previously, on 1st January 2014 at age 62, taken pension benefits from a DB scheme which give him an annuity of €18,000 per annum. However, before he took the tax-free lump sum entitlement, he was offered a pension of €21,000 per annum.

The factor to commute the annuity to a lump sum at age 62 is 28:1. However, the factor of 20:1 is used because the entire pension was accrued before 1st January 2014.

20 x €21,000 = €420,000.

Brian was not in a position to apply for a PFT at any stage so is entitled only to the SFT of €2,000,000.

His combined pensions are valued at €420,000 + €1,700,000 = €2,120,000.

His chargeable excess is €120,000.

He is liable to pay chargeable excess tax at 40% x €120,000 = €48,000.

This is taken off his fund of €1,700,000 to give a current fund value of €1,652,000.

3.5 Annuities, ARFs and Taxable Cash

3.5.1 Annuity Options

Where an individual is buying an annuity under a defined contribution arrangement like a personal pension plan, PRSA or employer pension scheme, a number of options may be available with regard to the type of annuity to be secured:

- Open market option; they may get quotations from all life companies, not just the one that holds the pension/PRSA. Occasionally, as mentioned earlier, an older plan may have a guaranteed minimum annuity rate so this should also be looked at. However, the guaranteed rate may be restricted and may not suit the client. For example:
  - The life company may only have to honour it on a particular day, for example, normal retirement date, or during a short period before or after this date. The guarantee might not therefore apply on early or late retirement.
  - It may apply only to one particular type of annuity, for example, single life, level, etc. If the consumer wants to take out a joint life annuity, for example, the guarantee might not apply.
- Level or escalating:
  - All things being equal a level annuity will provide a higher initial payment level, while an escalating annuity will provide a lower payment initially but one which increases at a set rate each year to combat inflation.
  - Buying an escalating or increasing annuity is a better hedge against longevity, but the risk is that the individual will not live long enough to benefit.
  - The individual should be aware of the inflation risk of a level annuity, that is, the purchasing power of their income may decrease each year.
- Guarantee period: one of the traditional objections to buying an annuity is the potential loss of capital if the individual dies within a short period of purchasing the annuity.
  - One way of protecting, to some degree, the capital invested in the annuity is to opt for a *guarantee period* for the annuity, that is, an initial period for which the annuity is guaranteed to be paid regardless of whether or not the individual dies during that period.
  - The standard guarantee period is five years, but in most pension arrangements the individual can choose a period from zero years, that is, no guarantee, to a maximum of 10 years.
  - The longer the guaranteed period, the more it costs, with this cost reflected in a lower annuity payment.
- Addition of reversion:
  - Reversion describes the situation whereby, on death of the annuitant, part of the annuity is set up to go to another individual, typically a spouse and typically for 50% of the value of the annuity payment.
  - This is often called a *spouse's pension* or *dependant's pension*.
  - It is paid for the beneficiary's lifetime.

- If the beneficiary of the reversion pre-deceases the annuity holder/retiree, the annuity ceases on death of the retiree.

- Additional costs apply.

• Enhanced annuity/impaired annuity rates:

- In certain circumstances, life companies may offer enhanced annuity rates to individuals with a reduced life expectancy.

- The life company may offer this enhanced annuity rate on the assumption that they will likely have to pay the annuity for a shorter period than normal, because of a serious medical condition.

3.5.2 ARF Versus Taxable Cash

When an individual has an ARF option, they may opt to take it all as taxable cash, rather than invest in an ARF.

There are a number of circumstances in which the option to take a taxable lump sum may be more appropriate for the consumer:

• Where the fund available for transfer to an ARF is small, for example, less than €20,000, and the costs and charges of maintaining an ARF for such a small size may be high.

• Where a lower effective tax and USC rate might be suffered on the taxable lump sum taken now than might apply to annual ARF withdrawals, for example, where the consumer has unused PAYE allowances and reliefs and standard rate band in the year in which fund is to be taken, which might not be available in future years.

• Where the consumer needs funds now to pay off loans or other debts.

However, the disadvantages of taking taxable cash over an ARF are:

• Death: potential inheritance tax disadvantage for children.

• Investment returns: miss out on gross roll up of investment returns.

3.5.3 Annuity Versus ARF

As an ARF (or vested PRSA)[9] can invest in an annuity, in part or fully, the choice between the ARF option and annuity will arise for many pension consumers. Even after choosing the ARF option over the initial annuity, you still have the option to invest in annuities with your ARF.

[9] References to an ARF in this section also include vested PRSAs.

Each option has its own particular advantages and disadvantages. In the case of the **annuity**, these are as follows:

Advantages of an Annuity	Disadvantages of an Annuity
• It provides a guaranteed level of income for life. The risk of 'living too long', that is, the 'longevity risk' is insured.	• Loss of access to capital. Once invested in the annuity, it cannot be retrieved, other than balance of annuity payments on death within the guarantee period, unless provision made in annuity for a continuing pension to surviving spouse/civil partner.
• No investment risk, after the annuity is purchased. The only risk of non-payment is the risk of the life company defaulting.	• Mortality risk: the individual could die before receiving back in annuity payments the sum invested in the annuity.
• Wide choice of annuity types and benefit options, to suit different circumstances.	• Timing risk: return is linked predominantly to long term interest rates ruling on the day the annuity is purchased. No participation in equity returns.
• Simple and easy to understand... consumer does not have to worry about ongoing income payments. Little ongoing advice needed.	• Lack of inflation protection, where level annuity or annuity increasing a low fixed rate is chosen.
	• Lack of income flexibility once annuity has started. Income pattern is set in stone once annuity has been purchased. Can't be varied.

In the case of the **ARF**, its advantages and disadvantages are:

Advantages of an ARF	Disadvantages of an ARF
• No immediate loss of capital. Capital can be preserved for dependants; inheritance of ARF can be deferred until 2nd death of ARF holder and spouse; balance of ARF on 2nd death is paid to children, less tax at maximum rate of 33%.	• Effectively required to withdraw at least 4% per annum from the ARF, rising to 5% per annum at age 71[10] which will run down the value of the ARF if investment return does not match this withdrawal rate.
• Income flexibility: income drawdown rate can be varied from 4% per annum to 100%, that is, total immediate drawdown. Rate of drawdown can be varied to suit changing circumstances, for example, drawdown could be increased in a period of ill health to pay for medical expenses.	• ARF bomb-out risk, arising from combination of investment risk, longevity risk and requirement to draw down at least 4% per annum up to 70 and 5% per annum thereafter. Longevity risk is not being insured; therefore, there is the risk of the ARF running out of money during the ARF holder's lifetime or the ARF regular withdrawal amount falling significantly in value.
• Opportunity to defer purchasing an annuity to a later date; ARF could be used to buy an annuity at a later more favourable date. For example, when annuity rates may be higher. • Opportunity to stagger the purchase of annuities, and so reduce the timing risk involved in buying an annuity on day one.	• If an ARF is used to defer an annuity purchase for a period: - There is the risk that annuity rates could be even lower when the annuity is purchased, due to improved life expectancy and lower interest rates. - The capital value of the ARF available to purchase an annuity could be lower than its initial value. Hence a lower annuity might be secured than could be secured now.
• Capital and income are rolled up tax free, until withdrawal is made from ARF.	• Annual minimum drawdown reduces the benefit of gross roll up, and estate planning opportunities.
• Opportunity to participate in equity and property returns which offer prospect of protection against inflation; not confined, as conventional annuities, to fixed interest rate returns.	• Complicated; ongoing and regular advice is required to operate ARF. • As customers get older they may no longer be competent to make investment decisions.
• Control over investment policy; there are a wide range of ARF products available, with a very wide range of investment fund options.	

[10] *Minimum annual drawdown rate at all ages of 6% per annum, if total ARFs and vested PRSA held by the retiree is greater than €2 million.*

An ARF and an annuity are two very different investment options and will suit different consumers in different circumstances.

One key advantage which an ARF offers is the opportunity to preserve capital for dependants and income flexibility (subject to minimum imputed distribution of 4%/5%/6% per annum which should be drawn down, as income tax and USC must be paid on it regardless of whether or not it is drawn).

However, an ARF does not carry the '*longevity' insurance* that an annuity does and this absence of longevity insurance, combined with a minimum drawdown rate, and investment risk, results in the risk of ARF *bomb-out,* that is, the ARF runs out of money.

The key advantage the annuity offers is the provision of a guaranteed fixed pattern of income payments for life. An individual entitled to the ARF option can split his or her retirement fund between an ARF and the purchase of an annuity.

Key issues to consider when considering an annuity versus ARF option with regard to the use of retirement funds at retirement include:

- *The consumer's need to take income from the retirement funds, in the immediate future and in the longer term?*

  How much income does the consumer need now? Has the consumer other sources of income in retirement, for example, social welfare pension and/or investment income, they can fall back on? Will the consumer continue to work for a period? Will the consumer have a need for a higher level of income in the future?

- *What other sources, if any, of wealth has the consumer?*

  Are the retirement funds in question the sole or main source of wealth the consumer has in retirement, or does the consumer have other significant financial assets they can call on?

- *Has the consumer one or more dependants or spouse/partner they wish to provide for?*

  The annuity offers limited ability and flexibility to provide for dependants, for example, through use of the guarantee period, capital protection and/or reversion. The ARF offers greater flexibility to preserve capital for dependants, subject to a minimum 4%/5% per annum withdrawal.

- *What is the consumer's state of health?*

  If the consumer has a reduced life expectancy, they may be able to secure an enhanced annuity rate. However, an ARF may be more suitable where a consumer has a significantly reduced life expectancy, as it can offer a much higher level of capital preservation for dependants than an annuity can. The ARF also offers flexibility in income withdrawals, so that higher or once-off withdrawals can be made to meet occasional medical expenses, for example.

- *What is the consumer's attitude to and capacity for investment risk?*

  A guaranteed annuity fully insures the retiree against future investment risk, whereas an ARF exposes the retiree fully to future investment risk.

  The ARF bomb-out risk increases where a consumer invests their ARF predominantly in low or no risk investments, due to the minimum 4%/5%/6% per annum withdrawal. Higher levels of withdrawal, combined with a low risk ARF asset allocation, increases the bomb-out risk even further.

3.6 Employee Leaving Service

3.6.1 Retirement Benefits

If an employee has less than two years in a retirement benefit scheme, the options, in general, are:

- Preserved benefit of their contributions. In this case the employee is given a preserved or paid up retirement benefit related to the value of their contributions. They may also have an entitlement (called vested rights) to all or a portion of the employer contributions paid to the scheme.
- Transfer value in lieu of preserved benefits, if any. The transfer would have to go to an approved scheme such as another employer pension scheme, a PRSA or a PRB. Transfers to a PRSA scheme are subject to restrictions if they are over €15,000.
- Refund of the member's contributions (ROCs) which would result in the loss of benefit from any employer contributions and would be subject to tax at standard rate if taken as a cash payment; if moved to a PRSA then there is no tax deduction.

If an employee has more than two years in a retirement benefit scheme, the individual is entitled automatically to a preserved benefit.

They can, if they wish, opt to take a transfer value in lieu of the preserved benefit. They can opt to transfer to another employer pension scheme of which they are joining, a buy-out bond in their own name, or a PRSA effected by them. However, some restrictions may apply to a possible PRSA transfer.

3.6.2 Death Benefits on Leaving Service

In the case where an employee leaves service and has death benefit entitlements, cover under the scheme usually ceases immediately. However, some schemes may offer a *continuation option* where the employee may be able to effect personal life assurance cover up to a certain limit with a specified life assurance company within, say, 30 days of leaving service, without being required to provide evidence of health.

Even if there is no continuation option in the scheme, the individual may be wise to take out a life cover policy if they have financial dependents and inadequate life cover in place. While this new life cover would be subject to medical underwriting, the majority of such individuals will be able to get this cover at normal rates.

3.7 Pension Adjustment Orders – Retirement Benefits

A Pension Adjustment Order (PAO) is a court order which orders the administrator of a pension arrangement, (an RAC, PRSA, employer pension scheme or a Buy-out-bond), to pay part or all of a member's retirement benefits when they become payable, to another person specified in the order.

PAOs may be made by the courts following the break-up of non-married and non-civil registered couples but they are primarily obtained on a decree of divorce.

A PAO will instruct the Pension Provider or Trustees to pay a specific percentage of the pension accrued during a specified period, e.g. 50% of the pension between the date of marriage 1/1/1999 and the dissolution of the marriage on the decree of divorce on 1/6/2024.

Where benefits from a pension are not sought during divorce proceedings, a **Nil PAO** should be drawn up which will specify a relevant period of say 1 day and a specified percentage of, say, .001%, effectively representing a NIL benefit.

Splitting Retirement Benefits

There are a number of potential *disadvantages* for the PAO beneficiary in waiting for the individual to take his or her retirement benefits before placing their share into their own name. The primary disadvantages of leaving the share, i.e. **Earmarking**, are:

- The PAO beneficiary has no control over the investment decisions; and
- The timing of crystallising the pension is dictated by the plan owner, or under the rules of an employer pension scheme.

An alternative to earmarking is **splitting**. This refers to the PAO beneficiary taking a transfer value of their share of the fund to another arrangement such as a PRSA or buy-out bond in their own name. The advantages to splitting are that the beneficiary gains control over their investment decisions and can choose when to take benefits, under normal pension rules.

If the PAO is subject to variation (that is, subject to possible change or cancellation in the future) the beneficiary secures their entitlement now by taking a transfer value and it can't be overturned later on. A disadvantage may be that they cannot return to the court in an attempt to increase the benefit once they have split the earmarked amount into their own pension contract. Of course, this could be an advantage if they split the PAO as their amount is secure.

The choice of splitting does not always remain with the beneficiary. In the case of an employer pension scheme, where the beneficiary has not sought his/her transfer value, the trustees have the option to compulsorily pay out a transfer value in certain circumstances:

- If the scheme is a defined contribution scheme;
- Where the member ceases to be a member, e.g. leaving service;
- Where the member ceases to be a member on death

3.8 Comparing Individual Pension Plans

There are many fiscal and regulatory differences between the various individual pension plans in terms of:

- Who can take out the plan.
- What types of funds can be contributed to the plan.
- Tax relief on contributions.
- Tax treatment of investment returns.
- When and how benefits can be taken from the plans.
- Tax treatment of benefits taken from the plans.

Two product comparisons that are considered here are:

- Standard versus non-standard PRSAs; and,
- Personal pension plans versus standard PRSA.

3.8.1 Standard Versus Non-Standard PRSAs

There are two different types of PRSAs:

- A standard PRSA; and
- A PRSA, which for the sake of clarity is often referred to as a *non-standard PRSA*. However, it is important to know that there is no official term called 'non-standard PRSA'; there are simply 'PRSAs' and 'standard PRSAs'.

A brief comparison of the main differences between the two types of PRSAs is set out in this table:

	Standard PRSA	Non-Standard PRSAs
Investment choice	• Only pooled funds, that is, life company unit-linked funds and other collective investment funds like unit trusts and open-ended investment companies (OEICs).	• Default investment strategy must be pooled funds, otherwise no other fund restriction.
Limit on charges	• Maximum 5% of contribution. • Maximum 1% per annum of fund.	• No statutory restriction on level of charges. However, no monetary charge can be applied, for example, no policy fee.
Disclosure of commissions and charges	• No disclosure at the point of sale. Disclosure at the point of contract issue.	• Disclosure of commissions and charges required at point of sale (generic allowed) and specific (at contract issue, if not previously given at point of sale).
Access to PRSA at workplace	• Employers who have employees not included in an employer pension scheme must provide access to those employees not included in the scheme to at least one standard PRSA and allow contributions to the PRSA to be paid by deduction from salary and wages.	• Non-standard PRSA does not qualify for employer to provide compulsory access to a PRSA at work for those employees not included in an employer pension scheme.
Sales and marketing	• A standard PRSA cannot be marketed or sold on a conditional basis, that is, that the consumer must take out some other financial product at the same time. • No document relating to the marketing or sale of a standard PRSA may *'solicit the purchase of, or otherwise advertise any other product'*.	• No specific prohibitions on conditional selling or bundling with other products.

3.8.2 Personal Pension Plans (RAC) Versus PRSAs

The self-employed and employees who are not included in an employer pension scheme at work, have a choice of contributing to:

- A personal pension plan;

  OR

- A PRSA;

  OR

- Both.

This table below outlines the main ways in which PRSAs are likely to differ from personal pension plans.

	Personal Pension Plan	PRSA
Fund choice	• No restrictions. • No legal requirement to have a default investment strategy, although plans will usually offer a *managed fund* as the default.	• Standard PRSA can only invest in *pooled funds*. • May be more limited fund choice than personal pension plan. • Default investment strategy will apply unless individual opts out in writing.
Charges	• No restrictions on types or levels of charges on contributions, fund values, or transfers in or out. • In particular, monetary charges, for example, policy fee, can be applied.	• Charges can only be a percentage of contributions and/or a percentage of the fund. No monetary charges allowed. • Standard PRSA has maximum charges of 5% of contribution plus 1% per annum of fund. • No initial charge can be made to any transfer received into PRSA. • No charge can be made on termination of PRSA or transfer of funds out of PRSA. • No charge can be made on suspension or variation of contributions.
Who can take out?	Must have or have had source of relevant earnings to take out and continue contributing, that is, • Employees in non-pensionable employment. • Self-employed.	Available to all, regardless of employment status. However, tax relief only available in respect of income from an: • Employment *(where the individual is not included in a pension scheme at work for retirement benefits);* or, • Self-employed trade or profession.

	Personal Pension Plan	PRSA
Who can contribute	• Only the individual normally. • However, employer can contribute provided payment is treated as a benefit in kind (BIK) for income tax.	• The individual; or, • Employer; or, • Individual and employer.
Tax relief on contributions limits	• Range from 15% to 40% of earnings depending on age. Limits are inclusive of PRSA contributions.	• As for personal pension plans. Limits are inclusive of personal pension plan contributions.
Employer obliged to offer 'net pay' facility	• No.	• Yes, for Standard PRSA where it is the employer designated PRSA.
When benefits can normally be taken	• 60-75.	• 60-75.
When benefits can be taken on early retirement	• Permanent incapacity. • Certain self-employed occupations from age 50 onwards.	• Permanent incapacity. • Certain self-employed occupations from age 50 onwards. • Employees on early retirement from 50 onwards.
How benefits may be taken	• 25% can be taken as a lump sum: - Tax free, up to a limit of €200,000 of all tax-free lump sums taken from all pension arrangements since 7th December 2005. - The balance up to €300,000 is subject to a standard rate income tax charge. • Balance can be transferred to an ARF or taken as taxable cash subject to PAYE at marginal rate.	• Same as for personal pension plans. • However, PRSA offers the alternative option of taking the 25% lump sum (within €200,000 tax free and €300,000 taxable at standard rate limits) when the PRSA is first drawn on, and retaining the balance in the PRSA,from which regular withdrawals (subject to PAYE) can be made. The balance left in a PRSA after the 25% lump sum is taken is subject to the relevant imputed distribution charge which applies to ARFs.
Death	• Value paid to estate.	• Same as personal pension plan. • If 25% lump sum has already been taken, any remaining balance in the PRSA on death is taxed as an ARF.
Life cover	• Separate or associated Section 785 life cover can also be effected.	• Death benefits cannot be integrated with Standard PRSA in one package. • Standard PRSA cannot promote or advertise any other product.

	Personal Pension Plan	PRSA
Transfers in	• From another personal pension plan only.	• From: - Employer pension scheme - Another PRSA. - A personal pension plan. - Pension adjustment order transfer value from any pension arrangement.
Transfers out	• Can be transferred to other personal pension plan or PRSA.	• Can be transferred to other PRSAs and employer pension schemes.
Limitation on benefits[11]	• Limits apply to tax relief.	• Limits apply to tax relief. • However, employer pension scheme limits apply to PRSAs in respect of AVC contributions.
Provision of regular information	• Under Life Assurance Disclosure Regulations, policy holder must receive an annual statement of value.	• Client must be provided with a half yearly statement of account, showing contributions paid since last statement and current value of PRSA. • Client must be provided with a half yearly investment report on the fund or funds the consumer is invested in. • Client must be provided with initial and ongoing annual statement of reasonable projection showing current annual value and projected retirement benefits.

3.9 Quantifying the Pension Need

There are four possible *pillars* or means of providing an income in retirement.

- Pillar 1: State Pensions

  The contributory state pension provides a pension to those who have paid the required number and type of Pay Related Social Insurance *(PRSI) contributions* during their working life.

  The non-contributory state pension provides a pension from the state pension age to those who pass a means test.

- Pillar 2: Private Retirement Provision

  Employer pension schemes, PRSAs or Personal Pensions can be used to fund retirement income.

[11] *Both products are subject to the same maximum tax-free lump sum and tax relieved pension fund limits.*

- Pillar 3: Personal Funds

  Personal funds may be used towards retirement income. Funds may be from a variety of sources, including, for example:

  - Savings or investments
  - Sale of a property
  - Sale of a business.

- Pillar 4: Continued income in retirement

  - Some people may retire from their main employment but continue to work at a reduced level which would supplement retirement income.
  - Retirees may have rental income from a property, which would supplement retirement income.

3.9.1 Quantifying the Retirement Income Shortfall

There are four steps involved in calculating the consumer's retirement funding shortfall:

Step 1
- Project current earned income to retirement

Step 2
- Determine percentage of earned income to be replaced

Step 3
- Deduct existing retirement provision (from the four pillars)

Step 4
- Quantify additional contribution required to make up shortfall

When the annual retirement income shortfall has been quantified, we must quantify the lump sum or capital required to provide this income. This is best calculated using annuity rates: e.g. an individual requires an additional €30,000 per annum. If annuity rates are 3%, €30,000/3% = €1,000,000 is the capital sum required at retirement.

Finally, based on whatever RAC and/or PRSA or DC scheme is appropriate to the consumer's needs, you then need to calculate what annual contribution to this arrangement will produce an additional projected retirement fund at the specified retirement age equal to the capital sum required.

Example #1

Fact-Find

- Emily is single, age 51, and her current income is €80,000 per annum
- She will be entitled to the full state contributory pension.
- Emily owns an investment property and receives rent of €8,000 per annum
- Emily contributes to a defined contribution employer pension scheme. The projected income at retirement age 68 is €22,000 per annum
- Emily has investments of €50,000 which she plans to use for her retirement income.
- She wishes to have retirement income, by way of annuity, of 50% of current income. She plans to retire in 17 years at age 68.

Assumptions

1. Her current income will increase by 2% per annum
2. Her rental income will increase by 2% per annum
3. Her investment will grow by 3% per annum
4. The annuity rate at retirement is 4% per annum
5. The state pension figure will be €18,000 per annum at retirement date.

Calculate

1. **Emily's retirement income shortfall**
2. **The additional retirement capital needed to meet this shortfall.**

Example #1: Workings and Answers

Current income of €80,000 increasing by 2% per annum = €80,000 x 1.4 = €112,000

(1.4 is the accumulation rate per thousand at 2% over 17 years. See accumulation and discounting tables in chapter 5.10.2, Financial Maths).

Required retirement income = €112,000 x 50% =	€56,000
Deduct State Pension	-€18,000
Deduct current pension arrangements	-€22,000
Deduct rental income = €8,000 x 1.4 = €11,200	-€11,200
Retirement income shortfall	**€ 4,800**

This would lead to a capital shortfall at age 68 of €4,800/4% =	€120,000
Less Investment €50,000 increasing by 3% pa = €50,000 x 1.653 =	-€82,650
Additional Retirement Capital Needed	**€37,350**

The following example quantifies the pension need and illustrates how this process leads to a recommendation.

Example #2

Fact-find

- Henry and Aileen, both aged 58, are married and have two children.
- Henry and Aileen are directors of their own company. They each take remuneration of €50,000 per annum.
- Henry also receives Schedule D income of €40,000 per annum from his other occupation as a self-employed farmer.
- They plan to retire from the company at age 68 when they sell the business to their children for an estimated €200,000.
- Henry plans to continue to farm until age 68 and to lease the farm thereafter which will provide an estimated income of €10,000 per annum at that time.
- Their objective is to have an income of 50% of their earnings at retirement.
- Aileen has a deferred pension of €9,050 per annum from a previous defined benefit employer pension scheme.
- Henry and Aileen have paid the required level of PRSI payments to receive the maximum state contributory pension each.

Based on the information provided in the fact-find, answer the following questions:

1. Quantify the retirement income shortfall for Henry and Aileen from age 68 onwards.
2. Calculate the additional retirement capital to meet this shortfall.
3. Advise them of their choice of pension arrangement.
4. Give an account of their retirement benefit options from their pension arrangement.

Assumptions

- The annuity rate at retirement is 3% per annum
- Their earnings from both the farm and the company will grow by 2% per annum
- Aileen's deferred pension will grow by 1% per annum over the next 10 years.
- The €200,000 from the sale of business is a net 'investment' figure.
- Pension contributions will grow at 4% per annum
- The state pension will be €16,000 per annum at retirement.

Example #2: Workings and Answers

Question 1

Requirement from age 68 onwards: Income objective: 50% of (€50k + €50k + €40k) = €70,000 €70,000 x 1.219 = (10 years compounded @ 2% as per tables)	€85,330
Deduct State Pension for Henry	-€16,000
Deduct State Pension for Aileen	-€16,000
Deduct Aileen's pension annuity: €9,050 x 1.105	-€10,000
Deduct the farm lease income:	-€10,000
Retirement income shortfall	**€33,330**

Question 2

Capital Requirement: €33,330/3% =	€1,111,000
Less Lump sum from the sale of the business	-€200,000
Additional Retirement Capital Required	**€911,000**

Question 3

Two employer pension schemes can be set up for each of them. They can be set up as Executive Pension Plans or as self-administered pension schemes.

