Pensions: Attain Retain and Transfer of Wealth

A paper presented by Aidan McLoughlin BCL, Solr, FITI, TEP to the Society of Trust and Estate Practitioners on 11 May, 2006

Introduction

The focus of this paper is on pension structures and their impact on estate planning and asset accumulation.

Pension structures vary significantly in terms of legal form, benefit structures and in terms of the specific tax legislation utilised. Recent developments intended to smoothen the difference have simplified matters for the investing public but have perhaps made matters more difficult for practitioners who need to deal with the more technical aspects of this field.

It is appropriate to consider some of the factors which have contributed to the development of pensions as an instrument off wealth accumulation. Then it is worthwhile to consider the basic structures utilised, the benefits likely to flow from those structures and the impact that that may have on an individual's estate. This will lead on to looking at planning ideas in this area as well as considering some issues for practitioners to consider in advising clients and in administering estates.

Pensions and Wealth?

Background

The traditional notion of Pensions is as an income stream usually payable in retirement. Sample definitions are as follows:

> "a regular payment to a person that is intended to allow them to subsist without working"
>
> "An annual income, usually associated with the period after retirement, but not necessarily so. A pension fund is a general term used to describe an investment fund built up during working life and used at retirement to purchase an annuity to provide a continuing income"

Definitions of Wealth on the other hand tend to read as follows:

> "Wealth usually refers to money and property. It is the abundance of objects of value and also the state of having accumulated these objects"

> "Total assets minus total liabilities."
>
> "The total value of the accumulated assets owned by an individual, household, community, or country."

To an accountant thefore Pensions were traditionally an item to include in a Personal P & L: Wealth was a Balance Sheet Item.

That traditional definition or distinction has now been altered. The fundamental cause of the change was the introduction of the Approved Retirement Fund (ARF) Regime in Finance Act, 1999. The changes introduced in that Act, the brainchild of Charlie McCreevy, effectively transformed Pensions into Assets. Similar to other assets they now had a capital value and were capable of being inherited.

The FA99 changes went further. They allowed ARFs to be provided by a wide array