Question 4

There are two options available on retirement:

- Traditional benefit option: They may take up to 120/80ths or 150% of final remuneration as a lump sum. 20 years completed service will provide this maximum. The remainder must be used to purchase an annuity.
- ARF option: Under the ARF option they can take 25% of their funds and invest the balance in an ARF. They can purchase annuities with part or all of the ARF.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] Limits on maximum contributions on personal contracts
- [ ] Important dates for personal pension contract investments, carrying forward and backdating contributions
- [ ] Employer pension schemes
- The main retirement benefit options available to a consumer when taking retirement benefits from:
  - [ ] A personal pension plan
  - [ ] A *PRSA*
  - [ ] An employer pension scheme
  - [ ] An *AVC* arrangement
  - [ ] A buy-out bond
  - [ ] ARF versus taxable cash
  - [ ] ARF versus annuity
- [ ] The main employer pension scheme benefit options available to an employee when leaving service
- [ ] Retirement benefits from PAOs
- [ ] How to quantify the Pension Need

04

Review: Life Assurance

This chapter incorporates a review of the various types of life assurance and illness products, and how to quantify protection needs. A comprehensive comparison of protection products is also included.

Learning Outcomes – after studying this chapter you should be able to:
understand the various types of life assurance cover;
understand the various types of Illness cover;
compare various protection products under the headings listed;
identify protection products most suitable to a consumer's needs; and,
quantify the level of protection needed to cover various events.

4.1 Types of Life Assurance Policies

Term Assurances

- Level term assurance.
- Convertible term assurance.
- Pension term assurance.
- Regular income benefit.
- Mortgage protection.

Whole of Life

- Guaranteed.
- Unit-linked.

4.1.1 Term Assurance

The life company undertakes to pay out a capital sum on death of the life assured during the policy term, in return for a continued payment of a regular premium. A term assurance policy never acquires a cash or surrender value.

Cover ceases at the end of the term of the policy, or earlier if the policy holder cancels the policy or stops paying the premiums.

The policy term can be from one year to 40 years depending on the life company. Most life companies do not allow term cover past 85 or 90 and often have a maximum age at entry of 75.

The premium can be fixed for the duration of the term along with a fixed sum assured OR the sum assured can be indexed annually and the premium will increase accordingly. The premium will vary according to the:

- Level of life assurance cover required.
- Policy term; the longer the term, the higher the risk of death within the term, the higher the premium.
- Age of the life assured: a younger person’s cover will cost less.
- Smoker/non-smoker status of the life assured: a loading to the premium (otherwise known as a rating) will be applied to a smoker due to the medical evidence of smoker related diseases.
- Health status: a loading may be applied to the premium for an individual who is not in good health. Actuaries in the life companies determine the appropriate cost, depending on medical statistics.
- Occupations and/or hobbies: A loading may be applied to an individual’s occupation. For example, a roofer may be charged a higher loading than an administrator. Regular trips in the air, as an amateur pilot for example, may also result in a loading on a premium.

A term policy can be written in various ways:

- Single life
- Joint lives (where the policy pays out on the first to die during the policy term)
- Dual lives (where a separate sum assured is payable on the death of each life assured during the policy term)
- Life of another (where the policy owner is a separate party from the life assured).

Term policies can be written *in trust* so that the beneficiaries receive the sum assured on death, without the death benefit being caught up in probate.

Writing a life policy under a 'life of another' basis would be recommended for cohabiting couples to avoid potential inheritance tax liabilities. This is also how a business or partnership protection policy might be set up. The owner of the policy is not the life assured. Once they pay the premiums, they will receive the death benefit without it being subject to tax.

4.1.2 Convertible Term Assurance

Convertible term assurance (CTA) is the same as *term assurance* but in return for an additional premium it provides an additional benefit - a **conversion** or **continuation option**, that is, the right to convert the cover at any time during the policy term into a new policy running for an extended period, regardless of the life assured's state of health at the time of conversion. For example, the cover can be extended even if the life assured is in bad health at that time and would otherwise be uninsurable.

The conversion option can usually be exercised up to the level of cover on the old policy but can be taken up for a lesser amount of cover. The premium then payable will be based on the length of the extended term and the individual's age at the date of conversion.

4.1.3 Death Benefits in Employment

There are two main situations:

- **Employer provided death benefits**

  In this case an employer provides life cover and/or dependant pensions to employees as part of their pension scheme, while an employee of the company. This is called death in service benefits. Typically, the level of cover would be a multiple of current salary. The employee is normally provided with the cover with no or minimal level of underwriting.

  The maximum that can be paid out as a lump sum is four times income, plus the accumulated value of any contributions paid by the employee. This is rarely exceeded for Employees. However, any excess amount may be used to either purchase an annuity for, or invest in an ARF on behalf of, the beneficiary.

- **Pension term assurance**

  Where an individual is self-employed or an employee in non-pensionable employment there is the option to effect a tax deductible policy called *pension term assurance*.

  - The premiums are treated as pension contributions for tax relief purposes.
  - Like a pension or PRSA, it can only be written on a single life basis.

- The term is generally to retirement age. The maximum term allowed is to an individual's 75th birthday.

- One important note about this tax efficient life policy is that it is designed to be used for family protection only. Therefore, it is not assignable.

4.1.4 Regular Income Benefit

Some insurers offer term assurances which pay out a regular payment on death, for example, €2,000 per month over the remaining term of the policy. This is called a regular income benefit. Some life companies provide a mix of both a lump sum and a regular income. These regular payments are treated as instalments of life cover and are NOT liable to income tax in the hands of dependants, despite the policy sometimes referring to an income benefit.

Once the life cover need is quantified, this option can be presented to the individual(s) and their preferences discussed.

4.1.5 Mortgage Protection

Mortgage protection cover is a form of term assurance which pays out a lump sum on death within the policy term. This lump sum life cover reduces each year in line with the anticipated reduction in the policy holder's outstanding mortgage; it is therefore decreasing term assurance, unlike normal term assurance where the cover remains level or increases but does not fall over the policy term.

Borrowers taking out a *capital and interest* mortgage (also known as a *repayment* or *annuity* mortgage) in respect of their principal private residence (referred to as *home loans*) will usually be required by the lender to take out a *mortgage protection* policy to clear off the outstanding balance of the mortgage should the borrower die during the mortgage term before the mortgage has been fully paid off.

In this way the borrower's dependants will then own the residence in full, without any outstanding mortgage.

The cover is set, at the start, equal to, or in excess of, the initial mortgage. The policy term will be the same as the anticipated mortgage term, that is, typically 25 or 30 years. Premiums are fixed for the full term.

By the end of the mortgage term the cover will have reduced to zero as the mortgage is assumed to be then fully repaid to the lender, assuming all repayments have been made on time. With a variable rate mortgage, no one can predict in advance what the mortgage interest rate, and hence what the capital outstanding, will be at any time during the mortgage term.

Some mortgage protection policies anticipate a high mortgage interest rate, say, 6% or 8% per annum, and so if mortgage interest rates do not increase above this level, the level of cover on the policy will always be at least sufficient to pay off the mortgage; there may be some funds left over after repaying the mortgage.

A mortgage protection policy is assigned to the lender as security for the mortgage; this means the lender is entitled on death to claim the death benefit on the policy from the life assurance company and use the funds to pay off the policy holder's outstanding mortgage; any surplus left over after repaying the mortgage is then payable by the lender to the deceased's next of kin.

This type of term assurance can be provided at a low cost because the sum assured reduces over the term.

The policy can be on a single life or joint life first death basis.

4.1.5.1 Code of Practice for Underwriting Mortgage Protection for Cancer Survivors

Insurers will disregard any disclosed cancer diagnosis where:

- The application is for Mortgage Protection life cover in connection with a mortgage on a principal private residence,
- The insurance cover sought is for €500,000 or less, and
- Treatment for cancer ended more than seven years prior to the application, or more than five years prior if the applicant was under 18 at the time of diagnosis.

4.1.6 Whole of Life Assurance Policies

Whole of life assurance policies differ from term assurance policies in three important ways:

- Whole of life policies can provide cover throughout life (but may not necessarily guarantee to, as it depends on the type of whole of life policy used). Cover doesn't automatically cease at the end of a fixed predetermined period of time, as it does under term assurances.
- Whole of life policies may carry a small encashment value. Term assurances have no encashment value at any stage. This encashment value may be encashed or it may be used to subsidise any additional premium cost after the actuarial review, normally in ten years from the start of the policy and every five years thereafter.
- Premiums are fixed or indexed on a term assurance policy so the overall cost of the policy can be seen from the outset. Whole of Life premiums are potentially reviewable.

Whole of life policies are split into two types: guaranteed and unit-linked.

Guaranteed whole of life policies are guaranteed to pay out a fixed amount on death in return for a fixed premium up to death, or up to a certain age, say 80.

Unit-linked whole of life policies will have an encashment value linked to the value of units in a life company unit fund. The encashment value arises as part of the premium in the early years of the policy is invested in a unit linked fund. As the cost of providing the benefit increases, less of the premium is invested in such units. The unit price fluctuates with the underlying asset values within the fund and, therefore, so too will the encashment value. Ultimately, if not withdrawn by the policy holder, units can be encashed to contribute to the cost of the benefits.

There is no guaranteed fixed level of cover or premium. The premium and sum assured under a unit-linked whole of life policy are subject to regular review. In practice, the premiums generally increase at review stage to maintain the same level of life cover. There is generally an option given to reduce cover for the same premium also. Reviews often begin 10 years into the policy with five-year reviews thereafter and possibly yearly from age 70 onwards.

Whole of life policies can be arranged on a single life, joint life or on a joint life last survivor basis. In the latter case the life cover is payable only on the death of the last survivor.

4.2 Serious Illness Cover and Income Protection

4.2.1 Serious Illness

Serious illness cover can be written on its own or in conjunction with life cover.

- This cover pays out a tax-free lump sum in the event of being diagnosed with one of the serious illnesses listed on the life company's policy document, i.e. their specified illnesses.

- Life companies generally have a very comprehensive list of illnesses on which a claim can be made but the main causes of claims are heart related conditions, cancer, and stroke. Exclusions of certain cancers described as non-invasive is the norm.

- The cost of serious illness cover is higher than life cover because it is more likely to pay out, or be claimed on, than a life policy.

- It can be written as:

  - An accelerated lump sum, written in conjunction with a life policy but if a claim on it is made, the life cover reduces by the amount of the serious illness amount paid.

  - A standalone policy which can be written *with* a life policy, with one premium, but each claim is separate and independent of each other.

  - A standalone policy with no life cover attached.

  - Single life, joint life or dual life.

- Most serious illness policies can be written to age 75.

Some serious illness policies provide a partial payment for certain illnesses or a partial prepayment of cover.

4.2.2 Income Protection/Permanent Health Insurance

Income Protection or Permanent Health Insurance pays out a regular income when an individual is unable to work due to injury or disability and is suffering a loss of income. It is a policy that protects a consumer's loss of income and once the individual returns to work, the claim is stopped. The policy, however, continues to be in force, i.e., unlike any other life policies or serious illness policies above, this policy is permanent, until the end of the term of the policy, once the policyholder continues to pay the premiums.

It may be claimed upon at any stage and as often as required. The policy will only cease in the event of premiums not being paid, on request to cancel or at the conclusion of the term.

The main features are as follows:

- The maximum benefit payable is normally 75% of income, less any state disability benefit that may be due. The benefit ceases if the life assured returns to work or is deemed by the life company fit to return to work, the end of the term (normally retirement age) or the life assured becomes unemployed and is not working.

- A deferred period, that is, the period that the claimant is not working but cannot yet claim, is normally 13, 26 or 52 weeks. The longer the deferred period, the lower the cost of the premiums, as the less likely it is to be claimed upon. Some policies allow for the deferred period to be removed in situations of claims arising from the same cause, for example, if Joe was receiving income protection and went back to work only to have a relapse five weeks later, they will reinstate the income protection without the deferred period. This clause will encourage people to get back to work if they can.

- Tax: full tax relief at marginal rate is allowed against premiums up to a limit of 10% of income per annum

- The availability and cost of income protection cover is very sensitive to the nature of the insured's occupation. Some occupations are not covered at all. In general income protection policies are subject to an increased level of underwriting.

4.3 Business Insurances

Life cover may also be required under a business structure, i.e. a Partnership or a Private Limited Company. The sudden death of a partner or a company director can cause immediate financial problems for the surviving partners or company. Life cover can be executed to prevent financial loss in this event.

4.3.1 Partnership Insurance Structure

There are two key components to the structure of a Partnership Insurance arrangement:

- An agreement to buy/sell a partner's share of business on his/her death

  AND

- Life assurance cover in place to provide funds on death to allow the surviving partners to buy back the deceased's share of a business from his/her estate.

There are two ways of arranging the life cover:

- **Life of another**

  One partner takes out a life policy on another partner's life. On death of the life assured, the surviving partner, who owns the policy and has paid the premiums, will then legally own the proceeds, without taxation implications. The proceeds can then be used to buy back the deceased's share of the business from his/her estate.

- **Own Life in Trust**

  Each partner takes out his own policy in trust for the other partner or partners for the value of his/her share in the business and pays the premiums. The proceeds, on death, must be used to purchase the deceased's share of the business from the estate. If not, there could be inheritance tax implications for the surviving partners.

Life of Another is the preferred method from a legal and taxation viewpoint. In addition, the distribution of costs to the partners are more equitable under a Life of Another policy. However, if there are multiple partners, there is a need for several policies which can become administratively unwieldy, i.e. six partners in a firm will require five policies per partner (30 policies).

4.3.2 Company Insurance Structure

A life policy on an Employee or Company Director of a company, for the benefit of the company, is normally called a Keyperson Policy. The death of a key person could lead to a financial loss to the company, due to the loss of the particular expertise, reputation, experience and contacts.

There is only one way to set up a Keyperson policy and that is through a Life of Another policy. The company owns the policy and pays the premium on the keyperson, i.e. the life assured. Keyperson policies are often set up at the same time as a company debt is being sought so that, in the event of death, the debt can be cleared. A more difficult loss to quantify in order to ascertain the sum assured required is potential loss of profits in the event of death of a keyperson. Often a multiple of salary is used, say between five- or ten-times remuneration. Whatever way the loss is quantified, it must not generate profit for the company, only provide for a loss or potential loss.

Keyperson policies are also used as security against company debts.

Keyperson policies should not be used for family protection, even in small family run companies. The sum assured will be paid to the company. Extracting the money from the company thereafter will give rise to taxation.

4.4 Quantifying Protection Needs

There are four main protection needs that can arise in relation to death:

- Family protection: the need can be quantified by calculating the loss of income into the household for the earners, and, in the situation where one person is caring for the home and children, the cost involved in paying an employee to care for the home and children in the event of their death.

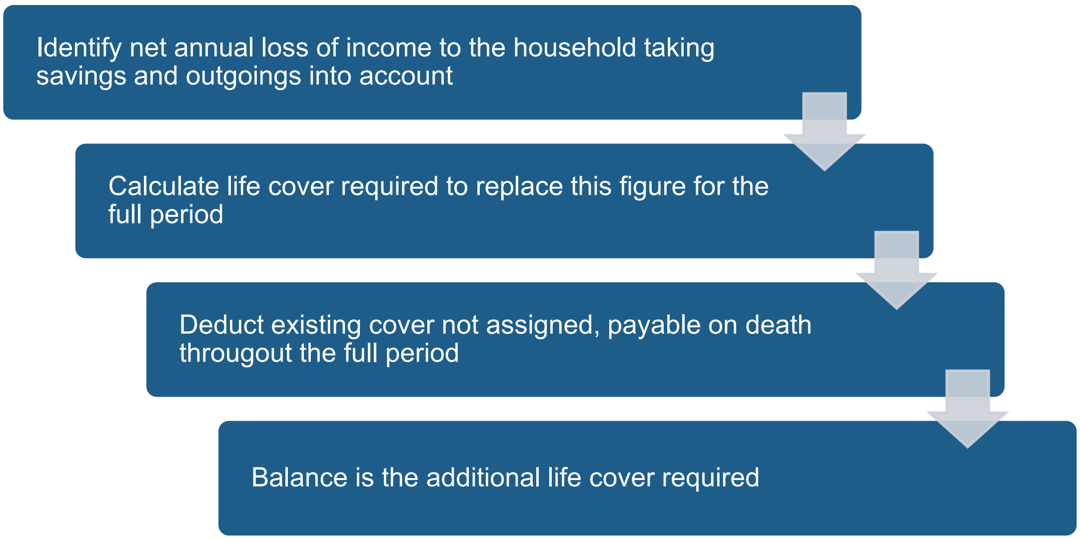
- Debt repayment: all mortgages and loans should be cleared on death of either partner.

- Inheritance tax: a Section 72 policy can be set up to sit outside of the estate for the purpose of paying inheritance tax. Any surplus not used to pay the inheritance tax will become part of the estate and subject to inheritance tax itself.

- Providing an inheritance for a dependant. If the need is a temporary need, as for family protection and debt clearance, term assurance may be the most suitable type of life cover to recommend. If the need is to pay for inheritance tax, a whole of life policy in the form of a section 72 should be recommended and, if the need is to provide for an inheritance for a dependant, a whole of life should be recommended or a term assurance for as long as possible if affordability is an issue. All else being equal, whole of life policies will be more expensive.

4.4.1 Quantifying the Loss of Income

The process for quantifying a life assurance protection need to cover loss of income can be split into these four steps:



The State Widow's, Widower's or Surviving Civil Partner's Contributory Pension is a valuable core protection benefit that may become payable to an individual after the death of their spouse or civil partner.

The maximum current personal rate of the pension (under age 66) is €237.50 per week, plus an increase for each dependent child under age 12 of €46 and an increase of €54 for children aged 12 and over.

For simplicity we will assume that the surviving spouse pays 20% tax on the gross state annual pension, when quantifying the life cover need.

In calculating the life cover needed to cover this loss of income, we simply multiply the amount of the loss by the number of years for which the cover is needed. This can be to retirement age, or until the children cease to be dependant.

4.4.2 Quantifying the Replacement Cover Required

4.4.2.1 Death of Income Earning Spouse and Death of Non-Income Earning Spouse

The loss of income may not necessarily be a loss of earned income by a breadwinner. It may be an additional outgoing to pay for childcare and/or homecare duties due to the death of the primary child carer and/or home carer. Quantifying the non-earner should start with the calculation of childcare costs up to age 13 or so and homecare costs for longer, as determined by the consumer's own requirements.

From there, the same four steps will apply to calculate if there will be a loss of income to the household and how much life cover would be required to replace it. The non-earner need will be greater if the family are renting their home rather than owning it. The rent will continue in the event of death whereas they would have mortgage protection cover to clear the mortgage debt and have that monthly saving each month.

Having identified a **current** annual loss of net income for dependants of, say, €2,000 pm which would arise if the client died today, there are two approaches to determining the amount of life assurance cover required to match this anticipated loss:

- Choose Term Assurance which provides a monthly payment of €2,000 pm on death, for the remainder of the term chosen.

  For example, if the identified earned income loss is, after taxes, €2,000 pm, then Term Assurance cover providing a monthly payment of this amount for the remainder of the term could be used.

  The key decision is the term chosen, which should match, as far as possible, the likely term of earned income, say up to the current State Pension age.

  OR

- Use Term Assurance to provide a lump sum on death, which when invested, is estimated to provide after tax a regular payment of €2,000 pm for the full term of the policy, i.e., as if the life assured died on the first day of the policy or the worst-case scenario.

  For example, if we assumed an investment return of, say, 2% pa, after taxes and charges, this table shows the capital sum required to provide a monthly payment of €2,000 pm for the full terms shown:

10-year term	15-year term	20-year term	25-year term	30-year term
€217,727	€311,451	€396,339	€473,225	€542,863

As a rule of thumb, we will assume that the cover above could be worked out approximately by taking 80% of the €2,000 pm payment for the full term required.

Example #1

25-year term:

Approximate cover required: = 80% x €2,000 x 12 x 25 = €480,000.

30-year term:

Approximate cover required: = 80% x €2,000 x 12 x 30 = €570,000.

Of course, in this case, the full cover is being provided for the full term of the policy, likely to be chosen to match the likely peak period of earned income, when the consumer's outgoings and responsibilities will be at their highest.

This can be argued to be too much cover as if, for example, the consumer died in the 25th year of the 25-year term policy, the full €473,000 cover would be paid even though there is a much-reduced term, if any, of earned income replacement then required.

However, there are factors to be considered:

- The consumer could die in the early years of the policy, when most or all of the full €473,000 would be required to replace the loss of earned income.
- The difference in cost between the full €473,000 life cover for the full 25 years and decreasing life cover of €2,000 pm for the remainder of a 25-year term may not be substantial and possibly affordable by the consumer.
- If the consumer's earned income increases substantially over time, for example, through career advancement etc., the full cover of €473,000 builds in some protection against the loss of this potentially higher earned income on death later on
- Some other anticipated income sources after death used to calculate the €2,000 pm earned income loss, such as the State Widow's Pension, may not materialise or may do so for a shorter period than anticipated because of unanticipated circumstances.

Example #2

Joe is aged 32 and needs to provide for his wife and two children, aged 6 and 3, in the event of his untimely death. He plans to take out a life policy for the period up until his retirement age, 68. Calculate how much life cover Joe requires based on the following information:

- Net relevant earnings gross pa €120,000.
- Assume net is 60% of gross.
- Unearned rental income €12,000[12]
- Existing life cover to retirement age €200,000
- Mortgage repayments €1,300pm with full mortgage protection on the mortgage debt.
- Life cover on a business loan of €30,000 over five years assigned to his bank.
- Cost of living expenses specific to Joe €13,000 pa.
- Assume his spouse will pay 20% tax on the state widow's pension.

Net Income pa = €120,000 x 60% =	€72,000
Mortgage saving pa =	-€15,600
State Widow's pension = €15,315 pa gross	
(€237.50 + €46 + €46) x 52.18[13]	
Net for beneficiary spouse = €17,193 x 80% =	-€13,754
Cost of living expenses specific to Joe	-€13,000
Net income loss per annum	**€29,646**

Convert the annual need to a lump sum:	
€29,646 x 36 years = €1,067,256	
Use the 80% rule of thumb €1,067,256 x 80% =	€853,805
Deduct existing life cover	-€200,000
Life Cover required	**€653,805**

[12] *Unearned income, e.g. rental income above, can be disregarded as the income will be received regardless of death.*
[13] *52.18 is used to calculate weeks in the year to include leap years (365.25/7).*

Example #3

Fact-find

- Mary, aged 33, and Gary aged 36 are married with two children aged 8.
- Mary works part time for an Accountancy practice and takes care of the children. She earns €30,000 pa.
- Gary is an Employee and earns €70,000 pa. Gary pays 5% of his gross salary into a defined contribution employer pension scheme. He has death in service cover of two times his income and income protection of 66% of income, both paid by the company. He wants to ensure he has enough life cover to protect his family.
- Mary and Gary have a mortgage on their home with a current mortgage balance of €300,000. The repayment is €16,000pa. They have a joint life level term policy for €350,000 assigned over the debt.
- They have no further debts or protection policies.

Based on the information provided in the fact-find, answer the following questions:

1. Identify THREE protection needs that Mary and Gary may have and state your reasons why.
2. Quantify Gary's lump sum life cover need, based on the following assumptions:
   - Gary's net income is 70% of his gross income.
   - There is a €10,000 pa reduction in outgoings if Gary dies.
   - Mary would pay 20% income tax on the state pension.
   - Mary requires replacement income until his retirement age 66.
   - The amount of lump sum life cover required is 80% of the total cover calculated for the full period.
3.
   a. What tax efficient form of life cover should Mary avail of and why?
   b. What limitations are placed on the premiums paid on this type of policy?

Example #3: Workings and Answers

Question 1

- Mary needs a life policy to protect her family from financial loss in the event of her death. There would be a loss of income of €30,000 pa and additional future outgoings to cover the cost of child and home care. The amount required must be quantified.

- Gary needs a life policy to protect his family from financial loss in the event of his death. He has death in service of two times his income which may not fully cover the family's financial loss in the event of his death. The amount required must be quantified.

- Both Mary and Gary should take out a Serious Illness Policy which would pay out a tax-free lump sum in the event of either of them suffering from a specified illness. This could be used to supplement income loss and/or pay for additional medical bills. Gary has income protection but the maximum he will receive is 66% of salary and is only payable after a deferred period. They could take out a joint life policy or a dual life policy.

Question 2: Quantify Gary's lump sum life cover need

Net Income	€49,000
mortgage savings per annum (debt cleared)	-€16,000
savings on household expenses (personal expenses Gary)	-€10,000
Widow's and dependants' pension €237.50 + €46 x 2= €329.50 x 52.18 = €17,193	
€17,193 less 20% income tax	-€13,754
Total Net Loss	**€9,246 pa**

Convert the annual need to a lump sum: Replacement income required for 31 years €9,246 x 30 = €333,188	
Use 80% rule of thumb: €333,188 x 80% =	€277,380
Existing Death in Service cover from Employer:	-€140,000
Existing term cover surplus to clearing mortgage debt	-€50,000
Life Cover now required	**€87,380**

Note to Student: The Life cover can be taken out as a term assurance lump sum which would be paid out on death and could be invested and drawn as needed. It could also be arranged under a term assurance policy which paid out a monthly payment for the remainder of the term.

Question 3

a. As Mary is in non-pensionable employment, she has a source of relevant earnings and therefore can take out a pension term assurance policy, otherwise known as a section 785 policy. This life policy cannot be assigned over a debt but can be taken out for family protection, so it is suitable for her need. She can avail of income tax relief at her marginal rate on the premium.

b. The premium must be within *pension* age related funding limits to avail of this relief.

Example #4

Fact-find

- Jack, aged 50, and Stephanie, aged 49, have three children, aged 20, 16, and 15.
- They own and work in their own company and take Directors' salaries of €60,000 each.
- They have recently taken out an adequate dual life serious illness policy.
- They took out a mortgage protection policy to cover the mortgage on their home fifteen years ago. Due to difficulties in making the mortgage repayments 12 years ago, the bank allowed them to avail of an interest only mortgage repayment schedule for three years. The capital and interest repayments subsequently resumed and will expire in 15 years.
- They have a holiday home with a mortgage of €100,000. The life policy taken out to clear the debt was not assigned and lapsed several years ago when they had difficulties with affordability. They are paying the capital and interest off the mortgage debt which is due to be cleared in 10 years.
- They have a term assurance policy which commenced eighteen years ago for €300,000 which they took out for family protection. The term on the policy is twenty years so it expires in two years. They are satisfied the sum assured would meet their needs.
- Their net assets are valued at €2,000,000. They intend to leave their assets equally to their three children on death. The children have not received any gifts to date.

Based on the information in the fact-find, answer the following questions:

1. Identify **FIVE** protection needs that Jack and Stephanie may have. Under each protection need identified, explain your reason for this need, and recommend a product type that may be suitable to meet the need and briefly state why.
2. Explain why a keyperson company policy would not be the most suitable choice for family protection.
3. Calculate the sum assured required to cover inheritance tax for their three children. Assume there are no CAT exemptions, and that they received no other gifts or inheritances. Explain to Jack and Stephanie what would happen if the sum assured on the section 72 policy exceeded the tax due.

Example #4: Workings and Answers

Question 1

1. **Family Protection need:**

   Jack and Stephanie should have life cover in place which would provide the surviving spouse and children with a replacement income in the event of either death. No one knows when death will occur, but the financial consequence is an immediate loss of income to the household.

   The term policy currently in place does not meet their needs as it will expire in two years and needs to be for a longer term, probably up until retirement age.

   Products Recommended and Why:

   They could take out 'Death in Service' policies paid by the company as the premiums would be tax efficient. Any amount in excess of four times income, i.e. €240,000, would be paid out as an annuity or invested in an ARF.

   Alternatively, they could take out a joint life first death term assurance policy with or without a conversion option.

2. **Income Protection Need:**

   If Jack and Stephanie were unable to work due to illness or injury, their income would cease for that period and they would need a replacement income.

   Product Recommended and Why:

   An income protection policy would pay up to 75% of income in the event of being unable to work due to illness or injury, after a specified deferred period. Ideally, they should have a lump sum in accessible savings to cover the loss of income in the short term, or perhaps in this instance, there are company funds that would continue to be paid as salary in the short term.

3. **Mortgage Protection Need: Private home**

   Reason Why and Product:

   This policy should be reviewed and possibly replaced. There may be a shortfall due to the period of interest only repayments which does not appear to have been addressed. Joint life first death Mortgage Protection for the amount of the remaining mortgage value over 15 years is required.

4. **Mortgage Protection Need: Holiday Home**

   Reason Why and Product:

   The holiday home debt should be cleared in the event of death of either Jack or Stephanie. It is a financial burden that should not be carried on to a surviving partner. A reducing sum assured (mortgage protection) for the current debt level over 10 years on a joint life first death basis will suffice.

5. **Inheritance Tax Planning Protection Need:**

   Reason Why and Product:

   When Jack and Stephanie die, there would be a significant inheritance tax liability on the children which could be covered by a Section 72 life policy in their names.

   They should take out a joint life second death life policy that would pay out on the second death for the specific benefit of paying capital acquisitions tax. The policy would be underwritten as a Section 72 Life Policy and the proceeds would be exempt from inheritance tax to the extent that they are used to pay capital acquisition tax payable by the three children.

Question 2

A Keyperson policy would not be suitable for family protection because the sum assured would be paid to the company on death and not paid to the family. The subsequent withdrawal of company funds would give rise to taxation.

Question 3

Total net assets €2,000,000

Three children with a threshold of €335,000 each = €1,005,000

€2,000,000 - €1,005,000 = €995,000

Capital acquisitions tax = 33%

€995,000 x 33% = €328,350

Assuming no exemptions, the current tax payable would be €328,350.

They can take out a whole of life, joint life second death, section 72 life policy for €328,350 which would be set up in trust for the three children equally for the purpose of paying this tax.

A section 72 life policy would sit outside the net asset amount of €2,000,000 for the purpose of paying inheritance tax. Any surplus sum assured over the tax due would become part of the estate's assets and itself would be subject to tax. Any shortfall would give rise to the children paying some inheritance tax.

4.4.3 Quantifying Serious Illness

While we can quantify the loss of income on death because death is final, it is more difficult to determine a level of serious illness cover to be recommended.

If it is being recommended in conjunction with a mortgage protection policy, it may be recommended to take out the cover as an accelerated payment where the policy would pay out in the event of the life assured being diagnosed with a specified illness *or* death, for the purpose of clearing the mortgage debt. In this instance, quantifying the cover is simple as it will match the mortgage debt. Or it may be taken in conjunction with a mortgage protection but may be taken as a standalone policy matching the debt or for a lesser amount of the consumer's choosing.

Quantifying a standalone policy not linked specifically to a debt, is often determined by the consumer's objectives, affordability and whether or not they have a level of income protection or are entitled to the state illness or invalidity benefit. The non-earning spouse would also have a serious illness need in so far as they may have additional medical costs or may need to pay for child and home carers.

4.4.4 Quantifying Income Protection Insurance

The maximum level of income protection that can be arranged is 75% of earned income less any social welfare payments. Ideally, the consumer would have this level of cover at the lowest possible deferred period of 4 or 8 weeks. However, the cost of income protection can be quite high so affordability often determines the level of cover the advisor will recommend in their suitability statement.

Other factors that will be taken into account for the purpose of quantifying your recommendation are:

- The deferred period. The longer this is, the cheaper the cover. Ideally, the consumer should have short term liquid savings to cover the initial weeks and/or months before the policy pays out.

- Underwriting is stringent and occupations are classed into different sections with different pricing structures and some occupations will be declined cover. The occupation will therefore also form part of the recommendation. A quotation including occupation type will help to determine the cost and therefore the affordability, leading to a rational recommendation and suitability statement.

4.5 Protection Products: Choosing the Right Product, Term and Optional Benefits

There are many different types of protection products, from sickness and accident policies to whole of life policies.

There are circumstances in which a consumer's protection needs can be met in part or total by more than one type of protection cover, for example, a life assurance need might be met by both a term assurance policy and a death in service policy provided by the individual's employer.

It may therefore be necessary to examine Protection cover under these headings:

- Term of cover.

- Benefits provided including risks insured, optional benefits and cash value.

- Cost.

- Taxation.

- Availability and suitability.

4.5.1 Term of Cover

The cover term should ideally be chosen to match the consumer's period of maximum protection need.

However, there is usually a trade-off between the term of cover provided and the cost to the consumer. In general life and serious illness cover costs more the older you get. Therefore, the longer the term of cover provided, the higher the cost.

Some products, like term assurances, may offer short term cover, but with the option to convert or extend the cover for a further period without fresh evidence of health, that is, a conversion option. This can offer consumers who want long-term cover the option to pay a lower premium now, but at the expense of paying a higher premium later on if they want to extend the cover.

The ability of the consumer to afford the premium may dictate the period of cover chosen.

4.5.2 Benefits Provided

The consumers' needs and objectives must be matched to the correct policy, that is, matching the purpose of the life cover with the correct policy. For example, if a consumer is borrowing money to purchase an asset and needs life cover to match the debt, the amount and term will be identified, and the policy must be set up with the same term and level of cover.

Benefits provided on life, illness and income protection policies can be:

- Lump sum on death.
- Lump sum on diagnosis of illness.
- Partial lump sum on diagnosis of illness.
- Accelerated lump sum on diagnosis of illness which is then deducted from the life cover sum assured in the case of life and illness policies.
- Regular income for a specified period or a mixture of regular income for a specified period and a once-off lump sum payment.
- An income protection policy may pay out a percentage of earnings to a maximum of 75% less the state benefit.
- Conversion options on term policies.
- Indexation options.
- Hospital cash, surgical cash.
- Waiver of premium.
- Child cover.
- Guaranteed insurability on certain life events.

4.5.3 Cost

Where the type, amount and term have been identified, generally the most suitable product will be the cheapest option on the market.

However, all benefits and optional benefits need to be taken into account as to the suitability to the consumer. Serious illness policies will, for example, vary with regard to illness covers and exclusions although they will, in general, be more similar than different.

During the underwriting process, the protection may not be accepted at standard rates due to medical factors or occupation details for example. In this case, the life company will offer new rates, that is, a new premium for the same cover or reduced benefits. In this instance, an adviser may be in a position, if they are not a tied agent, to talk to underwriters in other life companies to discuss their policies in relation to the specific rating. Another company's underwriting policies may allow them to accept the policy at normal rates or their ratings may not be as high. Therefore, an initial comparison of cost may not be sufficient to guarantee the cheapest option on the market.

4.5.3.1 Government Levy

Currently, all life policies incur an insurance premium levy of 1% payable to the Government.

4.5.4 Taxation

Some products may offer tax relief on the contribution, for example, PHI and pension term policies.

The taxation relief on a Section 785 pension term assurance policy is only allowed up to the personal age limits inclusive of pension payments, that is, add the annual pension premium to the annual pension life cover premium to ensure the total outlay is within the limits for tax relief.

Tax relief is allowed at marginal rate for both PHI policies (subject to 10% of income) and pension term assurances (subject to age related pension limits).

4.5.5 Availability and Suitability

Different types of policies may not be equally available and open to all consumers. Examples include:

- Pension term policies can only be taken out by consumers who have, or had at some stage in the past, a source of relevant earnings liable to income tax, that is, income from a self-employed trade or profession or income from a non-pensionable employment. They also must have made a contribution in the past to a personal pension or a Section 785 policy.

- Income protection policies will only pay a benefit to individuals who suffer a loss of earned income due to sickness or disability lasting longer than the deferred period. Therefore, such policies are not relevant to, say, a stay at home spouse /partner with no source of earned income.

- Some income protection policies might not be offered by some insurers to certain occupations, e.g. farmers, etc, or if offered are subject to a very heavy loading on the premium, e.g. sales person with heavy mileage.

- Group mortgage protection policies offered by lending institutions only provide cover to individuals who have a mortgage with that financial institution.

- Serious illness cover is generally less available than life cover; some insurers impose a maximum age at which they will accept serious illness cover applications and may impose a cap on the maximum amount of cover they will offer, particularly where the cover is being provided on term assurances at a guaranteed premium.

A comparison of the main protection products might be summarised as follows:

Cover and Main Benefits Provided	
Term assurances: Life Cover	A lump sum benefit in the event of: • Death; or, • Serious illness; or, • Death and serious illness.
Mortgage protection	A lump sum benefit in the event of: • Death; or, • Serious illness; or, • Death and serious illness. Cover decreases each year in line with the estimated capital outstanding on a capital and interest mortgage.

Cover and Main Benefits Provided	
Whole of life	A lump sum benefit in the event of: • Death; or, • Serious illness; or, • Death and serious illness.
PHI/ Income Protection	A regular income in the event of the insured suffering a loss of earned income by being unable to work due to sickness or disability lasting longer than the *deferred period*.

Exclusions and Restrictions on Cover	
Term Assurances including serious illness and mortgage protection	Suicide exclusion on life cover for first 12 months is common. Life cover max age of entry normally 75. Life cover max age to age 85 or 90 Life cover minimum term normally 5 years. Serious illness cover only applies to illnesses specified and defined in the policy conditions and each life company's policy conditions differ. Serious Illness max age of entry normally age 55. Serious Illness cover max age to 70 or 75
Whole of life	Suicide exclusion on life cover for first 12 months is common.
PHI/Income Protection	Benefit is only paid to the extent that there is a proven loss of income and for as long as the individual continues to suffer a loss of earned income by being unable to work due to sickness or disability. A maximum benefit payment limit may apply, for example, (two thirds of earnings less State invalidity benefit).

Optional Benefits	
Term assurances	Optional benefits may be added, for example, conversion option, indexation option, hospital cash, waiver of premium, etc.
Mortgage protection	Optional benefits don't usually apply but several companies now offer conversion option. Some providers now offer this cover on a dual life basis at little or no additional cost.
Whole of life	Optional benefits may be added usually only to unit-linked whole of life, for example, conversion option, indexation option, hospital cash, waiver of premium, etc.
PHI/Income Protection	Some plans may provide optional hospital cash, but usually no optional benefits.

Term of Cover	
Term assurances	Usually a choice between 5 and 40 years.
Mortgage protection	Related to the mortgage term, usually 5 to 30~35 years.
Whole of life	Whole of life. However, where the premium/cover is dependent on an investment assumption, cover may only be capable of lasting throughout life but not guaranteed to do so. Some unit-linked protection policies may be targeted to provide cover for a shorter period. To maintain the cover beyond that period would require a substantial increase in premium. Guaranteed whole of life policies with a fixed premium are more common now, and are used primarily for section 72 policies for inheritance tax planning.
PHI/Income Protection	Usually to a selected retirement age, for example, 55, 60, 65 or 70.

Premium Cost	
Term assurances	Varies by age, smoking status and health, and policy term. Premiums and cover guaranteed.
Mortgage protection	Varies by age, smoking status and health, and policy term. Premiums and cover guaranteed. However, cover may not necessarily be guaranteed to fully pay off the mortgage outstanding on death; individual mortgage protection policies are ‘interest rate sensitive’, that is, based on an assumed mortgage interest rate over the mortgage term. If actual mortgage rates exceed this assumed rate for a prolonged period, or if there are mortgage arrears outstanding on death, the sum payable under the policy may be insufficient to fully repay the mortgage outstanding on death. However, mortgage protection policies usually assume a much higher mortgage rate than current rates and so there is always some ‘comfort margin’ built in.
Whole of life	Varies by age, smoking status and health, and investment assumption in the case of unit-linked policies. Where premium is dependent on an investment assumption, for example, unit-linked cover, premium and/or cover may not be guaranteed for life, premium may be subject to increase for the same cover or cover could be reduced for the same premium. Where cover and premium are fully guaranteed for life, premium will usually be substantially higher than where such guarantees do not apply.
PHI/Income Protection	Varies by age, smoking status, health and by the nature of the insured’s occupation class and term of cover. Premiums and cover usually guaranteed.

Taxation	
Term assurances	Pension term policies qualify for full income tax relief within certain limits; otherwise no tax relief. No tax on benefit.
Mortgage protection	No tax relief on premium. No tax on benefit.
Whole of life	No tax relief on premium. No tax on benefit.
PHI/Income Protection	Premiums qualify for income tax relief up to 10% per annum of total income. Benefit subject to PAYE.

Underwriting Requirements	
Term assurances	Varies according to level and type of cover and age. Where serious illness cover applies, lower limits and/or different requirements may apply.
Mortgage protection	Varies according to level and type of cover and age. Where serious illness cover applies, lower limits and/or different requirements may apply. However, 'automatic acceptance' may apply under Group Policies where the life assured can answer 'No' to a limited number of medical questions.
Whole of life	Varies according to level and type of cover and age. Where serious illness cover applies, lower limits and/or different requirements may apply.
PHI/Income Protection	Varies according to level and type of cover, age and nature of occupation. Tends to be *heavily* occupation underwritten; certain occupations may be loaded or not offered cover at all.

Availability	
Term assurances	Widely available. However, serious illness cover may be less available than life cover to individuals over 50 and/or those with a family history of medical problems. Section 785 cover only available to those who have or had a source of relevant earnings liable to income tax.
Mortgage protection	Widely available. However, serious illness cover may be less available than life cover to older (That is, those aged more than 50) individuals and/or those with a family history of medical problems. Group mortgage protection cover offered by financial institutions only to those who have a mortgage with that institution.

Availability	
Whole of life	Unit-linked whole of life cover generally available. Guaranteed whole of life cover available from certain providers.
PHI/Income Protection	Certain manual occupations may not be able to obtain PHI cover or be subject to a substantial loading.

Cash Return if Terminated	
Term assurances	None.
Mortgage protection	None.
Whole of life	Non-guaranteed, unit-linked usually provide a cash return if encashed.
PHI/Income Protection	None.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- Reasons why you would recommend one protection product over another ☐
- The differences between a serious illness policy and an income protection (PHI) policy ☐
- The various benefits of life, illness and income protection policies ☐
- How to quantify a life assurance need ☐

05

Review: Investment

This chapter reviews the investment module, outlining the main types of asset classes and their suitability to a consumer's needs and objectives. We look in detail at investment products in order to draw comparisons before making a recommendation.

Learning Outcomes – after studying this chapter you should be able to:
understand the various asset classes and products available;
demonstrate your understanding of financial maths;
compare investment and savings products under various headings;

5.1 Investment Asset Classes

The main, or traditional, asset classes are cash, bonds, equities and property.

- Cash consists of deposits and money market type investments which could be very liquid investments, that is, can be turned into cash very quickly.
- Bonds are a form of borrowing for the issuer. Irish Government bonds are referred to as treasury bonds and those issued by the UK Government are referred to as gilts.
- Equities in the main are:
    - Shares quoted on a stock exchange.
    - Packaged retail and insurance-based investment products (PRIIPs) (also known as Collective investment funds which invest in a wide spread of different shares, for example, exchange traded funds, index funds for example, those tracking the FTSE 100 and unit-linked and unit trust funds investing directly in a wide spread of different shares.
- Property investments normally consist of commercial property in the form of offices, retail and factories, though larger scale residential investment funds are becoming more common. There are three main ways to invest in property:
    - Directly into one or more commercial properties.
    - Through a collective investment fund which, in turn, invests in a range of commercial properties. Most property funds will be situated in a particular area, for example, an Irish property fund, a UK property fund or a European property fund.
    - In a real estate investment trust (REIT), that is, a property company listed on a stock exchange.

Equities and Property are generally regarded as the most suitable investments to protect an investment from being devalued over time due to the impact of inflation. In this sense they are often referred to as ‘real’ assets, as they help the investment hold its ‘real’ value, or purchasing power, in today’s terms. However, they can also be the riskiest, as their values are more volatile, particularly in the short term.

The main investment asset classes can be compared at a high level as follows:

	Cash	Bonds	Property	Equities
Potential returns	Low/Negative	Medium	High	High
Investment time span to optimise returns	Short	Medium	Long	Long
Potential protection against inflation	Low	Medium	High	High
Liquidity	High	High	Low	High
Volatility	Low	Medium	High	High

5.2 Deposit Accounts

Deposit accounts vary according to a number of characteristics and, having ascertained a need for a capital secure deposit, when advising on their suitability to a consumer, the following should be taken into account with regard to the type of deposit:

- Minimum and maximum investment of the deposit.
- Does the account require regular lodgements?

- Can the account provide withdrawals and to what extent?
- Fixed term, if any.
- Interest rates; what are the interest rates and how frequently is interest credited to the account.
- Tax on interest: DIRT at 33% must be deducted at source unless an exemption is in place, for example, for the following:
  - Non-residents
  - Registered charities
  - Pension funds including PRSAs and ARFs
  - Companies, who instead pay a separate corporation tax of 25%
  - Individuals who have reached aged 65, or whose spouse/civil partner is over age 65, and their total income is less than €18,000, or €36,000 in the case of a married couple/civil partners
  - Individuals who are permanently incapacitated, if they are otherwise not liable to income tax on their overall income
  - Individuals who are permanently and totally incapacitated can reclaim DIRT arising from the investment of a compensation award which result from a qualifying personal injury, where the investment returns are the sole or main income (that is, more than 50%) of the individual.
  - First time buyers of residential property in certain circumstances can reclaim DIRT.
- Whether credited interest is made to the account or paid out as regular income.
- Penalties for early withdrawal.

5.3 State Savings

There are a number of State guaranteed savings and investment products. Returns are tax free, other than deposits which are liable to DIRT.

The main savings and investment products currently on offer are:

- Three year savings bond.
- Four and ten year national solidarity bond.
- Five year savings certificates.
- National instalment savings, a 12-month savings plan with a five year investment term thereafter.
- Deposit accounts.
- Prize bonds.

5.4 Shares

Shares in a public limited company may be, but are not required to be, listed on a stock exchange and can therefore be traded. Shareholders expect value from dividends received annually and capital appreciation of the share price. Many companies will not distribute dividends, or distribute at a low level, and shareholders may still be happy to invest due to the potential they see in the capital appreciation. Investing in shares provides zero capital guarantee.

In assessing the potential value of a particular ordinary share, investors usually look to a number of key numerical measures or metrics of the share value:

- Gross dividend yield.
- Dividend cover.
- Earnings per share.
- The price/earnings ratio (P/E).
- Net asset value (NAV).
- Market capitalisation.
- Earnings.

5.4.1 Factors Affecting Quoted Share Prices

Ultimately, the price of a quoted share is determined by the supply and demand for that share, at a particular moment in time. There are many factors which may determine the supply and demand, but the main three considerations are:

- General investment market factors:
  - General economic outlook.
  - Geopolitical events.
  - Investor sentiment.
  - Outlook for interest rates and inflation.
  - Outlook for corporate earnings.
- Factors affecting a particular sector.
- Factors affecting individual companies.

5.4.2 Investing in Shares: Advantages and Disadvantages

Investing in shares is high risk due to their volatility. Share prices will fluctuate for the reasons given above, but over the long term they have proven to provide the best method of protection against inflation risk. They provide the best long-term return over any other asset class.

The main benefits of investing in shares are:

- Potential for regular and increasing dividend income, from those shares which pay dividends.
- Potential for capital appreciation.

- Protecting against inflation risk over the long term.

The main disadvantages of investing in shares are:

- Shares are high risk. There is no guarantee on future dividend income and/or on the price at which the shares may ultimately be sold.

- Despite their reasonable liquidity, shares may not be suitable for income because of timing and volatility.

- Investment firms typically charge a set minimum fee so small trades may not be economical

5.4.3 Taxation of Returns from Shares

Dividends and capital gains from investment in shares which are personally owned, are liable to tax in the investor's hands.

5.4.3.1 Dividends

In summary dividends are liable to income tax, Universal Social Charge (USC) and, in certain circumstances, PRSI.

Dividends are assessed for income tax at the investor's marginal tax rate.

Dividends paid by Irish resident companies are normally subject to *dividend withholding tax (DWT)*, which is currently 25%.

The investor is taxed on the sum of the (net dividend received + DWT deducted), with the DWT then being allowed as a credit or deduction from the investor's total income tax liability. Where an investor opts to receive dividends in the form of shares from an Irish resident company (scrip dividend), instead of cash, DWT is applied to the gross cash amount and the net amount is then used to buy shares for the investor at the predetermined price.

However, the investor is still liable to income tax at their marginal rate on the gross dividend, with allowance for the DWT deducted at source, as if he or she had received the cash dividend payment.

A similar system operates in respect of dividends received on many foreign shares. Currently, however, there is no with-holding tax on UK dividends.

By being treated as *income* for income tax purposes, dividends are:

- Subject to the Universal Social Charge (USC);

- Subject to PRSI for Class S PRSI payers (self-employed people); for employees and those with occupational pensions taxed under Schedule E, PRSI is payable where their total taxable investment income exceeds €5,000 in a year. Note that no PRSI is payable over age 70 or over 66 if you were born before 1 January 1958 or you are in receipt of the State Pension. The rate of PRSI is currently 4%.

5.4.3.2 Capital Gains or Capital Losses

Any gain, after deduction of allowable expenses, made on the sale of a share is a *chargeable gain* liable to capital gains tax at a rate of 33%. However, the first €1,270 of chargeable gains in a tax year for an individual is tax free. This €1,270 allowance is *not* transferable between spouses/civil partners.

5.5 Bonds

Bonds are a form of borrowing by the issuer of the bond, for example, a government or a corporation, sovereign or corporate. As mentioned earlier, Irish Government bonds are called treasury bonds. They provide an income return in the form of a coupon expressed as a percentage of the nominal value of the bond and a guaranteed capital payment of the nominal value of the bond at a specified maturity date.

Most investors who invest in diversified collective investment funds will have exposure to bonds issued by different issuers.

5.5.1 Taxation from returns on bonds

There are two taxes payable on bond investments: income tax on the coupon and capital gains tax on any capital gain:

- Income from direct investment in bonds is liable to income tax and USC in the hands of the individual investor at his/her marginal rate so may be attractive to individuals who are non-income tax payers or paying tax at standard rate or perhaps they have tax credits to use.

- PRSI is charged at 4% on income from bonds for:

  - An individual who is self-employed and pays Class S PRSI.

  - Employees and those receiving employer pensions and who have gross taxable investment income of more than €5,000 in a year.

- The capital gain made on maturity or earlier sale of a Bond, other than an Irish Government treasury bond, is liable to capital gains tax and can be offset against realised losses. Irish Government treasury bonds are not subject to CGT and therefore, if a loss is realised, it cannot be offset against other chargeable gains.

5.6 Packaged retail and insurance-based investment products (PRIIPs)

Packaged retail and insurance-based investment products (PRIIPs) (also known as collective investment funds) are open-ended funds in which a large number of investors' money is pooled to invest in a diversified range of assets managed by a professional investment manager, and which operates on a unitised basis, that is, the value of each investor's holding is measured by the number of units or shares he or she owns in the fund.

They are typically structured as a unit-linked fund, a unit trust fund, or an investment company.

Most of these funds held in life companies, set up as unit-linked funds, are liquid, that is, an investor can switch funds or encash their investment with or without penalty, depending on the structure of the contract and for how long they are invested.

A fund of funds is an investment fund which invests in other similar investment funds, some of which may be with different providers. Specialist investment managers may be utilised in various funds and the return is expected to be greater, albeit with greater risk, and charging structures will generally be higher.

The asset classes used in a PRIIP are typically cash, property, bonds, equities, and commodity funds. They, therefore, offer better long term returns than deposit accounts, albeit with risk to capital, especially in the short term.

Each PRIIP will have an investment mandate, that is, a stated objective perhaps to produce a certain level of return or a level of return relative to some benchmark. Often the mandate will include a cap on the level of equities or another asset class to ensure diversification and reduce risk.

Hedge funds or absolute return funds strive to achieve an absolute positive return above the risk-free rate, while reducing risk. No two absolute return funds will be the same, as their constituent investments will be determined by the active manager's investment style.

An **Exchange Traded Fund** is a fund whose units or shares are traded on the stock exchange. The ETF buys a required basket of shares to replicate a stock index E.g. a S&P 500 ETF will want to own all the securities in the S&P 500 index in the exact weights they appear in that index. ETFs are typically much less expensive than actively managed unit linked funds.

5.6.1 Unit-Linked Savings Plans

A unit-linked savings plan is a life assurance policy but rather than the lump sum, as above, a regular contribution is made, normally monthly but sometimes annually. Units are purchased at their unit price of the day and as the underlying asset changes in value, so too does the unit price, and therefore the value of the savings plan.

The policyholder may encash the plan at any time for its value, which will be the daily unit price of the fund multiplied by the number of units held, less any early encashment charges and exit tax, if applicable.

As there is no capital surety, these are not suitable for short term savers, and due to the nature of funds, a risk assessment must be carried out, as in the investment bond above, to help match a client's risk tolerance to a fund or funds. These types of savings plans are suitable for the longer-term investor looking for greater return than deposits and who is willing to take a risk with their capital. A minimum term of ten years is usually recommended. Over the longer-term equities have always outperformed deposits and other asset classes. To reduce the risk, diversification can be applied within a fund or various funds to a spread of assets, e.g. bonds, cash and property.

Unit linked plans in the market are open-ended, that is, the policy holder can pay into the policy for as long as they want to, and encash the policy, in full or partially, at any time. The amount of savings can also be altered or placed on a premium holiday, if required.

Death benefits will normally apply at the rate of 100.1% of the encashment value.

This type of savings plan can be set up under Section 73 to fund for gift tax, after eight years minimum. The consumer can encash it themselves anytime, that is, decide not to use it for the initial purpose.

5.6.2 Investment Management

PRIIPs are managed by professional investment managers. There are two main investment management styles:

Active Management

The investment manager attempts to use their skills to outperform the performance of the benchmark against which the fund performance is to be measured. For example, an actively managed fund investing in European equities will attempt to outperform a specified index of European equities. In attempting to outperform the benchmark, certain limits may be placed on the investment manager in relation to risks which can be taken by the fund.

The objective of active investment management is to produce a return in excess of the overall market return, so that, for example, if the UK equity market in general increases by 8% during a period, the investment manager of an actively managed UK equity fund would be striving to achieve a return in excess of this.

Passive Management

Passive investment management aims to achieve average market returns at a lower cost than that of actively managed funds; it does not set out to beat the market.

One method of passive investment management in relation to stock selection is index tracking, where the fund aims to track a particular stock market index, for example, UK equity fund aims to track or mirror the movements up or down of the FTSE 100 Index.

So, if the FTSE 100 Index increases by, say, 6% over a period, the unit fund price should also increase by roughly this same amount. On the other hand, if the FTSE 100 Index falls by 6% over a period, the fund price should also fall by a similar amount.

5.6.3 Taxation, Charges and Levies of PRIIPs

- Funds based in Ireland are liable to exit tax, currently 41%. This is payable on exit or on every eighth anniversary of the investment, when the investment is *deemed* to be encashed. While invested, investment income and capital gains are generally tax exempt (termed 'gross roll up').

- Charges will vary between companies and individual funds and may include:

  1. **Initial sales charge:** A fund may impose a fixed percentage charge, e.g. 1% of the sum invested. However, these initial charges are becoming less common.

  2. **Fund Management charge**: This is an annual charge taken within the fund before the unit price is set. A typical management charge might be between 0.5% to 1.5%.

  3. **Trail commission**: Funds invested through intermediaries may have the option for the intermediary to include a trail commission with the fund management charge, typically between 0.15% and 0.5%. The intermediary can often choose a lower fund management charge in order to include a trail commission, thereby reducing their upfront commission and introducing ongoing commission to correspond with ongoing advice and reviews.

  4. **Administration charges**: Funds can incur other charges such as custodian, auditing and various professional service fees.

  5. **Early encashment charge**: Depending on the contract, early encashment penalties may apply to full or partial encashments from the fund, typically for up to five years, reducing each year, e.g. 5% year one and two, and 3%, 2% and 1% of the encashment amount in year three, four and five respectively.

  6. **Government Levy of 1%** of the investment amount on all life company investments.

  7. For regular savings plans there may also be a **monthly policy fee** and/or a **contribution charge** of a percentage of every contribution.

5.7 Tracker Bonds and Structured Retail Products

5.7.1 Tracker Bonds

Deposit tracker bonds are bank investments whereby the investor receives two returns at the end of the fixed term; the capital or partial capital guaranteed, and an interest payment which is related to the rise in certain stock market indices or a basket of shares. One potential advantage is that they are subject to DIRT rather than Exit tax. With low interest rates the availability of these bonds is limited in the present market.

Life assurance tracker bonds are fixed term bonds, usually between three to six years. They typically offer a percentage of capital guaranteed, often between 85% and 100%, of the capital sum and a bonus payable at the end of term. Most of the capital sum is placed on deposit with the fixed interest rate compounding annually to provide the capital protection at maturity. The remainder of capital is used to purchase an option or derivative with an international investment bank. The option or derivative will likely be linked to the performance of a basket of shares or a stock market index which will provide the bonus, if any, at maturity.

Exit tax is charged on the excess over the amount invested at 41%.

Both Tracker bonds and structured retail products (see below) may have a participation rate of more or less than 100% of the return, i.e., the investor may get 150% of the return of the tracked index. The downside would be that the gain might be capped at a certain percentage, e.g. 40% maximum return.

Attractiveness of these bonds is correlated with prevailing interest rates. If interest rates are low, the percentage amount that has to be used to provide for the capital guaranteed amount is higher, and therefore the amount available to provide for the bonus will be lower, resulting in relatively less favourable bonus terms.

5.7.2 Structured Retail Products

As a result of the lower interest rate environment in recent years, Tracker bonds have become less attractive and this has led to the development of more complex products called Structured Retail Products or Structured Bonds.

These investments will provide some element of capital protection and often will provide downside protection.

For example, one product currently in the marketplace, links the performance to an equity index. Provided the index does not fall more than 40%, the capital is fully protected. So, in this example the risk is lower than if the individual invested directly in the stock market index, as any market falls from 0% to 40% are eliminated for the investor. However, if the index were to fall by say 50% over the term, the capital protection ceases and the investment would fall by 50%.

In addition, of course, compared with direct investment in the market index, the upside potential is typically also lower as the total return on the SRP is capped. However, as above with Tracker Bonds, the participation rate on structured products may be much higher.

Structured products, just like Tracker Bonds, use derivatives to offer investors a combination of potential return with an element of protection. In using derivatives (typically options), structured products are as varied as the options that can be created and offered in the market.

As product manufacturers innovate and continue to create retail products using derivatives there is a broad spectrum and diversity of structured products available. More typically these can be based on for example the performance of an index, a group of indices, a small number of stocks, currencies or a basket of mutual funds.

Common Characteristics

- Fixed term to maturity (or specified early redemption event).

- Capital protection (ranging from zero to 100%). If there is capital protection, a fixed percentage of capital protection will apply at maturity regardless of the performance of the underlying asset.

- Soft capital protection. An element of capital protection applies but only if barriers are not broken, e.g. 90% capital guarantee at maturity as long as the price of the underlying asset does not fall below or rise above a certain percentage during the term of the investment.

- Participation rate: the fund may offer a performance return of greater than 100%, e.g. 150% return of the performance of the underlying two fixed interest bond funds. If the funds had a growth of 5% at the end of the term, the return would then be 7.5%, if there was no cap on the return.

- Returns are sometimes capped.

- Early encashment: The bonds, while they have a maturity date, may often be sold on a secondary market, subject to demand; but no capital guarantee would apply.

- An underlying financial instrument is used (certificate, deposit, warrant or notes)

- Derivative (typically an option)

Taxation

As structured products are significantly varied in how they offer the potential of return, they are also varied in terms of their underlying construction. Tax treatment varies based on their specific underlying make up. Their tax treatment needs to be clarified and understood in each instance prior to investment. As tax treatment may differ, the tax rate charged will also differ and this has a bearing on the net return for the investor. They may be chargeable to Exit tax, Income tax or Capital gains tax, depending on the type of structure and the underlying assets.

Benefits

- Structured products can enable access by retail investors to a range of different and non-standard investments.

- Where applicable MiFID II now requires that the best and worst-case outcomes are outlined which assists investors in understanding the risk of a complex product.

- MiFID II also requires full transparency of fees and charges, which aids product comparability which was historically opaque.

- Structured products can form part of an investor’s portfolio where it acts appropriately (aligned to investor risk appetite and time horizon) as a complement to more traditional assets held (diversification).

- Structured products can provide market exposure without full risk to capital.

Risks

- The level of protection to capital is based on the terms of the guarantee provided and this needs to be evaluated and understood. Partial or soft guarantees are sometimes described which can be (conditional) based on the achievement of certain hurdle events.

- The credit quality of the provider of the Guarantee will vary and is a key consideration (this is called Counterparty risk)

- Prevailing market conditions can impact the value of the option. (Market risk)

- Some structured products can be sector/region focused (e.g., financial stocks, oil stocks, German index) creating a concentration risk.

- While access to funds may be allowed, mid-term liquidity may be based on finding a willing purchaser.
- Usually investors must hold to a specified maturity date. (Liquidity risk)
- Inflation over the investment term can erode value in real terms. (Inflation risk).

Challenges

- Complexity in understanding the product. (Difficult for inexperienced investors).
- Closed-end investment, no ability to stay invested beyond the maturity date.
- Guarantees to capital need to be fully assessed and the best and worst-case scenarios understood.
- Difficulty in evaluating a future position (e.g., level of an index/stock price) at a specified time in the future.

5.8 Employee Share Incentives

There are four main tax incentive schemes whereby employees can invest in shares of their employer's company in certain circumstances:

- **SAYE schemes**: save as you earn schemes are savings related share option schemes approved by Revenue.

  There are two elements involved:

  - A savings element where an employee agrees to save a monthly amount from after tax income, of between €12 and €500 per month for a chosen period, either three or five years. Where a five-year-term is chosen, the savings may be left on deposit for a further two years at the end of the five-year-term. The end of the target period is called the bonus date. Any interest or bonuses added at that date is tax free and not subject to DIRT. This applies regardless of whether or not the employee uses the funds to buy shares in the company.
  - An approved savings related share option scheme set up by an employer under which an employee is given an option to purchase shares at a fixed price (which cannot be less than 75% of the market value of the shares at the time of granting the option) at a particular time. The option must not be capable of being exercised before the bonus date under the savings scheme. The accumulated savings plus bonuses can then be used by the employee to exercise the option and buy the shares within six months of the end of the chosen savings period.

  No income tax is charged on the granting or exercise of the option to buy shares. If the share price increases over the option price, the employee can exercise the option to buy them and sell them to make an immediate capital gain chargeable to CGT or hold on to the shares. PRSI and USC are also levied on any gain realised on the exercise of the option. If the share price decreases, the employee still benefits from the tax-free investment of the savings he has placed on the SAYE scheme regular deposit even if they do not take the option to buy the shares.

- **Approved profit-sharing schemes**: an APSS is an arrangement set up by an employer under a trust arrangement to provide a means of allowing employees to acquire shares in the company. No income tax applies to the shares up to an annual limit of €12,700 per annum. If they are disposed of within three years, the individual is liable to income tax on the lower of the sale proceeds and the market value at date of appropriation. PRSI and USC are levied on the individual at the date of appropriation (that is, the date of allocation), based on market value of the shares.

The trustee holds the shares which are allocated to each participating employee who receives any dividends payable directly, which are liable to income tax at his/her marginal rate. Capital gains tax is chargeable on the sale of the shares after three years. An individual might spread the disposal of shares over a number of years to avail of the annual CGT exemption of €1,270.

- **KEEP (key employee engagement programme)**: Share options provided under the scheme are subject to capital gains tax. The CGT only applies on disposal of the shares. The company granting the share option must be a *qualifying company* for the purpose of the relief and there are also limits applied to the amount available per individual who is granted the share option.

- **Restricted share schemes**: shares acquired under this scheme have a “clog” or restriction on the disposal of those shares. They are taxable immediately but the amount chargeable is reduced by between 10% and 60% depending on the period of restriction, which can range from 1 year to 6 years. The employee in this case is getting shares that have an existing value. This is in contrast with the KEEP scheme where they get no benefit from the options unless the share price appreciates.

5.9 Alternative Asset Classes

Alternatives are frequently less liquid than bonds and equities and even property but may provide diversity or a potential return that some investors will seek, albeit with a commensurate increase in risk:

- Private equity, that is, shares not listed on a stock exchange.
- Precious metals.
- Works of art.
- Collectable coins, vintage wine, etc.
- Commodities such as oil or gas.
- Foreign currencies directly or a currency fund.
- Derivatives and hedge funds.
- Infrastructure investment.
- Other emerging asset classes such as cryptocurrencies.

Investments in alternatives are often through exchange traded funds rather than direct investment or can be through futures and options in the case of commodities for example. Generally, these assets will be more volatile than traditional assets but may be attractive to the investor seeking to diversify as they may not have a strong correlation with traditional assets they already hold.

These alternative assets differ from the main asset classes in a number of different ways:

- They are frequently less liquid than bonds and equities, other than ETFs.
- The minimum investment is frequently higher.
- Investing in alternative assets may not be as highly regulated and protected.
- Alternative assets generally have more risk.

- They may be negatively correlated, or at least not as strongly positively correlated to the returns provided by traditional asset classes. For this reason, they may be useful in diversifying a portfolio.

When advising consumers on investing in various asset classes, it is not just their tolerance and appetite for risk that should be taken into account. They should have sufficient liquidity that prevents them needing to encash their higher risk investments in times of a bear market.

5.10 Financial Maths

When making recommendations to an individual as part of the financial planning process, the time value of money is a key element.

If an assessment shows a need for retirement income of €25,000 per annum, to commence in 30 years' time, the financial adviser needs to convert that current value into a future value. It is likely that inflation will reduce the purchasing power of the €25,000 over time. If we estimate a modest inflation rate of 2% per annum, the consumer would require €45,284 in the first year of retirement.

5.10.1 Compounding Growth

However, we also need to take account of the investment growth. If we estimate a growth of 5% per annum on an investment of €10,000, we compound this growth each year to get an accumulated value.

Example

€10,000 at a rate of 5% = €10,000 x (1.05)^10 = €16,289.

This can be calculated by multiplying €10,000 x 1.05 and multiplying each answer by 1.05 ten times.

OR

A financial calculator will compound it for you by keying in the following details:

- n = time, for example, years: 10
- I = interest rate for example, per annum: 5%
- pv = present value: 10,000
- payment: 0
- fv = future value: press 'solve' on fv = €16,289

The financial calculator is very useful when calculating a future value of both a lump sum and a regular premium.

5.10.2 Discounting

Discounting is a way of expressing the value of a sum of money, payable in the future, in terms of its value today, that is, its present value.

It is the inverse of accumulating or compounding, above, and is calculated therefore using division rather than multiplication:

Present value at 3% per annum of €1,000 payable after N years = €1,000/(1.03$^{\wedge(N)}$)

The financial calculator can easily calculate the discount using the formula above by keying in the known future value, the other factors and pressing 'solve' on the present value.

Note: for the purposes of this module, you are not required to have a financial calculator but are required to understand the formulae for calculating compounding and discounting.

The following accumulation and discounting tables will assist you:

Future value of €1,000 invested now at end of year x, at the rates shown				
After (years)	**1% per annum**	**2% per annum**	**3% per annum**	**5% per annum**
1	€1,010	€1,020	€1,030	€1,050
2	€1,020	€1,040	€1,061	€1,103
3	€1,030	€1,061	€1,093	€1,158
4	€1,041	€1,082	€1,126	€1,216
5	€1,051	€1,104	€1,159	€1,276
6	€1,062	€1,126	€1,194	€1,340
7	€1,072	€1,149	€1,230	€1,407
8	€1,083	€1,172	€1,267	€1,477
9	€1,094	€1,195	€1,305	€1,551
10	€1,105	€1,219	€1,344	€1,629
11	€1,116	€1,243	€1,384	€1,710
12	€1,127	€1,268	€1,426	€1,796
13	€1,138	€1,294	€1,469	€1,886
14	€1,149	€1,319	€1,513	€1,980
15	€1,161	€1,346	€1,558	€2,079
16	€1,173	€1,373	€1,605	€2,183
17	€1,184	€1,400	€1,653	€2,292
18	€1,196	€1,428	€1,702	€2,407
19	€1,208	€1,457	€1,754	€2,527
20	€1,220	€1,486	€1,806	€2,653
21	€1,232	€1,516	€1,860	€2,786
22	€1,245	€1,546	€1,916	€2,925
23	€1,257	€1,577	€1,974	€3,072
24	€1,270	€1,608	€2,033	€3,225
25	€1,282	€1,641	€2,094	€3,386

Present value of €1,000 payable at end of year x, at the rates shown				
Payable in (years)	**1% per annum**	**2% per annum**	**3% per annum**	**5% per annum**
1	€990	€980	€971	€952
2	€980	€961	€943	€907
3	€971	€942	€915	€864
4	€961	€924	€888	€823
5	€951	€906	€863	€784
6	€942	€888	€837	€746
7	€933	€871	€813	€711
8	€923	€853	€789	€677
9	€914	€837	€766	€645
10	€905	€820	€744	€614
11	€896	€804	€722	€585
12	€887	€788	€701	€557
13	€879	€773	€681	€530
14	€870	€758	€661	€505
15	€861	€743	€642	€481
16	€853	€728	€623	€458
17	€844	€714	€605	€436
18	€836	€700	€587	€416
19	€828	€686	€570	€396
20	€820	€673	€554	€377
21	€811	€660	€538	€359
22	€803	€647	€522	€342
23	€795	€634	€507	€326
24	€788	€622	€492	€310
25	€780	€610	€478	€295

5.10.3 The Internal Rate of Return (IRR)

The IRR is a useful way of comparing two different investments. It is in effect the rate of return from an investment. So, in general, the higher the IRR, the more attractive an investment proposal. It is a very useful method in comparing investments that have varying payments and payment dates, for example, comparing two regular premium savings plans or comparing a lump sum investment with a regular payment investment. The IRR is the term used to describe the interest rate at which the present value of one series of payments is equal to the present value of another set of payments, that is, the rate at which the net present value of the two series of payments is zero.

5.10.4 Reduction in Yield (RIY)

RIY is the term used to describe a means of expressing the impact of all projected charges in a savings or investment product over a period of time, in terms of a reduction in the yield or return that would otherwise have been provided if the policy carried no charges at all.

5.10.5 Annual Equivalent Rate (AER)

AER is the return on deposits in terms of the rate payable at the *end* of the year. The Central Bank Consumer Protection Code requires that any advertisement for a savings or deposit account must show the AER along with the relevant interest rate quoted.

5.11 Lump Sum Investment Products: Comparisons

There are a number of different lump sum investment products available. These products can be looked at under a number of different headings:

Investment return	Risks	Guarantees	Investment term
Taxation	Access	Charges	Broad suitability

5.11.1 Investment Return

Is the return to be provided in the form of:

- Income;

  OR

- Capital growth;

  OR

- A combination of income and capital growth.

5.11.2 Investment Risks

What potential investment risks is the product subject to? What risks could cause the investor to get back less than they invested or a lower return than they expected or needed?

Market Risk

The risk that an investment is subject to economic developments and other events that influence the entire market such as geo-political events, interest rate changes and inflation risks.

Interest Rate Risk

The risk that interest rates will change. This would affect deposit rates and bond prices. It could also reduce the value of other asset classes if investors move to deposits.

Inflation Risk

The risk that the inflation rate will be higher than the investment growth so that the investment will be less, in real terms, at maturity, i.e. it will have less purchasing power.

Specific Risk

This applies to the risk of investing in one company, or a small group of companies. Diversification into different sectors or other asset classes can mitigate this risk.

Active Investment Management Risk

The risk that the fund manager may not beat the benchmark return.

Currency Risk

An investment outside the euro countries will give rise to a currency risk and may give pause for thought about timing of encashment, if the investment is open-ended.

Gearing Risk

If the investment is authorised to borrow funds, there is an internal interest rate risk of its loan. If the investment falls in value, the loan and interest must be repaid. If there is a difficulty with this repayment, the bank or lender may call in the debt. Recovery of the value of the investment would therefore not be possible.

Liquidity Risk

The risk that you cannot sell or encash your investment quickly, for the actual market price.

Credit Risk

This risk is generally linked to corporate bonds but also extends to Government bonds if they default on promises.

Counterparty Risk

The risk that the guarantee provided by the financial institution will not hold as they default.

Target Return Risk

The risk that the investment value won’t equate to the required funding objective at a particular time in the future, for example a savings plan required to deliver funds to cover children’s university bills.

5.11.3 Guarantees

Are there any guarantees on returns, on:

- Income?
- Capital?
- Capital growth?

If there are guarantees, who is offering the guarantee and what is the value of such a guarantee from such a provider?

5.11.4 Investment Term

Has the product a particular minimum investment term for which the investment must be held or is recommended to be held?

Some products may offer particular benefits, for example, a guarantee, if retained for a particular term or terms.

5.11.5 Taxation

How are investment returns taxed in the hands of the investor? Are there any tax benefits attached to 1 product?

5.11.6 Access to Funds (Liquidity)

Is there access at all times to part or all of the investment? Do any potential penalties apply on part or total encashment?

5.11.7 Charges

What charges apply to the investment:

- Initial charges.
- Recurring charges.
- Early encashment/exit charges.

Do charges vary by the size of the investment, and/or by the length of time the investment is held?

5.11.8 Sustainable Finance Disclosure Regulations (SFDR)

The Sustainable Finance Disclosure (SFDR) forms part of the Sustainable Finance Framework and applies to all financial firms (including financial advisors) since March10th 2022.

The SFDR requires all financial advisors who provide investment advice on packaged retail and insurance based products (PRIPP's) and MIFID products to comply with the SFDR level II.

Specifically financial advisors are required to:

- Consider and factor in sustainability in their advisory process,
- Provide information in accordance with the SFDR both on their website and specifically with each customer at product level (at the pre-contract stage)

Incorporate sustainability investment considerations into their financial fact find. With proactive questions regarding whether the client would like to take sustainable investments into consideration for any potential investment that they might take.

5.12 Suitability Before Comparison

Investment types suitable to the consumer should be determined before comparisons are drawn up. Only then can a recommendation be made of the *most* suitable investment type. The suitability of an investment for a client will be based on their needs and objectives including their attitude to and capacity for investment risk. This will be assessed through a combination of factors:

- Is there a capital guarantee requirement? Is it full capital or part capital?
- Completion of a risk assessment with the consumer.
- Does their choice of investment match the risk assessment and if not, why not?
- Is the consumer able to bear the risk attached to the product?
- Age and health of the consumer.
- Vulnerable consumers should be accounted for under CPC guidelines.
- The adviser should take care that the consumer should not enter into a long-term product unless they will not need the funds until after expiry. Emergency liquid funds should be in place.
- The consumer’s past investment experience.
- The consumer’s current investment portfolio.
- Other financial needs and objectives of the consumer.

5.13 Developing a Recommendation: Comparing Products Available

At this point of the financial planning process, a decision in relation to general product requirements will have been made with the consumer. The assessment of suitability may lead to a recommendation of one investment type or it may lead to an investment portfolio being created, with different products for different needs, for example, a client may have a different attitude towards taking risk on a long-term pension product than on a savings plan for a child’s education.

A comparison of the main investment products might be summarised as follows:

Deposits and State Savings Certs and Bonds

	Deposits with banks/credit unions in the State	State Savings Certs, Bonds and National Solidarity Bonds
Return	Can be either: • Income, that is, interest paid out. • Capital growth, that is, interest accumulated in account.	Capital growth. Savings certs offer a guaranteed return at half yearly anniversaries. Savings bonds and National Solidarity Bonds normally offer guaranteed returns at yearly anniversaries.
Investment risks	Capital secure. Some deposits offer a fixed return over a fixed period. Subject to some investment risks • Inflation risk. • Interest rate risk where it is not fixed. • Default risk by the bank or credit union, over the deposit guarantee protection, that is, €100,000 per individual.	Capital secure. Returns guaranteed by the state. Subject to some investment risks: • Inflation risk as returns are fixed in monetary terms.
Investment term	Fixed terms on term accounts only.	Varies with the products from three-year bonds to 10-year bonds.
Taxation	Deposit interest is subject to DIRT at 33%. No USC. Gross interest subject to PRSI for Class S or when the holder's investment income exceeds €5,000 per annum. Over 65s or individuals who are permanently incapacitated can apply for DIRT exemption.	Tax-free returns. No DIRT, USC or PRSI on returns.
Access	Varies by the notice period or term, if applicable. Some notice accounts may offer periodic partial withdrawals during the term. Penalties will generally apply to early encashment of fixed term or notice deposits.	Seven working days' notice.
Charges	No explicit charges. A breakage penalty may apply as above.	No explicit charges. Returns are scaled to provide higher returns for longer terms.

Comparison of listed shares and bonds as an investment

	Shares listed on a Stock Exchange	Bonds listed on a stock exchange
Return	Can be a combination of: • Dividend income, but some companies don't always pay dividends and • Capital growth.	Provide a fixed income return for the duration of the bond. Provide a guaranteed capital payment of the nominal value of the bond at maturity.
Investment risks	Ordinary shares carry no guarantees. Shares may be subject to: • Market risk. • Specific risk. • Currency risk. • Inflation risk although shares in the long term offer the best protection against inflation risk.	• No guarantee on capital value if the bond is sold before maturity. • If the bond is purchased above par (its nominal value), then capital loss is guaranteed at maturity. • Bond issuer default risk. • Interest rate risk. An increase in interest rates usually cause bond values to fall. • Inflation risk as returns are usually fixed in monetary terms. • Currency risk if in non-euro currency.
Investment term	No fixed investment term.	Varies from a few months to up to 15 years and more.
Taxation	Dividends from Irish resident companies subject to dividend withholding tax (DWT) at source. Dividends from foreign companies may be subject to a local withholding tax. Investor liable to income tax, USC and PRSI (Class S and others whose investment income exceeds €5,000 per annum) with credit for income tax allowed for DWT, if any, deducted at source. Gain is liable to CGT at 33% but can be offset against CGT losses. The first €1,270 of gains in any one year are free from CGT.	Income paid gross liable to income tax, USC, PRSI (Class S and for others whose gross investment income exceeds €5,000 per annum). Gains on Irish treasury bonds are exempt from CGT. Gains from other bonds are liable to CGT at 33% but can be offset against other CGT losses. A loss on one investment can be offset against a gain on another investment.
Access to funds	Very liquid – probably three days.	Very liquid – probably three days.
Charges	1% stamp duty on purchase. Stockbrokers commission on purchase and sale.	Stockbrokers commission on purchase and sale.

5.14 Comparing Unit Linked bonds and Trackers

A common question is how to compare a unit linked bond with a tracker bond.

We cannot easily compare a unit linked bond with a tracker bond under *risk* because the level of risk is dependent on the bond's underlying asset classes. One bond may be a level three on a risk rating and another a level six.

However, we can compare them under other headings:

	Unit-linked Bonds	Tracker Bonds
Return	Unit-linked bonds will have capital growth only but may offer regular withdrawals to meet an income need.	Capital growth only. There is usually: • A guaranteed minimum return at maturity which tends to be between 85%-100%. • A bonus related to the performance of various stock indices or a basket of shares generally. • A cap on maximum return is common. • Participation rate will not necessarily be 100%, can be lower or higher.
Investment risks	Varies according to the investment objective of the fund or funds which can be in different asset classes, sectors, geographical areas, etc. The risks will vary but come under these headings if they apply: • Market risk. • Specific risk. • Active investment management risk. • Currency risk. • Gearing risk. • Liquidity risk. • Inflation risk although shares traditionally provide the best protection against inflation risk. • Interest rate risk. • Default risk. • Counterparty risk.	May be subject to some of the following investment risks: • Market risk on bonus. • Inflation risk. • Counterparty risk. • Default risk possibly.
Investment term	Usually no fixed investment term. An Investor should have the ability and intention to leave the investment over the longer term, say five years or more, and avoid encashment if there is a short-term decline.	Usually a fixed term typically five years.

	Unit-linked Bonds	Tracker Bonds
Taxation	Funds accumulate tax free (gross roll up). For those established in the State, exit tax of 41% is levied on gains at exit or every eight years (deemed encashment).	Life assurance trackers attract exit tax at 41% on gains and deposit-based trackers 33% DIRT. The same DIRT exemptions apply as with deposits.
Access to funds	Usually within a few working days.	Usually no access until maturity but may be allowed, subject to a penalty.
Charges	Combination of some or all of: • Initial charge. • Encashment charge. • Annual fund charge.	Initial charge being the difference between: • The initial investment amount; and, • The sum of the cost of the derivative/option to provide the bonus and the amount invested to provide the guaranteed capital sum at maturity. Initial charges are therefore already reflected in the bonus terms and capital return promised. 1% stamp duty levy for life assurance tracker bonds only.

5.15 Advising on Investment Needs and Objectives

Advice in relation to savings and investments should be based on a holistic view of the consumer's overall short, medium and long-term needs.

Following a full fact-find, suitability and risk assessment, the Advisor should follow these steps:

- Identify the consumer's needs and objectives and terms of these objectives:
  - The consumer may have an **income objective**, e.g. a third level fund needs to be available in ten years for their eight-year-old.
  - The consumer may have a **lump sum objective**, e.g. they might need a deposit to purchase a house in three years.
  - The consumer may have a **capital growth or capital protection objective**, e.g. they have €50,000 and want to invest it according to their appetite for risk. They may have a specific longer term need for this investment, e.g. early retirement, or they may have no specific objective for the funds.
- Ensure the consumer has an adequate level of **emergency funds** on demand. A consumer should have at least 3 x monthly income in a liquid investment such as a deposit account or other product with access restriction no longer than 7 days. The emergency fund should also be in a capital guaranteed investment product.
- Quantify the level of **income** required for the Consumer's needs and objectives and quantify the capital needed to provide this income.

  AND/OR

- Quantify the **Lump Sum** capital required for the Consumer's needs and objectives.

  AND/OR

- Calculate the future value of the **capital investment**, given a particular growth rate over a specific term.
- Account for inflation rates and investment growth rates in your calculations.

Example

Fact-find:

- Grainne and Andrew, aged 42, are married with two children, twins aged 8. Grainne is a G.P. Doctor and earns €4,100 net per month. Andrew works part time with a community development programme and earns €1,600 net per month.
- Grainne's Uncle has died, and she is due to receive an inheritance of €50,000.
- They recently built their own home and have used all of their savings in order to borrow as little as possible.
- They estimate that third level fees and associated living costs for the children's education will amount to €80,000, in today's money. They wish to have this lump sum available in full in 10 years' time.
- They currently have no regular savings. They can afford to save €1,000 p.m.

Based on the information in the fact-find, answer the following questions:

1. Explain to Grainne and Andrew why you recommend that they have an Emergency fund. Recommend to them how much they should have in this fund, where it should be invested and why.
2. Calculate Grainne's capital acquisitions tax liability from the inheritance due and her net amount available for investment.
3. Taking inflation into account, how much will Grainne and Andrew require in 10 years-time for college fees?
4. Advise Grainne and Andrew how they can achieve their objective to have third level costs in place in 10 years-time.
5. List the two main investment risks associated with a unit linked investment that is non-geared and invested in Eurozone equities.
6. You inform Grainne and Andrew that you will send them a Suitability Statement regarding the investment proposal. Explain why.

Assumptions

- You have carried out a risk assessment and Grainne and Andrew are in the medium to high risk category. They are willing to take risk with their capital in order to potentially achieve a greater return in the long term.
- Inflation of 2% per annum.
- Grainne has received no other gifts or inheritances.
- Investment growth over the longer term is 3% per annum.
- €500 p.m. invested in a unit linked fund at 3% per annum growth will accumulate to €69,870 in ten years.
- The Consumer Protection Code applies.

Example: Workings and Answers

Question 1

An emergency fund is a priority investment need for all consumers who depend substantially on earned income to live on. The fund should be readily available at short notice without financial penalty to meet unexpected expenditure or reduced income. The fund should have total capital security and therefore a deposit account with no longer than 7 days-notice would be suitable.

At least three times their monthly income should be invested, i.e. at least (€5,700 x 3) €17,100.

Question 2

€50,000 Inheritance. Threshold €32,500

€50,000 - €32,500 = €17,500

€17,500 x 33% = **€5,775 CAT due**

€50,000 - €5,775 = **€44,225 available for investment**

Question 3

Compounding tables: 2% per annum over 10 years is €1,219 per €1,000.

€80,000 in ten years @ 2% inflation:

Lump sum required in 10 years: 80 x €1,219 = €97,520

Question 4

1. Using €17,100 as an emergency fund, they may invest the balance of the net inheritance i.e. €27,125 over 10 years. Assuming 3% growth in a unit linked investment as per their risk assessment and agreement, this would result in a fund of:

   €27,125 x 1.344 = €36,456

2. Savings of €500 p.m. in a unit linked plan = €69,870

   €69,870 + €36,456 = €106,326 which will provide for the €97,520 required.

   OR

3. Save the full amount, or more, from their disposable income of €1,000 p.m. in a unit linked fund.

   If they save €1,000 p.m. at 3% growth over 10 years, they will accumulate an estimated €139,740 which will exceed the estimated costs of third level education. The net inheritance, after the emergency fund is deducted, can be invested separately, for their own use.

Question 5

- Market risk
- Specific risk

Question 6

We are obliged, under the Consumer Protection Code, to provide you with a suitability statement which will set out our recommendations to you in relation to your savings and investments plan. We will give our reasons why we are making specific recommendations that will match our understanding of your needs, objectives, affordability, and risk assessment.

5.16 Investing for Income

The majority of investment products generally available in the market place are orientated or designed primarily for capital growth.

Some consumers may have a need to generate income immediately from their investments, for example:

- A retired consumer on an inadequate pension who wants to supplement his pension by drawing on his investments.
- A consumer who has been made redundant and has received a termination payment. If the consumer does not find work soon, he or she may need to draw on their investment to financially support themselves for a period.
- A consumer who has become permanently disabled as a result of, say, a car crash and who has received a large compensation award. As they cannot work again, they will need income from their investments to meet ongoing medical and day to day expenses.
- A widow with young children who has received a life assurance and pension scheme lump sum payout, following the sudden death of her husband. She will need to take income from her investments to supplement her widow's pension, to financially support her children etc.

These are only some examples of where the immediate investment need may be to generate income from investments, rather than capital growth.

Some products which may be suitable for generating income include:

- Deposits, that is, income paying, although with interest rates low, income is really only generated by gradual withdrawal of the capital sum.
- Shares listed on a stock exchange, which pay out regular dividends.
- Income distributing PRIIPs (for example, unit trusts), that is, who distribute their investment income, usually half yearly, to investors.
- Irish Government bonds, that is, treasury bonds, which pay a yearly income until the bond's maturity.
- There is an interaction with the consumer's taxation position in determining the most suitable product or combination of products for a consumer who may or may not seek income from his or her investments. For an investor under 65, who is using their income tax credits and paying tax at the highest rate, a capital gain may be more preferable at 33%. However, if the investor's income is low or there are unused tax-deductible payments or credits, an investment subject to income tax and USC may be preferable:

Income tax exemption limit 65+	Individuals age 65 and over, whose total income is below the following limit, are exempt from income tax: • Single: €18,000. • Married: €36,000. Marginal relief applies when the income exceeds the income exemption limit but is less than twice the limit; tax is limited to 40% of the excess of the income over the limit.
Standard rate tax band	The level of taxable income subject to tax at the standard rate tax rate: • Single/widowed: €42,000 • Married/civil partners, one income: €51,000 • Married/civil partners, two incomes: €51,000 plus max €33,000.[14] • One-parent family: €46,000.
Tax deductible expenses Medical expenses[15] Covenant payments Cost of employing a carer	May be able to generate taxable investment income to match tax deductible expenses related to caring for a sick or incapacitated relative.

[14] *Maximum €49,000 and max €31,000 for second earner*
[15] *Generally, only deductible at standard rate, except for nursing home expenses which are deductible at marginal rate.*

The following examples illustrate how these taxation features can interact with the choice of investment product to produce investment income:

Example #1

John and Mary are in their late 60s and are both retired. Their only income is John's pension income which amounts to €31,000 per annum. They also have €80,000 to invest.

Their income exemption limit is €36,000 in the 2024 tax year. They are not liable to PRSI as they are over age 66.

They can therefore receive another €5,000 of gross investment income in the 2024 tax year, before becoming liable to income tax.

For example:

- They could invest in a treasury bond and obtain a gross tax-free return.
- They could invest directly in Irish quoted shares and reclaim the dividend withholding tax deducted on the dividend payments.
- They could invest in a deposit account, and, as they are over age 65, the deposit interest would not be liable to DIRT, provided their total income including the deposit interest, did not exceed the income exemption limit.

However, in the case of a treasury bond and shares, the income would be liable to USC, but the deposit interest would not.

On the other hand:

- Investment in a life assurance investment bond/PRIIP would not normally be recommended in such a case as the exit tax deducted within the fund could not be reclaimed by John and Mary, even though they are non-taxpayers. However, this income would not be subject to USC.

John and Mary could obtain a tax-free income return of, say, 3% per annum, by, say, investing about €80,000 in a medium dated treasury bond as the income from it would not be subject to DIRT, and the income produced, say 3% x €80,000 = €2,400 per annum, would, when added to their other pension income of €31,000 per annum, be under the income exemption limit of €36,000. However, this income would be subject to USC.

Example #2

Fiona is aged 52 and is financially supporting her elderly mother who requires full-time care.

Fiona is a higher rate taxpayer and is entitled to an annual deduction of about €35,000 per annum related to employing a carer to look after her elderly mother and paying for some of her medical expenses.

Fiona has accumulated savings and investments, which have been invested in capital growth investment products.

Fiona could alter her investment portfolio to invest some of her funds in higher yielding shares and/or corporate bonds, which would produce higher levels of taxable investment income which could be offset against the tax deductible medical and care expenses.

Please note that the above examples concentrated only on the different taxation treatment of investment income and note that the impact of personal tax credits and reliefs has been ignored, for the sake of simplicity.

Other issues related to the choice of investment product, for example, the risk inherent in the product, the consumer's attitude to risk, etc. were also ignored for the sake of clarity on the taxation differences of the various products.

5.17 Comparing Fund Performance

5.17.1 Past Performance League Tables

In choosing which collective investment fund or funds to invest in, advisers and consumers alike frequently look at *past performance tables*, often compiled by product providers or published in newspapers, etc.

Advisers and consumers alike will frequently be swayed by good immediate past performance of particular funds. Clients and advisers are naturally more drawn to;

- Funds that have performed well, both in absolute and relative terms, in the past, particularly in the very recent past.

- Fund managers and product providers that have a number of funds which appear to have performed well in the past, particularly in the very recent past.

This is despite the usual warning ... *past performance may not be a reliable guide to future performance*.

However, the practice of using fund past performance tables, showing only unit growth, as a means of choosing an actively managed fund is potentially unsafe as a significant amount of research indicates that there is no definite and lasting connection between a fund's past relative performance and its likely long-term future relative performance.

5.17.1.1 Predicting Future Returns

Past performance tables are positively dangerous as a basis of predicting or indicating the level of absolute return a fund may produce in the future. For example, just because a fund produced a return of 10% last year is no guarantee or indication that the fund will produce a return of 10% this year.

A fund's future investment performance will be dictated by a combination of factors:

- The fund's investment strategy, for example, actively managed or passively managed.

- Future economic conditions, which will determine movements in the stock markets. No one can predict these in advance.

- The costs and charges incurred by the fund, for example, the level of fund management charge.

- The fund manager's skills, where the fund is being actively managed.

- Luck!

As none of these factors is directly related to what has happened in the past, the past absolute performance of a fund is no indication as to its absolute future return.

However, it is valid to indicate that past returns produced by certain asset types, for example, equities and property, have tended to outperform in relative terms returns from deposits, provided the higher risk attached to such investments is also highlighted at the same time.

5.17.1.2 Recommending a Fund

As past performance is no guide to future returns, the adviser should recommend a fund or funds for a consumer whose investment objectives and associated risk profile best matches the consumer's financial needs and attitude to risk, at the lowest cost to the investor. This would include the Investor's time horizon for the investment, i.e. risk assets should only be considered when the individual can invest over the longer term.

The fund's risk profile will be dictated by the fund's investment policy or mandate, that is, what objective is being set for the fund manager. Is the fund designed for capital growth or income? Will it be actively or passively managed? What level of risk is the fund allowed to take to achieve its objectives?

As pointed out already, the most important factor which impacts on the performance of a Managed Fund is the *asset allocation* chosen by the fund manager, that is, the split of the fund between the four main asset classes, that is, cash, bonds, property and equities.

Therefore, in recommending a managed or mixed fund for a consumer, where such a fund is appropriate for the consumer's needs, it is important to choose a fund whose investment mandate and asset allocation best matches the consumer's needs and attitude to risk.

For example, each of the following funds might be described as being a *managed* fund:

Fund	Percentage in cash	Percentage in bonds	Percentage in property	Percentage in equities
A	10%	25%	25%	40%
B	5%	10%	10%	75%
C	5%	25%	20%	50%

In the above example, while Funds A and B might both be described as being 'managed' funds, they are very different funds; Fund A has 40% in equities, but Fund B has 75%. Fund B is likely to be more volatile than Fund A.

The level of asset allocation is also important when considering the past performance of competing managed funds; it is more likely that varying asset allocations will determine relative performance rather than the skill of the investment manager in picking the individual stocks to invest in.

Some managers may ascribe different labels such as balanced, aggressively managed, cautiously managed, etc., to a managed fund to attempt to describe the asset allocation policy of the particular managed fund, which are usually based on a varying allocation to equities.

When considering a managed or mixed fund, therefore, it is important to:

- Check the investment mandate or objective of the fund? Has the fund a particular investment objective? Is such an objective consistent with the consumer's attitude to and capacity for investment risk?

- Check if the fund has a published risk rating either from the fund provider itself and/or from a third party? How does the provider describe the risk profile of the fund?

- Ascertain the current asset allocation policy for the fund.

Some funds may have a defined benchmark asset allocation, against which the investment managers are allowed to vary to a limited extent. For example, a fund manager may have set a benchmark asset allocation of 60% equities, 20% bonds, and 20% property as being the optimum long-term asset allocation to produce good returns with an acceptable level of volatility. The fund manager may vary from this allocation from time to time, as investment conditions change, but this is the long term split of the fund.

Other funds may not have a defined asset allocation; rather it being left up to the fund managers to vary from time to time as they see fit. However, the problem with this approach is that the fund managers may not actually be able to make large scale changes in the asset allocation, for example, may not be able to dump a large volume of, say, Irish equities within a short time. Therefore, the asset allocation of such funds may change rather slowly and may become unduly influenced by the asset allocation of other competing managed funds, that is, a fund manager does not want to get too much out of line with competing funds, in order that the fund’s performance will not substantially under perform its competitors.

- Will the fund be regularly rebalanced so that its asset allocation and hence risk rating may not drift away from current levels over time?

- Only recommend a fund to consumers where the current asset allocation policy of the fund closely matches the consumer’s attitude to risk.

  For example, a managed fund that is, say, 75% invested in equities is in reality likely to display a level of volatility much like an equity fund. If an equity fund was considered to be too risky for a particular consumer, due to its potential volatility, is a managed fund with 75% invested in equities suitable for this consumer?

- The customer’s time horizon.

All other things being equal, recommend the fund with the lowest level of annual fund charge.

5.18 Savings Plans Comparisons

Savings plans can be compared under a number of different headings:

Investment type	Investment risks	Savings term	Taxation
Access	Other benefits?	Charges	Minimum/maximum savings

Investment Type

The main alternatives are:

- *Deposits*, including National Instalment Savings; and,
- *Investment plans*, linked to unitised investment funds, for example, a unit-linked fund or unit trust.

Investment Risks

The investment risks attached to the product would be similar to the risks for the same investment types outlined earlier for lump sum investments.

Savings Term

Has the plan a fixed-savings term at the end of which savings cease, or is it open ended?

Taxation

How are returns taxed? Are there any tax benefits attached to the product?

Access to Funds

Is there access to part or all of the accumulated savings? Do any potential penalties apply on part or total encashment?

Other Benefits

Are there any other benefits attaching to the plan?

Charges

What charges apply to the investment:

- Initial charges, for example, bid/offer spread.
- Recurring charges, for example, fund charges.
- Early encashment/termination charges.

Are charges generally front ended or spread?

Do charges vary by the size of the investment, and/or by the length of time the investment is held?

One way of comparing the impact of charges is to look at the respective reduction in yields (RIYs) based on the same assumptions, regarding savings amount, savings term and investment assumption.

Maximum/Minimum Savings

Some products may limit the maximum amount which can be contributed to the plan and/or specify a minimum savings amount.

A comparison of the main savings plans might be summarised as follows:

Investment Risks	
Deposits	Capital secure. Some deposits may offer a guaranteed return over a fixed period. Subject to some investment risks: • Inflation risk. • Interest rate risk, where interest rate is not fixed. • Default risk. However, deposit guarantee scheme protects 100% of deposits with banks operating in Ireland, up to a maximum of €100,000.
National instalment savings	Capital secure; guaranteed by the State. Subject to some investment risks: • Inflation risk, as returns are fixed in monetary terms.
SAYE (that is, savings related share option scheme)	As for deposits, until accumulated funds are used to purchase shares under share option scheme. However, option does not have to be exercised. Fixed deposit rate applies to deposit part. If option exercised, the shares usually carry no guarantees on dividend payments or capital value. Shares subject to following risks: • Specific risk. • Currency risk, if denominated in non-Euro currency. • Inflation risk. However, traditionally shares have, over the long term, offered the best protection against inflation. • Liquidity risk.
PRIIPs (for example, life assurance savings plans and unit trusts)	Varies according to the investment objective of the fund or funds the investor invests in. Most products offer a choice of different fund types, for example, funds investing in particular asset types, sectors, and/or geographical areas, as well as managed or mixed asset type funds. Depending on the fund or funds invested in, investment may be subject to some investment risks: • Market risk. • Currency risk, in relation to any non-Euro assets held by fund. • Inflation risk. However, traditionally shares and property have, over the long term, offered the best protection against inflation. • Interest rate risk. • Default risk.

Investment Term	
Deposits	Deposit accounts can be on demand, have a notice period or have a specific term. .
National instalment savings	12-month savings term. May be left to accumulate at fixed rates for another five years after the end of the savings term.
SAYE (that is, savings related share option scheme)	Deposit savings part has minimum savings term of either three or five years. If five-year savings term is chosen, funds can be left for a further two years in the deposit account, that is, up to seven years in total. After shares are acquired, there is no minimum hold period thereafter.
PRIIPs	Usually no fixed investment term. Due to nature of charges which can be imposed (particularly plans with front ended charges) and potential volatility of fund returns, most providers recommend a minimum savings term of at least 10 years.

Taxation	
Deposits	Deposit interest is subject to DIRT at 33%. Some individual investors may not be liable to DIRT that is, an individual who is, or whose spouse is: • Over 65; or, • Permanently incapacitated. AND not otherwise liable to tax on the deposit interest, subject to completing a declaration. No USC. Gross deposit interest subject to PRSI for Class S and for others whose gross investment income is more than €5,000 per annum.
National instalment savings	Tax-free returns. Not liable to DIRT, PRSI or USC.
SAYE (that is, savings related share option scheme)	Interest added at end of savings period is not subject to DIRT. No income tax on exercise of share option, provided it is not exercised within three years of obtaining option. Any gain realised in exercise of share option is liable to PRSI and USC. Investor liable to income tax on gross dividend, with credit allowed for DWT, if any, deducted at source. Gain is liable to CGT at 33%. However: • The first €1,270 of gains in tax year are free from CGT. • A loss on one investment can be offset against a gain on another investment.
PRIIPs	• Funds accumulate tax free • Exit tax at 41% applies on gains realised on encashment and on deemed encashments every eight years, and on income distributions. • No USC or PRSI.

Access to Funds	
Deposits	Notice and term accounts do not usually allow withdrawals during the notice/term period; some may allow some access subject to a penalty on interest.
National instalment savings	Seven working days' notice.
SAYE (that is, savings related share option scheme)	Funds may be withdrawn from deposit account, but a lower return may then apply. Proceeds of quoted share sale usually available after three working days. However, if shares are not quoted or listed shares, there may be no guaranteed market for the shares.
PRIIPs	Usually within a few working days. Funds usually priced daily. However, property funds frequently retain the right to defer encashment requests for a period, for example, up to six months, in circumstances where there is negative cash flow into the fund and the fund needs to sell properties to raise cash.

Other Benefits	
Deposits	None.
National instalment savings	None.
SAYE (that is, savings related share option scheme)	None.
PRIIPs	Some plans may offer either a fixed amount of 'free' life cover or offer the option to add life cover to the plan, where the cost will be deducted from the plan each month by way of encashment of units.

Charges	
Deposits	No explicit charges. However, a *breakage* penalty in terms of reduced interest may be applied on early withdrawals during some notice or term accounts.
National instalment savings	No explicit charges. However, returns are scaled to produce higher returns the longer the investment is held. Early withdrawal will therefore lead to a lower rate of return than if the investment were held for a longer period.
SAYE (that is, savings related share option scheme)	No explicit charges on deposit part of scheme. Stamp duty may apply on purchase of shares under share option.
PRIIPs	Combination of some or all of: • Bid/offer spread. • Non-allocation period, during which contribution is not used to purchase units. • Monthly policy fee. For example, typically €3~€4 per month. Provider may have an option to increase in line with inflation. • Encashment /termination charge. • Annual fund charge. Depending on the nature of the charges, plans will usually be of the: • Front end charge type; or, • Spread charge type.

Minimum/maximum Savings	
Deposits	None generally.
National instalment savings	Minimum €25 per month, maximum €1,000 per month.
SAYE (that is, savings related share option scheme)	Minimum contribution to savings scheme of €12 per month, maximum of €500 per month. However, contribution must be limited to amount likely to be required to purchase the number of shares granted under the share option.
PRIIPs	Usually a minimum of €75 - €125 per month. No maximum usually.

5.18.1 Reduction in Yield (RIY)

One way to compare the potential impact of different charging structures under unitised savings plans is to compare the projected *reduction in yields (RIYs)* over different periods, based on the same contribution level and investment assumption. As set out in Chapter 10.4, the RIY is the term used to describe a means of expressing the impact of all projected charges in a savings or investment product over a period of time, in terms of a reduction in the yield or return that would otherwise have been provided if the policy carried no charges at all. The lower the RIY the better.

A front-loaded charging structure will produce a high RIY in the early years. The spread charge type plan is likely to be more suitable for savers who may stop and start saving, that is, who have a low degree of certainty of being able to maintain the contribution for the full term of the plan. The front-end charge plan, on the other hand, would suit savers who have a high degree of certainty of being able to maintain contributions for the full savings term.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] The main asset classes
- [ ] Factors affecting quoted share prices
- [ ] Employee share incentives
- [ ] Financial maths
- [ ] Comparing fund performance

06

Review: Loans

This chapter will give a brief overview of the QFA Loans module.

Learning Outcomes – after studying this chapter you should be able to:
understand the various types of housing loans;
demonstrate your understanding of the tax reliefs that apply;
compare home loan products under various headings; and,
describe the different types of consumer credit available to individuals.

6.1 Loans as Part of the Financial Planning Process

In relation to client loan needs, the objective is to match, as far as possible, the most appropriate loan products (particularly in relation to term and cost of borrowing) to the client's loan needs and financial resources.

Individuals, throughout their lifecycle, have different loan needs. The size, cost and length of time a loan is granted depends on a number of factors. The most common form of security over a loan is a legal mortgage on a property. A mortgage is not the actual loan, but is the act of conveying the interest in a property to a lender in return for a loan.

Types of Loans

- Housing loans
- Personal consumer credit

6.2 Credit Institutions and Intermediaries

6.2.1 Credit Institutions

Credit Institutions are those that are authorised to provide credit, that is, lenders, such as banks and building societies.

6.2.2 Mortgage Credit Intermediaries

Mortgage credit intermediaries are authorised under the European Union Consumer Mortgage Credit Agreements Regulations, 2016 (CMCAR) to:

- Present or offer credit agreements to consumers.
- Assist consumers by undertaking preparatory work or other pre-contractual administration in respect of credit agreements.

Mortgage credit intermediaries may also be authorised to provide advisory services, that is, the provision of personal recommendations to a consumer in respect of transactions relating to credit agreements.

6.2.3 Credit Intermediaries

Credit intermediaries arrange certain other forms of consumer credit for consumers, for example, a garage who arranges car finance or a shop arranging goods for sale on hire purchase agreements. The CCPC (Competition and Consumer Protection Commission) has responsibility for the regulation of credit intermediaries and also monitors complaints in relation to the advertising of credit, jointly with the Central Bank of Ireland under the Consumer Credit Act, 1995.

6.2.4 Credit Servicing Firms

These are firms that manage or administer credit agreements such as mortgages or other loans on behalf of unregulated entities, for example, when a bank sells a loan book to a vulture fund. They must apply for authorisation to the Central Bank of Ireland.

6.3 Housing Loans

A *housing loan* is defined in the Consumer Credit Act as covering loans provided to a person on the security of a residential property, whether or not it is that person's principal private residence.

6.3.1 Security

Housing loan lenders require legal security for loans advanced. This security can come in many different forms:

- A legal mortgage over the property in question. This is often referred to as the prime security.

- A personal guarantee by a third party to make the loan repayments, if the borrower defaults on making repayments. This guarantee is sometimes referred to as collateral security, that is, additional to the prime security of a legal mortgage on the property.

- Insurance, which is also sometimes referred to as collateral security. In some cases, the insurance is effected and paid by the borrower (for example, mortgage protection), while in other cases the insurance is effected and paid directly by the lender, for example, mortgage indemnity guarantee insurance.

Whilst the legal mortgage is the prime security for a housing loan, the prime consideration in assessing a housing loan application is the income capacity of the borrower to fund future loan repayments. The forms of security previously listed are fall backs, that is, to be called on if the borrower becomes unable or unwilling to make any further repayments. Housing loan lenders would ideally hope not to have to enforce or claim on any of the other forms of security listed above.

Therefore, lenders exercise considerable effort in underwriting housing loan applications in order to ensure, as far as can reasonably be predicted, that the applicant will be able to afford to make the repayments for the level of loan granted to him or her for the expected duration of the loan.

6.3.2 The Mortgage Process

The component parts of the mortgage process are:

- The consumer makes an initial loan enquiry with a bank or through a mortgage credit intermediary. The mortgage adviser completes a fact-find, assesses their needs and objectives and advises whether these objectives are within the Central Bank’s limits and the bank’s criteria.

- The mortgage adviser outlines the loan process, costs, and documentation required to process a loan application.

- The consumer receives an Approval in Principle (AIP) from the mortgage provider and finds a suitable property.

- The consumer and mortgage adviser complete a mortgage application and submit it to the mortgage provider with the supporting documentation.

- The consumer appoints a Solicitor to carry out the conveyancing and investigation of the property title.

- The mortgage adviser and consumer meet to review loan needs and decide on a loan product. The mortgage adviser issues a mortgage suitability statement to the consumer.

- The consumer arranges home insurance and life cover as required by the terms of the mortgage. Legal assignments are taken where required by the mortgage provider.

- The formal loan offer pack is issued to the Solicitor. The Solicitor and consumer meet to sign the loan offer.

- The Solicitor requests the loan cheque from the lender and certifies the title of the property. The Solicitor closes the purchase.

6.3.3 Taxation and Reliefs in Relation to Housing Loans

- The *Help to Buy* incentive is designed to help first-time buyers to fund their deposit. A first-time buyer who buys a new house or apartment, or builds their own home, can get a refund of income tax and DIRT paid over the previous four years. The amount that can be claimed is the lesser of €30,000 or 10% of the purchase price or the value of the self-build on completion To qualify the borrowers must obtain a mortgage of at least 70% of the purchase price. The maximum property value allowed is €500,000.

- Mortgage interest relief was re-introduced in the 2023 finance bill for homeowners who had an outstanding mortgage balance of between €80,000 and €500,000 on their primary home on 31 December 2022. Relief will be available on the increased interest paid on a mortgage in 2023 when compared with the amount paid in 2022. The tax relief on the increase will be at 20%, the standard income tax rate. The relief will be capped at €1,250.

- Purchasers of property must pay stamp duty. For residential property up to a value of €1 million, the rate is 1% and is 2% thereafter. Non-residential property incurs stamp duty of 7.5%.

- Capital gains only apply to properties other than the principal private residence.

- Rent a room relief allows individuals to earn up to €14,000 per annum in income, tax-free, from renting out a room or rooms in their sole or main residence in the State, to be used for residential purposes. An important point to note is that if the gross income exceeds this amount, the entire amount is then subject to income tax, as rental income.

- Tax relief on rental income: Where a borrower takes a loan to purchase a property for investment purposes they can offset 100% of the interest accruing on such a loan against rental income from the same property for income tax purposes.

6.3.4 Central Bank Lending Regulations

The regulations apply to the purchase of residential property by:

- First-time buyers (in the case of joint loan, both parties must not have owned property before).

- Non-first-time buyers.

- Investors.

They do not apply to:

- Switcher mortgages or refinancing.

- Housing loans arranged to address arrears.

- Negative equity borrowers.

There are three principal tests covered by the Regulations:

1. **Loan-to-value (LTV) limits**. The LTV limits under Central Bank regulations are 90% maximum for a buyer borrowing for their PDH or 70% for an investor. Lenders may impose stricter limits other than these maximum limits recommended by the Central Bank. Lenders may also breach the limits by up to 15% of the total aggregate monetary amount of their loans advanced in one year to buyers of their PDH.

2. **Affordability: loan-to-income (LTI) limits**. Under Central Bank regulations, mortgages on a PDH are subject to maximum income multiples. The borrowing limit is generally 3.5 times gross income which can be combined incomes for a joint mortgage. This limit is increased to 4 times for first time buyers. Lenders generally apply more prudent practices in addition and assess affordability further by applying an NDI test (net disposable income). Lenders will also generally assess the likelihood of higher future income, in addition to current income. Note that this test does not apply to Investor mortgages.

   Each lender will apply their own criteria for when they will, and why they will, lend outside of these two standard Central Bank rules.

3. **Stress tests**. The Consumer Protection Code requires lenders, in the case of all mortgage products provided to personal consumers, to carry out a stress test on future affordability on all housing loan applications, unless the interest rate is fixed for five years or more. A stress test increases the current available interest rate by an additional 2% to assess whether the applicants can afford the additional repayments in the event of interest rate increases. They must have proven repayment capacity that meets this test, e.g. their bank statements must show that they are currently paying out at least this figure between rent and savings and perhaps loans due to be cleared.

Example

Kate and Ed are first time buyers and want to know the maximum property price they might be able to purchase, under Central Bank guidelines. They earn €80,000pa jointly.

Their maximum loan to income is €320,000.

Their loan to value maximum is 90%.

The maximum purchase price is €320,000/.9 = €355,555

6.3.5 Upfront Costs Involved in Buying Property

- Loan application fee – often charged by mortgage intermediaries;
- Valuation fee;
- Structural survey;
- Acceptance fee;
- Stamp duty;
- Solicitor’s fees;
- Legal outlay, e.g. land registry fees.

6.3.6 Insurances

In addition to the life assurance need to clear the mortgage debt on death, which has been detailed in the chapter reviewing life assurance, household insurance is required in the event of damage or destruction to the property. Insurance companies will primarily have two main payouts; the rebuild cost and the cost of contents. Homeowners may add on specific risks such as theft of specific items.

6.3.7 Compiling a Mortgage Application and Supporting Documentation

6.3.7.1 Collecting Client Information

In relation to housing loans, the key fact-finding information is collected by:

- The mortgage lender in the form of the loan application form; and/or

- The mortgage intermediary / mortgage credit intermediary, who may have their own generic loan application form which may be acceptable to a number of lenders as a preliminary basis of determining whether that lender is prepared to make a loan offer to that applicant.

In general, such application forms are designed to seek the following common information about the borrower and their financial situation:

- Personal and financial information, as in a general fact-find

- Credit history of applicants

- Details of all bank accounts

- The breakdown of their income, e.g. salary, overtime, bonuses

- Details of the property to be purchased

- Details of the type and amount of housing loan being sought

- Details of their Solicitor

- Declaration **signed** by applicants

6.3.7.2 Compiling Supporting Documentation

- Anti-money laundering documents

- Proof of earnings

- Six-month bank statements or other loan statements

- Twelve-month credit card statements

6.3.7.3 Approval in Principle (AIP)

Some lenders, prior to issuing a formal letter of offer, may indicate *approval in principle,* or *pre-loan approval* where the lender is (and subject to many caveats) prepared in principle to advance a certain level of loan to the applicant. This AIP can last from three to 10 months depending on the lender.

Approval in principle is normally used by borrowers to:

- Assess how much they can afford to borrow.
- Understand the documents they will need to gather and will require for full loan approval.
- Enable them to place a booking deposit on a property (within a price range) before seeking full loan approval.

Many borrowers, especially first-time buyers, find that obtaining approval in principle gives them peace of mind and helps them focus on properties within their price range.

When the right property comes along, the ability to provide an approval in principle to the vendor/estate agent helps speed up the negotiations. This is particularly important in a rising property market.

6.3.7.4 Loan Offer

Once a borrower has found a property and the loan is formally approved by the lender, the loan offer is issued. The borrower's solicitor is required to finalise their part of the conveyancing process. The solicitor must carry out a review of the loan offer and complete the related legal work.

The solicitor provides the lending institution with an undertaking that the legal work will be completed to enable the property and mortgage process to enter into the completion stage (also known as closing).

Example – Mortgage Process

Fact-find:

- Matt, aged 46, and Tim, aged 40, are married.
- Matt is an I.T. Consultant and earns €65,000 per annum. Tim is a teacher and earns €45,000 per annum.
- They are currently renting a property costing €1,800 p.m. and now wish to purchase their own home.
- They are first time buyers and wish to have the debt cleared by age 65.
- They have €50,000 in a deposit account and regularly save €1,200 p.m.

Based on the information provided in the fact-find, answer the following questions:

1. Advise Matt and Tim how much they can borrow under Central Bank guidelines, and the maximum purchase price of a property allowed within these guidelines. Show your calculations.
2. Matt and Tim wish to buy a property and progress with a mortgage application. Explain the mortgage process and list the documents they will need to provide.
3. Inform them of the costs involved in buying property and insurances that will be required before they can draw on the housing loan.

Assumptions

- The variable interest rate is 2.75% per annum.
- The borrowing cost per thousand at 4.75% over 19 years is €6.64 p.m.
- They are both in full-time employment.
- They wish to maintain the repayments over the longest term possible.
- You are a Mortgage Officer in ABC Bank where they are seeking advice.

Example – Mortgage Process: Workings and Answers

Question 1

There are three principal tests covered by the Regulations:

1. Affordability or Loan-to-income limits (LTI):

The borrowing limit is 4 times gross joint income.

(€65,000 + €45,000) x 4 = €110,000 x 4 = €440,000

2. Loan-to-value limits (LTV):

The maximum they can borrow is 90% of the property value

The maximum property value/purchase price is €440,000/.9 = €488,888

3. Stress tests:

A stress test increases the current available interest rate by an additional 2% to assess whether the applicants can afford the additional repayment in the event of interest rate increases. They must have proven repayment capacity that meets this test, e.g. their bank statements must show that they are currently paying out at least this figure between rent and savings and perhaps loans due to be cleared.

Variable rate 2.75% plus 2% = 4.75%

Cost per thousand over 19 years at 4.75% = €6.64 p.m.

€6.64 x 440 = €2,921.60 p.m.

As they are paying €3,000 p.m. between savings and rent, they have proven repayment capacity for the maximum borrowing of €440,000.

Question 2

Application: An application is completed which forms the basis of the fact-find. The following information is included:

- Personal and financial information, as in a general fact-find;
- Credit history of applicants;
- Details of all bank accounts;
- The breakdown of their income, e.g. salary, overtime, bonuses;
- Details of the property to be purchased;
- Details of the type and amount of housing loan being sought;
- Details of their Solicitor;
- Declaration signed by applicants.

Supporting documentation:

- Anti-money laundering documents;
- Proof of earnings;
- Six-month bank statements or other loan statements;
- Twelve-month credit card statements.

Once an **Approval in Principle** is received, they may put an offer on the property.

A **valuation** on the property must be obtained.

They will receive a **suitability statement** outlining the reasons why the mortgage product applied for is the most suitable to them.

The lender will complete the **underwriting process** by checking the accuracy of the information sent.

The **Solicitor will receive the Loan Offer pack** and will complete the conveyancing process.

Question 3

The costs involved in buying their property include:

- Valuation fee;
- Structural survey;
- Solicitor's fees;
- Stamp duty;
- Legal outlay, e.g. land registry fees.

Life assurance will be required on both lives to clear the mortgage debt in the event of death of either Matt or Tim.

House Insurance is required in the event of damage or destruction to the property.

6.3.8 Comparing Housing Loans

Housing loans can be compared under a number of headings:

Interest rate	Capital repayment	Risks	Repayment term
Penalties and charges	Affordability/cost	Flexibility minimum/maximum savings	

Method of Repayment of Capital

The main methods of repayment of capital are:

- Annuity, or capital and interest mortgage, where level monthly repayments are made consisting partly of interest on the outstanding capital and partly a repayment of the capital.
- Interest only, where the mortgage is repaid in one bullet repayment:
  - Through the accumulation of a lump sum in a life assurance savings policy. This type of mortgage is usually referred to as an *endowment mortgage* or an *interest only mortgage*, that is, only interest is paid to the lending institution during the course of the mortgage term. This method is increasingly less common in recent times.
  - From the lump sum entitlement of the borrower under a pension arrangement, for example, a personal pension plan or PRSA. This type of mortgage is usually referred to as a *pension mortgage* or an *interest only mortgage*, that is, only interest is paid to the lending institution during the course of the mortgage term. This method is increasingly less common in recent times.
  - The sale of the underlying asset (for example a property investment).

Interest Rate

The main options usually offered to the borrower with regard to the payment of the interest on a housing loan are:

- Variable rate (generally called the *standard variable rate*), where the interest rate can be varied by the lender and hence will move up and down in line with interest rates generally. Sometimes a lender may offer a *discounted variable rate* where the interest rate is discounted for a period for new mortgage holders.

- Fixed rate, where the rate is fixed for a particular period, for example, three or five years. An early redemption fee can be applied if the loan is repaid within this period. At the end of the period it will revert to the variable rate then ruling or the borrower can opt for a new fixed rate at the fixed rates then ruling at that time.

- Tracker variable rate, where the rate is linked to ECB interest rates. These are no longer available in the market, and existing mortgage holders who are on a tracker rate need to consider if they should switch, given the rise in ECB interest rates.

Risks and Rewards

Is there a risk of not repaying the mortgage by the end of the mortgage term? This is a particular issue for interest only mortgages, where the borrower may run a risk of not having the necessary lump sum to repay the mortgage in one lump sum at the end of the mortgage term.

Risks and rewards when choosing a mortgage type:

	Risk	Reward
Variable rate loans	That interest rates will increase from current levels and hence increase the borrower's repayments.	Interest rates may fall from current levels and hence reduce the borrower's repayments.
Fixed rate loans	• That the fixed rate will exceed the variable rate over the fixed rate period. • That the borrower may want to redeem the loan early or make a partial payment, within the fixed rate period which may result in a penalty. • That the variable or fixed rate applying at the end of the fixed rate period will be higher than the initial fixed rate.	• The fixed rate could save the borrower money if the variable rate over the fixed rate period was higher. • Protects the borrower against market volatility and provides certainty of the cost of monthly repayments, which enables the borrower to budget.
All housing loans	• That the borrower could become unable to repay the loan and go into arrears, possibly resulting in repossession. • That the value of the property falls, leading to negative equity.	• Property values could increase substantially and so lead to considerable growth in equity.

Repayment Term

Issues here include:

- The longer the term, the lower the monthly repayments. This needs to be balanced against the fact that the longer the term of the mortgage, the higher the total repayments will be.

- The maximum mortgage term. This can be relevant in the case of pension mortgages where the borrower cannot get access to their lump sum entitlement under their pension arrangement until retirement age, which might not be until 60 or 65.

Penalties and Charges

The charges and penalties which might be levied:

- When applying for and obtaining the mortgage.

- On partial or total early repayment of the capital borrowed, during the term of the mortgage? For example, fixed rate mortgages.

Affordability/Cost

The main ways of comparing the cost are:

- Maximum margin over current ECB rate, in the case of tracker mortgages.

- Is the cost fixed or variable?

- The typical APRC (previously referred to as APR) which is the expected annual rate of interest (including costs) payable over the life of the loan.

- Cost per €1,000 borrowed.

- Comparison of gross monthly repayments, either year one cost and/or average monthly cost.

- Comparison of net monthly repayments, that is, after any tax relief, either year one cost and/or average net monthly cost.

Flexibility

Is there flexibility to:

- Make irregular repayments of capital? A consumer might have a surplus lump sum which he or she might want to use to pay off part of the mortgage.

- Vary the term of the mortgage; maybe extend the term to reduce the cost of repayments at a time of financial distress.

- Increase the mortgage amount, for example, where the borrower wants to carry out improvements and needs to borrow additional funds.

- Suspend repayments for a period.

- Change between capital repayment methods, for example, change from endowment back to capital and interest, etc.

- Change between different interest charging structures (for example from fixed to variable, and back again).

- Split the mortgage between different capital repayment methods, for example, part capital and interest and part pension mortgage.

6.3.9 'Interest Only' Loans

Most loans are repaid on the capital and interest mortgage basis, that is, a regular repayment consisting partly of interest on the outstanding loan and partly a repayment of capital.

In some cases, a lender may be prepared to provide a loan on an *interest only* basis, that is, the borrower pays interest on the full loan throughout and undertakes to repay the loan in full in one payment at the end of the loan term for example, from:

- The proceeds of an endowment mortgage savings plan;
- A lump sum entitlement under a pension arrangement; or,
- From the sale of an investment property or other investment assets.

Interest only loans can potentially be a cheaper way of borrowing for some individuals, than a capital and interest loan, if there is a projected positive difference between the:

- The after-tax investment return which can be earned with the funds which would otherwise have been paid to the lender as capital repayments during the loan term, and
- The net cost of borrowing.

Example #1

If I can borrow at, say, 4% per annum, then an interest only mortgage will only make sense if I can be reasonably certain of earning an after-tax return of more than 4% per annum with the funds which I would, under a capital and interest mortgage, have repaid to the lender as capital repayments.

If, for example, I can make a return after tax of 5% per annum with these funds, then I can make a 1% per annum return on these funds which are only costing me 4% per annum to borrow.

But if, for example, I can only make a return after tax of 3% per annum with the funds which I would, under a capital and interest mortgage, have repaid to the lender as capital repayments, then I am making a 1% per annum loss as these funds are costing me 4% per annum to borrow. In this case I would have been better off on a capital and interest mortgage.

A positive gap between the net cost of borrowing and the investment return earned on funds which, under a capital and interest mortgage would have been repaid to the lender as capital repayments, can arise through a combination of circumstances:

- Tax relief on the loan interest which reduces the net cost of borrowing, for example, where borrowings are for commercial purposes, or to purchase a rental property where 100% of interest can be written off against the rental income.
- Tax relief on pension plan contributions used to accumulate a fund to repay the loan in one sum at the end of the loan term.
- Earning a net (after tax and charges) investment return greater than the net cost of borrowing in whatever vehicle is used to accumulate the capital to repay the loan in one sum at the end of the loan term.

However, even if there is a projected positive gap between the projected net investment return and the projected net cost of borrowing, interest only mortgages contain some disadvantages and risks for the borrower:

- The anticipated positive gap may not be obtained, and hence the interest only loan may cost more than the capital and interest loan and/or lead to a shortfall in the sum available to repay the loan at the end of the loan term, due to one or more factors:

- Higher loan interest rates than anticipated.

- Less tax relief than anticipated, for example, reduction in pension tax relief and/or reduction in loan interest tax relief.

- Lower investment returns, after tax and charges, than anticipated.

  If all repayments required from time to time are made under the capital and interest loan, on the other hand, the loan is guaranteed to be repaid in full by the end of the loan term.

- Because the loan will have to be repaid in one sum at the end of the loan term, the borrower is subject to timing risk with whatever vehicle he or she is using to accumulate the capital to repay the loan in one sum at the end of the loan term.

  For example, an individual's pension plan may need to be accessed at a time of depressed investment markets, to provide a lump sum to repay the loan in one sum.

- More expensive level term assurance cover will be required under an interest only loan, as the full loan remains outstanding until the end of the loan term; under a capital and interest loan, less expensive mortgage protection cover is sufficient.

- There is the risk that the borrower may need to repay the loan for some reason, before the time when he or she anticipates having a capital sum available to repay the loan.

- The anticipated savings on the interest only loan over the capital and interest loan, may be available only towards the end of the loan term and it is possible that the loan may be repaid before then, and hence the loan may not last long enough to fully realise the projected savings.

- Where a pension plan is being used to accumulate a lump sum to repay the loan in one sum at the end of the loan term, it may be necessary to fund for a multiple of the loan amount as only a proportion of the pension plan proceeds may be available as a tax-free lump sum to repay the loan at retirement. This will mean a significantly increased gross and net outlay over the loan term than that which would have applied under a capital and interest loan.

Example #2

John is self-employed and is borrowing €200,000 on an interest only basis. He aims to repay the €200,000 in 15 years' time at age 60, with a lump sum from a personal pension plan.

To repay the full loan only from his tax-free lump sum entitlement would require his pension to accumulate to €200,000 x 4 = **€800,000** in 15 years' time.

To repay the full loan with a combination of his 25% lump sum entitlement, which is assumed to be tax free, and taking the balance as a taxable lump sum from his pension, would require (assuming a marginal tax rate of 40% + 8% USC +4% PRSI) a total fund of circa **€327,869**Tax-free lump sum: €327,869 x 25% = **€81,967.25**

Taxable lump sum: €327,869 - €81,967.25 = €245,901.75

Net lump sum: €245,901.75 - 48% (Tax & USC &PRSI) =**€118,032.84**Total sum available for loan repayment = €81,967.25 + €118,032.84 = **€200,000**

6.3.10 Paying Off a Loan

A housing loan is the reverse of an investment; instead of somebody paying the investor a return, the borrower must pay a *return* to the lending institution, in the form of interest.

6.3.10.1 Repayment of a Loan

It is not uncommon to find consumers who have both a mortgage outstanding and capital investments of an amount greater than the mortgage, so that the consumer could pay off the mortgage if they wanted to.

This could arise in situations such as:

- A consumer with an old mortgage, where the amount outstanding is now relatively small, and the consumer has accumulated savings greater than this amount.
- A consumer who receives an inheritance.
- A consumer who receives a windfall payment, for example, lottery win, compensation award, sale of some asset, etc.
- A consumer who has managed to accumulate substantial capital from savings.

Where someone has an outstanding mortgage and a lump sum of a greater amount available for investment, you should consider whether the lump sum should be *invested* in paying off part or all of the mortgage, as opposed to being invested in some other investment opportunity. By paying off the mortgage, the borrower earns a return equal to the net cost of borrowing, by releasing the borrower from the obligation to continue making repayments on the loan.

There are five important factors to be considered, when considering whether the consumer would be better off paying off the mortgage with the lump sum available or investing it and maintaining the mortgage:

- The anticipated net *return* achieved by paying off the mortgage, that is, the net interest saved, compared with the net investment return that could be earned on alternative lump sum investments. Both amounts should be looked at, net of tax.
- Will the consumer be subject to a redemption penalty by the lender if he repays the mortgage early, for example, the early repayment of a fixed rate mortgage?

- The consumer's liquidity position. If the lump sum represents the consumer's only substantial available capital sum, it may be more appropriate for the consumer to retain access to this lump sum or at least to part of it, rather than use it totally to pay off the mortgage and then have no access to a capital lump sum, without having to borrow again, in the event of an emergency.

- The consumer's attitude to borrowings. Many consumers want to clear the mortgage from the family home as soon as possible, regardless of whether it makes financial sense to do so. A mortgage free home gives people a greater sense of security.

- The size of the lump sum, compared with the mortgage, will influence decisions.

Example #1

Joe is married and has just inherited €35,000 from his mother, free of inheritance tax. He has an outstanding domestic mortgage of €25,000 at a standard variable rate of 3% per annum. He is no longer entitled to mortgage interest tax relief. So, his net cost of borrowing currently is 3% per annum.

He has other savings and investments of €14,000, mainly in deposits.

Assume that the best medium-term risk free and tax-free investment return that Joe could currently earn with the €35,000 would be 0.98% per annum, with the 24th Issue Savings Certificates, if held for the full five-year term.

So, investing €25,000 of the inheritance by paying off the mortgage would earn Joe a higher return than that if invested in Savings Certificates (3% versus 0.98%) per annum. Of course, Joe could earn a potentially higher return in other risk assets, for example, by investing in equities or unit funds, etc, but in return for a greater level of risk.

Against this, if Joe uses the €25,000 of the inheritance to pay off the mortgage, he will lose access to these funds. However, he has €14,000 of savings and investments already and €10,000 of the inheritance, and so has reasonable liquidity.

In this case it would seem to make financial sense for Joe to pay off the mortgage with €25,000 of the inheritance. However, care should be taken when giving this advice, particularly if the consumer may not be in a position, under central bank rules, to take out a mortgage again, for example, due to stringent repayment capacity rules or interest rate stress tests.

- In other cases, if the consumer is more willing to take a risk with their investments, investing in a risk-based investment is likely over time, to produce a higher investment return than using the lump sum to pay off the mortgage, so that the consumer would be better off, in the longer term, not using these funds to pay off the mortgage.

However, care needs to be taken to ensure that the part or total repayment of a mortgage does not give rise to a penalty payment from the lender, which would apply particularly in the case of a fixed rate mortgage.

Such a penalty could totally change the financial sense of repaying the mortgage, and therefore needs to be allowed for.

The decision to pay off other non-mortgage loans that do not attract tax relief, for example, personal loans, credit card bills, etc. is usually more straightforward, as the net cost of borrowing is usually likely to be substantially in excess of the net investment return that could be earned by investing in other investment opportunities.

Example #2

A personal loan might currently cost 8% per annum or more. Assume the net return on Savings Certificates is 0.98% per annum over five years.

Therefore, paying off the loan at 8% per annum is likely to be a far better option than continuing to pay the loan at 8% per annum, while earning a lower return on funds invested.

However, the question of the consumer's liquidity position must always be considered, for example, will paying off the loans leave the consumer with little or no readily available funds and no access to future credit?

6.3.10.2 Accelerated Mortgage Repayment

Traditionally, a borrower's repayments on a capital and interest mortgage vary with changes in interest rates. So, for example, if interest rates decrease, the borrower's repayments decrease to a level at which the repayments would repay the mortgage within the same term as before.

However, in recent years as mortgage interest rate levels have decreased, some lenders offer the borrower the option to maintain his or her repayments at the level which applied before the mortgage rate reduction. However, only the reduced interest rate is charged to the loan account. Therefore, by paying more than is required to pay off the loan within the original term, the borrower is paying off his mortgage faster, that is, accelerating the repayment of his or her mortgage.

An example will illustrate how this can work.

Example

Joe takes out a €100,000 capital and interest mortgage at 5% per annum over a 20-year term.

The initial annual repayments are €7,846 per annum (mortgage protection has been ignored for simplicity sake).

After three years, the mortgage rate is reduced to 4.5% per annum. The lender advises Joe that his revised annual repayment is now €7,572 per annum. However, the lender also offers Joe the option of maintaining his repayment at €7,846 per annum and thereby pay off his mortgage earlier.

This table shows the comparison of the options:

Year	Reduce repayments		Maintain repayments	
	Payment	Capital O/S at year end	Payment	Capital O/S at year end
1	€7,846	€96,976	€7,846	€96,976
2	€7,846	€93,800	€7,846	€93,800
3	€7,846	€90,466	€7,846	€90,466
4	€7,572	€86,810	€7,846	€86,530
5	€7,572	€82,989	€7,846	€82,418
6	€7,572	€78,996	€7,846	€78,120
7	€7,572	€74,823	€7,846	€73,629
8	€7,572	€70,463	€7,846	€68,935
9	€7,572	€65,906	€7,846	€64,031
10	€7,572	€61,145	€7,846	€58,906
11	€7,572	€56,169	€7,846	€53,550
12	€7,572	€50,969	€7,846	€47,953
13	€7,572	€45,535	€7,846	€42,104
14	€7,572	€39,857	€7,846	€35,993
15	€7,572	€33,923	€7,846	€29,606
16	€7,572	€27,722	€7,846	€22,931
17	€7,572	€21,242	€7,846	€15,957
18	€7,572	€14,471	€7,846	€8,668
19	€7,572	€7,395	€7,846	€1,052
20	€7,572	€0	€1,075	€0

Joe decides to maintain his repayments at €7,846 per annum, when interest rates fall after three years.

So, by opting to maintain the annual repayments at €7,846 per annum that is, Option 2 above, even though the interest rate has been reduced to 4.5% per annum, the borrower in this example:

- Pays some €2,120 extra in repayments; but,
- Pays off the mortgage nearly one year earlier.

The additional annual repayment of €7,846 - €7,572 per annum, that is, just under €23 per month, effectively earns a return equal to the net cost of the borrowing, which could be a good return for that €23 per month savings compared with returns available on other alternatives, for example, National Instalment Savings, deposits, etc., particularly where some or all of the interest is not tax deductible.

Against this it should be remembered that the borrower loses access to the capital paid off by the additional €23 per month savings, in this example, as it is used to reduce his borrowings rather than, in the case of alternative savings vehicles, be available to meet future expenses, for example, the cost of children's education, build up a nest egg, etc.

However, some lenders will allow borrowers who accelerate their mortgage repayments in this manner to borrow against the additional capital paid off, if they need funds in the future.

The option to accelerate the repayment of a mortgage should always be considered where a consumer has surplus funds available for regular savings, without a specific savings objective in mind. However, the potential loss of access to the additional repayments needs to be also taken into account.

6.4 Consumer Credit

Now we will look at other forms of consumer credit outside of housing loans. The term consumer credit refers to a range of different forms of credit agreements provided by credit institutions, credit unions, and retail credit firms to consumers.

6.4.1 Credit Sale Agreements

Where the consumer purchases goods now from a retailer with the aid of a loan provided by a finance company. The loan is arranged for the consumer by the retailer, acting as a credit intermediary. The goods cannot be repossessed if the consumer defaults on the loan repayments. The consumer owns the goods from day one.

6.4.2 Hire Purchase Agreements

Where the consumer agrees to hire goods for a period of time from a finance company. At the end of this period, the consumer will have an option to purchase the goods in question from the finance company, provided the consumer has paid all payments required under the agreement. However, the consumer is not obliged to purchase the goods.

An example of such an arrangement is car finance, where the garage acts as a credit intermediary between a consumer who wants to buy a car but needs finance to do so, and a finance company. The garage sells the car to the finance company for cash. The finance company then enters into a hire purchase agreement with the consumer under which it hires the car to the consumer for an agreed period in return for payments by the consumer to the finance company.

The finance company owns the car, not the consumer, during the hire purchase agreement period. Ownership of the car may pass to the consumer at the end of the agreement, provided all repayments have been made by him or her and the consumer opts to take ownership of the car.

Some hire purchase agreements provide for a balloon or large lump sum payment to be made at the end, in order for ownership of the car to pass to the consumer. Other agreements may have higher level repayments and a nominal €1 payment at the end to obtain ownership of the car.

The garage typically receives a commission from the finance house for acting as a credit intermediary in arranging car finance for the consumer.

6.4.3 Personal Contract Plans

A *personal contract plan* (PCP) is a type of hire-purchase agreement being offered by many car sales companies arranging finance agreements for their customers. Like a hire-purchase agreement the individual does not own the car until the final payment has been made. With a PCP, repayment is broken down into three parts:

- The deposit: the deposit is typically between 10% and 30% of the value of the car, depending on the finance provider. This can be paid either as an upfront payment, or a trade in can be used to offset this.

- Monthly repayments: PCP agreements are usually made for terms between three and five years. PCPs generally have low monthly repayments, which can make them seem more affordable when compared to other forms of finance.

- Guaranteed minimum future value (GMFV): the GMFV is the amount the consumer will have to pay to own the car at the end of the agreement. It is calculated by the finance company and is based on its estimate of the future value of the car at the end of the agreement, for example, three or five years. It takes into account such things as, the type of car, length of agreement, the condition of the car at the end of the agreement and the annual mileage.

At the end of the PCP agreement, there are a number of options available to the consumer;

- Pay a final payment (the GMFV, also known as a *balloon payment*) and keep the car.

- Hand the car back.

- Put the car down as the deposit on another car and enter into another PCP agreement.

There are many conditions attached to each of the above options and the guaranteed value agreed at the beginning of the contract will only hold if a number of terms and conditions have been complied with, such as not exceeding a certain mileage, etc.

A PCP agreement is not a very flexible form of credit as the payments are fixed for the term and it is unlikely that the amount can be changed throughout the term.

6.4.4 Conditional Sale Agreements

Similar to hire purchase, but with one important difference. Under hire purchase agreements, the consumer has an option, but is not under any obligation, to take ownership of the goods in question at the end of the agreement. Under a conditional sale agreement on the other hand, transfer of ownership of the goods from the finance company to the consumer is obligatory when certain conditions of the agreement have been fulfilled, for example, all repayments under the agreement have been made by the consumer.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] Legal security on loans
- [ ] The mortgage process
- [ ] Risks and rewards on mortgage types
- [ ] Consumer credit

07

Assessing Suitability and Making a Recommendation

This chapter brings together the financial planning process and the advice provided by the financial adviser; ensuring the suitability of a product or service for a consumer and making recommendations. The chapter looks at the CPC requirements when assessing the suitability of a product or service. You will learn why affordability is crucial and of its impact on prioritising your strategy. You will learn all elements of the statement of suitability which you will then be able to produce for any product or service, following the first four steps of the financial planning process.

Learning Outcomes – after studying this chapter you should be able to:
understand and demonstrate proficiency in the execution of the five-step financial planning process;
explain how to assess affordability as part of the suitability assessment process;
explain what is meant by prioritising a consumer's financial needs and objectives;
understand the obligations on a financial adviser for recommending the most suitable product and the statement of suitability which must be produced prior to any product recommendation; and,
how to develop a recommendation and be able to construct a statement of suitability.

7.1 The Financial Planning Process

In Chapter 1 we dealt with the fact-finding part of the process and we now move on to assessing suitability and developing a recommendation.

7.2 Prioritising a Consumer's Financial Needs and Objectives

Prioritising a consumer's financial needs and objectives is often required because:

- **Affordability**: the consumer has limited financial resources and so cannot meet all their identified financial needs and objectives, and/or

- **Urgency**: some financial objectives are more urgent than others.

7.2.1 Affordability

A key part of the *suitability assessment* process is to assess whether the consumer can afford the ongoing financial commitment you have recommended. The financial adviser is not expected to predict future changes in circumstances but should ask questions, in the fact-finding process, about any *likely* changes in circumstances which could lead to a reduced disposable income. If a consumer commits to a financial product or service that he/she cannot reasonably be expected to afford in the long run, the consumer may lapse or terminate the product early and hence suffer a financial loss; it is therefore not in the consumer's best interests to overstretch themselves financially with a financial product or service.

The consequences of an inability to repay a mortgage repayment or a life assurance premium could be drastic. The consequences of not being able to afford a savings premium or a pension contribution would be minimal in comparison. Assessing suitability correctly should help to mitigate risks of lack of affordability. For example, if there was a likelihood of a consumer not being able to afford a life cover premium in the future, due to, say, the birth of a child, perhaps they should take out less cover/sum assured, the premium of which they should be able to continue to pay for the duration of the policy. The financial adviser should be aware of the circumstances that could arise which could negatively change the consumer's regular income and expenditure.

For example, these changes of circumstances might include:

- An increase in mortgage repayments due to the end of a favourable fixed rate or introductory variable rate.

- A reduction in earnings arising from any number of factors including:

  - Lower or no bonus payments.

  - Lower or no overtime payments.

  - Reduced hours.

  - Maternity leave

- Redundancy.

- Ill health.

- An increase in expenditure due to a number of factors including:

  - Birth of a child.

  - Increased rent outgoings.

- Increased taxes.
- Inflation leading to price increases in goods and services.
- Ill health.

7.2.1.1 Assessing Affordability for Housing Loans

Lenders exercise considerable effort in underwriting housing loan applications to ensure, as far as can reasonably be predicted, that the applicant will be able to afford to make the repayments for the level of loan granted to the consumer, for the duration of the loan. Under the Consumer Protection Code, an affordability assessment must include consideration of:

a. The information gathered during the fact-find; and,

b. In the case of all mortgage products provided to personal consumers, the results of a test on the personal consumer's ability to repay the instalments, over the duration of the agreement on the basis of a 2% interest rate increase, applied to the lender's variable rate, that is, a stress test is applied.

c. In the case of interest only mortgages, the lender must assess the consumer's likely ability to repay the principal at the end of the mortgage term. Where the interest only period is less than the full mortgage term, the mortgage lender must carry out an assessment of the consumer's likely ability to repay the capital and interest repayment that will apply at the end of the interest only period. This assessment must be on the basis of a 2% interest rate increase, at a minimum, above the interest rate that will apply at the end of the interest only period if known, or on the current variable interest rate, if the applicable interest rate is currently unknown.

7.2.1.2 Prioritising Recommendations Where Affordability is an Issue

Example #1

You review a consumer's financial affairs, and after identifying and quantifying a consumer's needs you propose to make recommendations to the consumer that will require a total outgoing of €350 per month.

However, the consumer's surplus income each month is just €150.

What do you do?

There are two possible solutions:

Meet each need to the extent possible, for example, in the example above, to the extent of 150/350, that is, 43%. So, for example, if one of the recommendations were to effect a 20-year term assurance policy for, say, €250,000 cover at a monthly premium of €90, the consumer would instead effect €100,000 cover at a monthly premium of, say, €36 per month.

OR

Certain financial needs are prioritised, and these are met to the extent possible, leaving other less urgent needs unsatisfied at this stage.

The first option is not usually desirable as it will mean that both more and less urgent financial objectives will all be only partly satisfied. It is usually better for the consumer with limited financial resources to satisfy some urgent financial needs and objectives in full and less urgent needs not at all for the time being, rather than attempting to only partly satisfy all identified needs and objectives. The information in a well assessed fact-find will help to guide the financial adviser to make a reasonable recommendation despite limited financial resources.

Example #2

Your original recommendations to the consumer were:

- Effect a term assurance policy for a sum assured of €250,000 at a monthly premium of €90.
- Effect a savings plan of €100 per month to meet a savings need in 10 years' time.
- Effect a PRSA of €160 per month, to provide a retirement income in 25 years' time.

As the consumer can only afford €150 per month, the recommendation might be modified to, say:

- Effect a term assurance policy for a sum assured of €250,000 on a 12-year convertible term at a monthly premium of €50.
- Effect a savings plan at a monthly contribution of €100 per month.

However, depending on the consumer's tax situation, it may be worth further discussion on future plans and cash flows and your recommendations may include retirement planning:

Example #3

As in the examples above, the consumer has €150 per month disposable income for the purpose of financial planning.

He has agreed to take out the convertible term policy, giving him the full life cover that he requires for family protection at a cost of €50 per month.

He is paying tax at the marginal rate so:

He can effect a PRSA with a contribution of €83.40 per month which will cost a net €50 per month.

AND

A Savings Plan of €50 per month.

Note: the savings plan will not suffice for the lump sum required in ten years, so this will only make sense if the consumer's cash flow assumptions allow for greater savings in the future, for example, loans paid off, income to be increased, or assets to be sold.

7.2.2 Urgency of Financial Needs

In prioritising financial needs, the normal course of action is to:

- Ensure there is sufficient *Emergency Funds* in place, before a consumer commits to a long term financial commitment to meet some other financial need.

- *Prioritise protection needs ahead of savings and pension needs.*

  The rationale for this is that no one knows when death or serious illness will strike. The consumer should therefore be protected immediately, as far as possible, against these contingencies. There may be more time to meet savings and pension needs.

- *Prioritise life assurance cover ahead of serious illness cover*, where both are required but the consumer can't afford both.

  Some serious illnesses might not necessarily lead to a permanent and total loss of earned income in the way that death will. The consumer may have employer sick pay and/or social welfare disability benefits to fall back on.

- *Prioritise savings and retirement funding needs in order of the anticipated savings/pensions term*, putting shorter term objectives ahead of longer term objectives.

  For example, if a consumer aged 34 has a 10-year savings need and, say, a pensions need at age 60, then the savings needs might be addressed first as this is required before the pension.

The above suggested order of priority is based on the premise that some financial needs and objectives are more urgent than others, in that the need is more immediate. Longer term financial needs and objectives can possibly be deferred for a period, until the consumer's financial resources permit.

Of course, there may be individual circumstances in a case which may dictate a different order of priorities than suggested above, e.g. if the savings need was not urgent, the need to start funding a pension may take priority. Pension funding is advisable as soon as an individual commences employment.

7.3 Developing a Recommendation

The fourth step is the process of developing and presenting a recommendation to the consumer.

A recommendation may consist of one or more of:

- *Advice only.*

  The end result of every case is not always that the consumer should effect a new financial product. There may be many cases where:

  - A consumer may not need any additional financial products at this time, and/or

  - Relatively minor adjustments to the consumer`s existing portfolio of financial products may be all that is required. For example, switch the fund choice of a unit-linked bond to an allocation more in keeping with the consumer's current attitude to risk and investment objectives.

- *Advice to effect a new financial product or products*, where the consumer's identified financial needs and objectives are not being met by the current portfolio of financial products held by the consumer. The intermediary may be able to arrange this product or products for the consumer.

- *Advice to terminate or encash some existing financial product or products held by the consumer.*

  However, this course of action should only be recommended where the existing financial product or products clearly no longer meets any identified financial need of the consumer and the funds committed to the particular product or products can be better redeployed to meet some identified unsatisfied financial need of the consumer.

7.4 Suitability of Financial Advice

The Financial Adviser must set out their recommendations to the consumer in written format stating their reasons why the recommendation is made, according to how it meets the consumer's needs, or, in other words, how it is 'suitable' to the consumer's needs.

In addition, the recommendation must take account of the consumer's ongoing affordability to meet the financial commitment associated with the product and that they are financially able to bear any risks attaching to the product or service;

- Consumer's needs and objectives must be clearly stated

- Consumer must have affordability for the recommendation

- Consumer must have the capacity for risk(s) involved

- The product or service must be consistent with the consumer's attitude to risk

Only products suitable for the consumer's needs can and should be considered by the adviser before a recommendation on one product or service is recommended. This product or service is deemed to be the 'most suitable' for that consumer. The Adviser should state:

- Why a product or service *offered* to a consumer is considered to be *suitable* to that consumer; or

- The reasons why the product options contained in a selection of product options offered to a consumer are considered to be the *most suitable* to that consumer; or

- The reasons why a *recommended product* is considered to be the *most suitable* product for that consumer.

Suitability statements shall contain an outline of the advice given and information about how the recommendation meets the needs of the customer under the three specific bullet points we looked at above.

The suitability statement should point out whether regular reviews are needed – an adviser will need to confirm to the client if they will provide a periodic review and demonstrate how its managed. If periodic reviews are carried out, it is acceptable to only note changes and not repeat full information. Periodic assessment, if promised, shall be carried out at least annually.

Suitability statements should generally be provided pre-sale. However, they can be provided immediately post-sale provided:

- The customer has agreed to this;

- The intermediary has given the customer the option to delay concluding the contract until they get the suitability statement.

7.4.1 Specimen Suitability Statements

Set out below, are specimen suitability or ‘reason why’ statements in line with the Consumer Protection Code requirements in relation to:

- Protection need
- Retirement funding need
- Lump sum investment need
- Mortgage need

The wording is a specimen only; in practice, each suitability statement will have to be crafted to the particular circumstances of the individual case in question.

Each of the following specimen *suitability* statements are divided into four or five separate parts:

- Statement of the consumer’s personal and financial situation relevant to the recommendation.
- Identified financial need(s) and objectives, and generic product type(s) that can meet that need;
- Recommendation of a specific product type and how it will meet the consumer’s financial needs and objectives; including affordability;
- Recommendation of most suitable product, from the range of suitable products outlined;
- Warning statements where relevant and all other associated risks if any, attaching to the recommended product, and how the risk profile of the product is aligned with the consumer’s attitude to and capacity for investment risk, where relevant.

It is assumed in each case that the adviser is an intermediary who can arrange, and provide advice on, a number of suitable products in each case.

7.4.2 Protection Need

Sample Statement of Suitability for a Protection Need

Important Notice – Statement of Suitability

This is an important document which sets out the reasons why the product(s) or service(s) offered or recommended is/are considered suitable, or the most suitable, for your particular needs, objectives and circumstances.

Needs and Objectives

Based on the information you have given us in relation to your current financial position and to your current and future needs and objectives, we have identified that if either of you were to die, the surviving spouse and children would suffer a financial loss.

You would like to protect your family's income in the event of your premature death.

A life policy can be set up to meet this need.

You have already taken out a life policy to cover your debts, and now require a life policy to cover loss of income to the household in the event of death. The term on the policy will be 22 years, i.e. to retirement age.

We have calculated that a life policy of €300,000 could be used to meet this need, having taken account of the changes in income and expenditure in the event of death.

Relevant Personal and Financial Information

- You are both aged 45 and estimate that you will retire at age 67.
- You both earn income of €60,000 per annum.
- You are both in good health and have two children aged 9 and 10.
- You have the affordability to pay the premium on a life polity.
- You do not wish to continue the life policy after retirement age.

Suitability and Recommendations

We would recommend that you effect a dual life 22 year term assurance policy for a sum assured of €300,000, for the following reasons:

- The policy will provide guaranteed life assurance cover of €300,000 for 22 years, at a fixed premium.
- Dual life cover is slightly more expensive than joint life cover but if one of you die, the survivor will still have life cover for the benefit of the children, in the event of their subsequent death.

Plan Recommendation

Having researched the market, we recommend that you effect a dual life policy with Munster Life Assurance for a sum assured of €300,000 over 22 years at a cost of €92 per month. This premium comes within your affordability as stated by you and is fixed for the duration.

Munster Life's premium is the most competitive on the market and they have an excellent claims payout record and customer service.

The enclosed Key Features document explains how the policy works in more detail. Please read it carefully to make sure you understand the benefits provided by the plan, and the restrictions and exclusions on the cover.

Signed: ______________________________ ________________

Adviser **Date**

7.4.3 Retirement Funding Need

Sample Statement of Suitability for a Retirement Funding Need

Important Notice – Statement of Suitability

This is an important document which sets out the reasons why the product(s) or service(s) offered or recommended is/are considered suitable, or the most suitable, for your particular needs, objectives and circumstances.

Needs and Objectives

Following an analysis of your financial needs and objectives based on the information you have given us, we have identified that you:

- Will have an income shortfall in retirement when you stop working, after taking account of your existing financial provision for retirement and your stated minimum level of desired income in retirement;
- Wish to build up funds now so that you will have an income in retirement;
- Would like to avail of tax reliefs available while saving for your retirement;
- Will not need access to these funds until retirement age;
- Wish to gain a return in excess of inflation and in order to achieve a return better than deposit rates, you are willing to take risk with your capital, as specified in the Risk Profile we completed.

Personal and Financial information

- You are self-employed and are entitled to contribute to PRSA, because you have taxable earnings from a self-employed trade;
- You currently have surplus income of €500 per month which you can afford to use to save for your retirement;
- You are aged 34 and earn €50,000pa. A contribution of €500 per month is therefore below your maximum allowed for tax relief purposes of 20% of earnings;
- Currently, you have no provision for retirement funding in place.

Suitability and Recommendation

We would recommend that you effect a PRSA to which you will contribute €500 per month gross, in order to accumulate an additional retirement fund to make up part of the identified income shortfall in retirement.

We believe this recommendation is in your best interests as it will allow you to bridge part of your anticipated income shortfall in retirement, with the benefit of tax relief on your contributions, within the limit of what you can currently afford to save, and tax-free investment returns during the period to retirement.

Plan Recommendation

We recommend that you take out a PRSA with Leinster Life Assurance.

- The plan is specifically designed to build up retirement benefits for individuals like you, who are self-employed and do not have an employer pension arrangement.
- The plan allows you to invest your monthly contribution in one or more investment funds, managed by Leinster Life Assurance and allows you to switch funds if required (four free switches per year). The funds we have currently selected match your attitude to risk as determined from the risk profiling exercise we carried out.
- The plan allows for premium flexibility if your circumstances change.
- The charging structure on the plan is very competitive with an AMC (annual management charge) of .75% and broker fee of .25% per annum.
- The plan accepts single premium payments if this was required in the future.

You should be aware of the following risks attached to our recommendation:

- The investment funds offered by the plan do not provide any investment guarantees; the value of your plan at any time could therefore fall below the total amounts contributed to it.
- There is no guarantee that the plan will provide any specific level of retirement income. The projected retirement fund is not guaranteed as it depends on the contributions you pay to the plan and future investment returns, which are not guaranteed.
- Future income tax relief at 40% is not guaranteed; the higher rate of tax could be reduced; pension tax relief could be reduced, restricted or abolished at any time, by the Government. Your earnings could also fall so that you qualify for tax relief only at the lower standard rate and not at the higher rate.
- Please note that there is a transfer penalty applied if you move the plan to an equivalent plan with another life office within the first five years.

We recommend that you regularly review this financial plan to ensure that it continues to meet your needs and objectives.

The enclosed Preliminary Disclosure document explains how the plan works in more detail and sets out sample projected benefits. Please read it carefully to make sure you understand the benefits provided by the plan and its various restrictions.

Signed: ________________________________ ____________________

Adviser **Date**

7.4.4 Investment Need

Sample Statement of Suitability for an Investment Need

Important Notice – Statement of Suitability

This is an important document which sets out the reasons why the product(s) or service(s) offered or recommended is/are considered suitable, or the most suitable, for your particular needs, objectives and circumstances.

Needs and Objectives

Following an analysis of your financial needs and objectives based on the information you have given us; we have identified the following:

- You have a sum of €50,000 available for investment now, after taking account of your existing savings and investments;
- You require long term capital growth.

Relevant Personal and Financial Information

- You understand that your capital is not guaranteed, and you may suffer losses in the short term, which may be substantial.
- You wish the funds to pass easily and rapidly to your spouse, in the event of your death.
- You will not need access to these funds for at least ten years.

Suitability and Recommendations

We recommend that you invest your €50,000 in a life assurance unit-linked investment bond. We believe this recommendation is in your best interests as it will allow you to participate in the long-term capital growth potential offered by such funds, which is likely (but not guaranteed) to be higher than the return provided by deposits over the same period.

- The bond allows you to invest in one or more large investment funds, managed by professional investment managers, with a wide range of risk profiles. Over the long term, funds like this investing in a mix of shares, bonds and property, although unguaranteed, have produced returns better than deposits.
- The bond can be arranged on a joint life basis, so that ownership of the bond passes automatically to your spouse in the event of your death, as required by you, without having to go through your estate and without a need to encash the bond.
- You can get access to your funds within a few days. You can take partial encashments from the bond or encash it totally at any time. However, due to the impact of the initial charges involved and investment risks, it is recommended that you should be prepared to leave the funds untouched for at least three years, and preferably longer. You have indicated that you do not intend to use the funds for at least five years.
- Your investment accumulates tax free. Tax is only deducted from any gain you make on encashments from the bond, or on accumulated gains every eighth anniversary.

Plan Recommendation

- We recommend that you effect the investment bond with Connaught Life Assurance. They offer one of the widest range of investment fund options, offering a choice of both active and passive investment management styles and funds managed by internal and external investment managers. In particular, they offer a wide range of fund options consistent with your risk rating.
- Their bond has very competitive charges; If you leave your funds invested in the bond for five years, the projected impact of expense and charges would be to reduce your investment return by 1.4% per annum.
- Connaught Life Assurance is a very large secure life company with an AA+ rating, higher than other companies we looked at.

Warnings

You should be aware of the following risks attached to the recommendation:

- Most of the investment funds offered by the bond provide no guaranteed investment return.
- You could get back less than you invest, particularly if you need to encash or draw on the bond within the first five years in unexpected circumstances.
- In certain circumstances encashment requests from their property fund could be subject to a maximum delay of six months.
- Past performance of the funds is not a guide to future returns.

The enclosed Key Features document explains how the bond works in more detail. Please read it carefully to make sure you understand the benefits provided by the bond, and its restrictions.

Signed: ________________________________ ____________________

Adviser **Date**

7.4.5 Mortgage Need

Sample Statement of Suitability for a Mortgage Need

Important Notice – Statement of Suitability

This is an important document which sets out the reasons why the product(s) or service(s) offered or recommended is/are considered suitable, or the most suitable, for your needs, objectives and circumstances.

Needs and Objectives

Based on the information you have given us in relation to your current financial position and your current and future needs and objectives, we have carried out product research specifically in relation to mortgages, as you requested at this point in time. The specific requirements which we believe are of most importance to you are as follows:

- You would like to borrow funds to finance the purchase of your own home.
- You wish to borrow the maximum allowed under current lending regulations up to age 60.

Relevant Personal and Financial Information:

- You are a first-time buyer, age 32 and single.
- You are in full time employment in the public sector and receive PAYE income.
- You have no other income
- You are currently renting property as your home and are also saving €xxx each month. We have ascertained that you have met the lending criteria for a personal mortgage in relation to affordability, including the bank's stress tested mortgage rate.
- You wish to maintain the same repayments over the next few years.

Suitability and Recommendations:

- From the information you have given us, we recommend that you effect mortgage for 28 years up until age 60. We recommend that you initially choose a three year fixed rate mortgage. This will ensure that your monthly repayments will not change during the first three years. This can be of benefit if interest rates rise above the fixed rate chosen but can be a disadvantage if interest rates fall below your specified rate. Please note that the variable rate currently is 0.35% lower than this fixed rate.
- You instructed us to limit our advice between two banks, ABC Ltd. and XYZ Ltd. As both banks, in principle, are willing to provide you with your required mortgage, we recommend you effect the mortgage with XYZ Ltd. given that their three-year fixed rate is 0.25% lower.
- Based on your financial situation you can meet all monthly repayments, therefore making you eligible for the loan required to purchase your own home.
- Based on your financial situation, you can meet the balance of the purchase price and associated costs of buying the property such as legal fees and stamp duty.

Warning: If you do not meet the repayments on your credit agreement, your account will go into arrears. This may affect your credit rating, which may limit your ability to access credit in the future.

- **Associated Risks:** The value of your property may fall and the property could be worth less than the loan amount outstanding, e.g. you could be in negative equity.
- If you are unable to make loan repayments, further interest will be accrued and payable.
- If the variable rate stays the same or decreases, you will have paid back more on your fixed rate than you would have had to pay had you chosen the variable rate. By not choosing a longer term fixed rate you may lose out if interest rate increase and the variable rate and fixed rate may be much higher in three years' time when your fixed rate term ends.

Signed: ______________________________ ________________

Adviser **Date**

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] Why it may be necessary to *prioritise* a consumer's financial needs and objectives
- [ ] The main areas each suitability statement should cover
- [ ] A specimen statement of suitability in respect of a *protection need,* a *pension* need, an *investment* need and a *mortgage* need

08

Client Reviews

The importance of client reviews are highlighted in this chapter; what should be covered when meeting a client; changes in personal circumstances, external developments which you need to consider and controlling the exposure to investment risk.

Learning Outcomes – after studying this chapter you should be able to:
exhibit knowledge of the process of client reviews; the frequency and what should be covered in your review meeting;
demonstrate the ability to discuss a client risk profile; what changes are needed and how you as an adviser have controlled risk for the client; and,
prioritise consumers' changing needs in the short, medium and long term

8.1 Introduction

The process of identifying and satisfying consumer financial needs does not stop once the initial recommendations have been implemented. Clients will continue to need financial advice on their changing personal circumstances and on the ongoing suitability of the initial products recommended. It is also a regulatory requirement.

Personal and Financial circumstances can change, and not always for the better. A Financial Adviser should be prepared to give advice to clients whose circumstances may have deteriorated.

Therefore, regular reviews of both the client's position and the products recommended will be essential in order to check if the portfolio of financial products held by the client at that time continues to meet the client's then current and anticipated financial needs and objectives, as far as is possible.

The normal procedure is to have a planned review, in order to detect and allow for any changes in:

- Client's financial and personal circumstances
- External developements
- Product requirements
- Investment market conditions

8.2 Frequency of Review

The frequency of the planned review will depend on a number of factors:

- The client's wishes.
- The extent and scope of the initial advice provided to the client.
- The likely rate of change in the client's circumstances.
- The likely rate of change in external developments.
- The likely rate of change in product developments.

The default planned review period is usually one year.

Unplanned reviews might be necessitated by a sudden and unexpected change in:

- The client's circumstances.
- Financial conditions, for example, sudden increase or decrease in interest rates, a sharp and sudden fall in stock markets, etc.
- Circumstances surrounding a particular product held by the client, for example, Equitable Life losing the court battle with its annuity policy holders, or a change in the taxation treatment of a particular product, etc.

8.3 Personal Circumstances

Changes to the client's personal circumstances since the original fact-find was completed and the recommendations implemented will almost always create a need for review.

The Central Bank *Consumer Protection Code* specifies that:

> *"A regulated entity must gather and maintain a record of details of any material changes to a consumer's circumstances prior to offering, recommending, arranging or providing a subsequent product or service to the consumer. Where there is no material change, this must be noted on a consumer's records."*

Therefore, at any review with a client it is important to seek to gather and record sufficient information to detect any 'material' changes in the client's circumstances.

8.3.1 Personal Changes

Examples of personal changes would include changes in the individual's health, for example, a client has a serious deterioration in his or her health or that of their spouse/partner, which could necessitate an urgent review of their financial affairs.

8.3.2 Family Changes

Examples of family changes which can often give rise to a need to review a client's financial position:

- Marriage or the birth of a child.
- Death of a spouse/partner.
- Illness
- Divorce or separation.
- Elderly parent who needs long term nursing care.

8.3.3 Employment/Earnings Changes

Changes in the client's employment or earnings position may also prompt you to review the client's financial position, as it may lead to a change in needs and affordability of existing commitments:

- Retirement or redundancy. Ideally, the review should take place just *before* the retirement or redundancy actually takes place.
- Onset of ill health can lead to reduced earning capacity.
- A change of employment may signify a change in income and pension arrangements.
- A promotion might mean a significant increase in the client's income position.
- Change of employment status from employed to self-employed, or vice versa, will entail a significant change in the client's income and pension arrangements.
- Self-employed clients may find it appropriate to review their retirement funding arrangements at the end of each tax year, particularly before the following 31st October backdating tax deadline.

8.3.4 Financial Plans and Objectives

A consumer's financial plans and objectives are likely to change over time and this should prompt a need for regular reviews.

A consumer's financial resources may change over time, for the better or worse. Where a consumer's financial circumstances improve, some financial need or objective which was given low priority before and a recommendation not proceeded with, due to insufficient income at the time, may at a subsequent review be prioritised and some action may be taken on the recommendation.

Example

At an initial meeting with a new consumer, a range of protection, savings and pension needs were identified. However, the consumer could not afford to proceed with the pension recommendation at that time, due to a limit on available surplus income.

At a subsequent review, the client's financial position had improved substantially, due to the expansion of his business, and the pension recommendation can be re-tabled and given a higher level of priority at that time.

8.3.5 Risk Profile

There are many circumstances which can lead to a sudden change in a client's attitude to and capacity for investment risk. For example, redundancy or business failure, marriage breakup, ill health, inheritance of funds and property, retirement, etc.

As clients age, they tend to become less tolerant of investment risk as they have a lower capacity for such risk, for example, the older you are, the less time there is to recover investment losses through future investment gains and/or future earned income.

8.3.6 Client Request

In some cases, the client may request that you review their affairs on a regular basis, or on a once-off basis because of the occurrence of some event, for example, sudden redundancy.

8.4 External Developments

External developments may also make it appropriate to review both the client's financial position and existing products. The following are examples to consider.

8.4.1 Tax Changes

Changes in taxation may affect a client's financial position and/or the appropriateness of financial products already held. For example, a change in income tax rates or a change in the rules on pensions would create a need for a client review.

Examples of this include:

- The general trend of reduction in tax relief limits on personal pension plan and personal PRSA contributions, over the years.
- A widening gap between DIRT and exit tax rates, currently at 8%.
- A change in USC rates.
- Changes in capital acquisition tax thresholds.

- A reduction in the standard fund threshold over the years.

8.4.2 Market Changes

Changes in the investment markets, for example, a steep fall in stock markets may mean that a review of the client's existing investment and saving products would be appropriate and, in some instances, quite urgent. A client may 'panic' when he or she reads of '*tumbling stock markets' and reads headlines such as '€3bn wiped off stock market today!'.* They may need reassurance and possibly a review of their investment portfolio, although 'panic' recommendations should not normally be made.

As a further example, falling interest rates may mean the client faces an income shortfall, if he or she had been depending on deposit interest income, which could seriously affect his or her financial position.

8.4.3 Product Developments

New types of financial products may come to the market, which may suit some clients better than products and options previously available.

The introduction of ARFs in the 1999 Finance Act, as an alternative to buying an annuity, is an example of a product development which may necessitate a review for clients approaching retirement.

Similarly, other products may be discontinued, fall out of favour or be abolished by legislation e.g. the abolition of the AMRF requirement from January 2022.

8.5 Product Requirements

An important factor in determining when a client's position should be reviewed will be the original product recommendation or recommendations made.

8.5.1 Life Assurance Products

There are a number of situations in which life cover products should be reviewed:

- When there are options available on the life product, such as to convert to an alternative type of product. Life assurance options are important as they can usually be exercised by the client without the need for further evidence of health, but they are usually time limited.

- If the life product has been written under trust, it will be important to review the trust on a regular basis in order to ensure that the beneficiaries are still appropriate.

- A unit-linked whole of life product may have an automatic review period for the sum assured and premium level.

- To ensure that the sum assured is still adequate to meet the level of financial protection required by the client. For example, the effects of inflation or a change in the consumer's circumstances may result in existing life assurance cover no longer being sufficient or they may have too much cover.

8.5.2 Savings Plans

A savings plan may need to be reviewed:

- To ensure that the chosen fund or funds is still appropriate to the client's needs and current risk profile; a switch to a different type of fund may be appropriate in some circumstances.

- To check if the projected value of the plan is still on target to meet some stated financial objective or plan, e.g. a plan taken out to meet third level education costs will need to be reviewed regularly to see if it's on track to fund the estimated costs.

- As a plan nears the end of its fixed term, where it has a fixed savings term. There may be a need to reinvest the emerging proceeds.

8.5.3 Investment Products

A client's investment portfolio needs to be reviewed regularly:

- To ensure that the chosen fund(s) is/are still appropriate to the client's needs and current risk profile; a switch to a different type of fund may be appropriate in some circumstances.

- To review the performance of the portfolio/funds against the client's stated objectives and investment mandate for the fund/portfolio. A change of investment manager(s) may be warranted if there is a systematic failure to meet stated objectives and investment mandates, for example, a fund which indicated that its objective was to be in the top quartile, but which has consistently been in the lower 3rd and 4th quartiles over the last three years.

- Times of extreme volatility in investment markets can cause some clients sleepless nights; a review of their portfolio against their needs and objectives and attitude to risk, may be required. However, as pointed out before, the adviser should be careful not to recommend substantial changes in a client 's portfolio at such times; markets can bounce back quickly.

- When a product reaches the end of its fixed term. For example, after a tracker bond matures. The proceeds may become available for reinvestment.

- Where a client is depending on regular income/withdrawals from a product or products. For example, a consumer taking regular withdrawals from an ARF, or a client taking so called *automatic income* payments from a unit-linked bond. The likely future sustainability of ongoing payments should be reviewed regularly in the light of changing investment markets.

- To ensure that a client is making maximum use of various tax reliefs and allowances. For example, utilising the annual €1,270 capital gains tax exemption where a client holds equities directly.

8.5.4 Pension Products

Pension products should always be reviewed by the adviser and client on an annual basis.

- To check that any regular contribution commitment is appropriate to the client 's available surplus income. For example, a client 's income could have increased or decreased significantly since the last review.

  Contributions to a pension plan, whether regular or single amounts, are dependent upon the client 's income and Revenue's maximum limits. As earnings rarely remain static, it is appropriate to hold a regular review, particularly before a tax deadline like 31st October.

- To ensure that the chosen fund or funds in a defined contribution arrangement is still appropriate to the client's needs and current risk profile; a switch to a different type of fund may be appropriate in some circumstances, for example, as a client is approaching retirement.

- To check if the projected value of the pension plan is still on target to meet some stated financial objective or plan; for example:

  - To replace a particular percentage of the client's earnings.

  - To provide a particular level of retirement benefit.

- Tax and/or other changes stemming from the Budget/Finance Act could have an impact on a client's contributions and it may be appropriate to ensure that the client has maximised contributions before the end of each tax year. This would apply, for example, to AVC contributions.

- To check if there have been any legislative changes that may cause them to adjust their plan.

- If they have a vested PRSA, then approaching age 75 they will need a review to be made fully aware of the impending freezing of the funds involved.

8.5.5 Loans

A client 's housing or other loan or loans may be reviewed to see if the rates being charged by the client 's current lenders are competitive compared to other finance currently available in the marketplace, or where a fixed rate period has ended. This is now an annual requirement under the Consumer Protection Code for Variable mortgage holders, and at least 60 days in advance of the cessation of a fixed rate.

However, the potential savings in moving a mortgage to a more competitive lender need to be weighed against the costs involved in such a move, for example, legal fees, etc. Some banks offer ‘switcher funds’ to pay for these extra fees, and to gain market share.

Clients with existing tracker mortgages need to consider the impact of recent increases in the ECB interest rate and whether they might be better off to switch.

8.6 Controlling the Exposure to Investment Risk

During any portfolio review, the aim should always be to adjust the risk profile of the client 's investment portfolio to that level of and capacity for risk the client is *then* prepared to accept until the next review period.

Remember you will be establishing the customer's attitude to and capacity for risk at the outset, during the fact-finding process of getting to know the customer.

Risk can never be eliminated. However, the following list of points should be looked at to ensure that risk has been mitigated in as far as possible:

- Ensure diversification between the main asset classes, appropriate to the client 's current risk profile.

- Avoid over concentration of investment in specific financial institutions, securities, industries, or geographical areas.

- Ensure that the portfolio gives adequate protection against inflation, in so far as possible.

- Ensure adequate liquidity in the portfolio, so that longer term investments may not need to be drawn on, if the client needs funds for an immediate purpose.

- Be aware of the potential risks involved in investments which contain underlying gearing. Gearing increases potential returns, but also potential losses.

8.7 Example: Review

Example

Fact-find

- David and Claire are aged 35 and have one child, Henry, aged 12.
- Claire was recently diagnosed with a serious illness and is currently receiving income protection of 50% of her previous salary. This includes the social welfare illness payment.
- Claire's prognosis for long term recovery is good.
- Their net disposable income has reduced by €1,100 p.m.
- They have post office savings of €140 p.m., funded by the monthly child benefit payment. The current value is €5,000.
- They have a unit linked equity-based savings plan of €200 p.m., with a current value of €5,000.
- David is an employee and contributes €300 p.m. to a SAYE scheme. The bonus date is in 6 months.
- They have a joint life serious illness plan costing €100 p.m. and the sum assured is €50,000. Claire's illness is specified on the policy.
- They have a mortgage protection plan in place for their mortgage debt, costing €23 p.m.
- They have dual life family protection for 25 years at a cost of €68 p.m.
- Claire contributes €200 p.m. to a PRSA and David is paying 5% of gross income into his defined contribution employer pension scheme through his employment. His Employer matches his contribution.

Based on the information provided in the fact-find, answer the following questions:

1. What further information on the products they hold would assist you in your advice?
2. David has told you that they have reduced their monthly expenditure, but their shortfall remains at €700 p.m. Advise David of the steps they should take now in order to manage their monthly income and expenditure shortfall.
3. What monthly expenditure should remain in place as priority?
4. Explain why you recommend that other monthly expenditure should remain in place.
5. What advice might you give David and Claire in relation to their unit linked fund?
6. David and Claire have taken your advice and carried out your recommendations. The serious illness policy has been claimed. What recommendation would you now make for David?

Example: Workings and Answers

Question 1

- Does the mortgage protection plan have life cover only or is there accelerated serious illness cover with it?
- Will David's Employer contribution cease if he puts his pension contribution on a premium holiday?
- Does Claire think that she will return to work? i.e. is the income and expenditure shortfall temporary?

Question 2

Use the monthly child benefit as income	€140
Suspend the unit linked savings contributions	
(assuming no penalties)	€200
Serious illness claim: monthly premium ceases	€100
	€440
Shortfall reduced from €700 to €260 (€700 - €440)	

- The lump sum serious illness cover, and/or the emergency fund in the post office, should be used to supplement the remaining shortfall of €260 p.m. and any additional medical costs.
- The €300 p.m. into the SAYE will cease in 6 months and will cover the shortfall.

Question 3

The mortgage protection life cover and the family protection life cover should continue as priorities. The need for both of these policies remains. In addition, even if Claire's prognosis is good, Claire's illness may affect her ability to be underwritten for life cover at normal rates.

Question 4

- David's SAYE has a bonus date in 6 months. At that point he will be able to purchase shares under a fixed price option which hopefully is significantly less than the market value now. He could sell them and make a capital gain and retain the funds in their emergency fund. So, it makes sense to continue making the contributions for a further 6 months.
- Claire is entitled to continue her PRSA payment but will not be entitled to income tax relief until she resumes working. She could suspend the premiums for a period, in order to prioritise more short term needs, such as protection and educational costs for Henry.
- David should continue to fund for his retirement as long as it is affordable. He gets tax relief on the contributions and the Employer matches his 5% contribution. It is likely that the Employer would not continue to pay the 5% if David stopped his contributions.

Question 5

A risk assessment may show a change in appetite for risk since Claire's illness and that the unit-linked investment is no longer invested in the most appropriate fund or funds. On the other hand, the unit linked plan may be ideal to fund for university costs for Henry, and therefore it is important to continue with the plan if it is affordable. Ideally the plan contribution could resume in six months when the SAYE contribution is due to cease.

Question 6

David no longer has serious illness cover as it was a joint life policy and not a dual life policy. David should apply for serious illness cover in his own name.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] The need for a regular planned review of a client's financial needs and resources
- [ ] The factors which might necessitate an immediate unplanned review of a client's financial needs and resources
- [ ] The main changes in personal circumstances which could necessitate a client's financial needs and resources
- [ ] The main external developments which could necessitate a client's financial needs and resources
- [ ] The main changes in financial products which could necessitate a client's financial needs and resources
- [ ] Controlling the exposure to investment risk

How well do you know your textbook?

Chapter 1

- What are the five main types of financial needs a typical consumer might have at different times in their life?
- Why is good financial planning important to consumers?
- What is the purpose of knowing the consumer?

Chapter 2

- In what circumstances might consumers be able to generate investment income without paying tax on the return?
- Why might taxation influence investment decisions?
- In what circumstances can an individual claim medical expenses relief?
- What is the position with regard to CGT when one spouse dies and leaves property and shares to the surviving spouse?
- How can gift and inheritance tax liability be reduced?

Chapter 3

- Outline the maximum amount that an individual aged 42, in receipt of net relevant earnings, can invest in a personal pension or PRSA and explain the importance of dates in relation to claiming relief on these contributions.
- Explain the difference between the maximum lump sum an individual may take from a personal contract (personal pension or PRSA) and the tax-free maximum lump sum.
- Summarise the retirement benefit options for an individual taking retirement benefits from:

  a. A personal pension plan or PRSA.

  b. Employer pension scheme
- Consider the different types of annuities an individual could buy with the proceeds of a defined contribution retirement arrangement.
- Define a 'chargeable excess' that may arise from a benefit crystallisation event.

Chapter 4

- List the various types of life assurance policies.
- Describe, to a consumer, the main features and benefits of a serious illness policy and income protection policy.
- What tax relief may be available on **some** protection policies?

Chapter 5

- Give a brief description of the main asset classes.
- List the alternative asset classes
- Give an account of your understanding of PRIIPs
- List the potential types of investment risk.
- Under what headings might you compare two savings products?

Chapter 6

- Give an example of a credit intermediary.
- What are the three principal tests covered by the regulations, in relation to mortgage approval?
- List the types of upfront costs involved in property purchase.

Chapter 7

- What are the main sections every reason why statement relating to an investment product should have?
- Draft a reason why statement that you might use in relation to a particular housing loan recommendation.

Chapter 8

- What are the possible taxation changes which could impact on a client's needs and objectives, and necessitate a client review?
- Why should you regularly review a lump sum investment product? Consider all the various reasons.

Are you ready for your exam?

01

Do you understand the exam format?

Familiarise yourself with the structure and requirements of the exam. Understand how many questions you'll need to answer, the time limit, and any specific instructions or scoring methods.

02

Have you covered the full course material?

Have you read and understood the full textbook? Have you used the additional supplementary study resources available in your online Study Hub (pre-recorded videos, microlearning webinars, exam preparation masterclass recording)?

03

Have you created a revision plan?

Develop a study plan that outlines your exam preparation strategy. Break down your study sessions into manageable chunks and allocate time for each topic or chapter. Ensure you have sufficient time to review all the relevant material before the exam.

04

Test yourself with Past Exam Papers

LIA provide you with four past exam papers with solutions and examiner feedback. These papers are essential for every student's exam preparation. This will help you become familiar with the types of questions typically asked and allow you to practise applying your knowledge. Time yourself during these practice sessions to get used to working within the exam time constraints.

05

Have you tested yourself under exam conditions?

Test yourself by answering past exam questions without referring to your study materials under exam conditions. This will help reinforce your knowledge and identify any remaining gaps you need to address.

06

Have you familiarised yourself with the Online User Guide and Exam Regulations, which can be found in your Study Hub?

This will help you become familiar with the online exam environment and the rules that need to be followed.

07

Have you checked your computer set up and broadband speed and stability in preparation for your online exam?

Please consult the Online Exam User Guide for further information regarding system requirements. This will help ensure your exam runs smoothly.

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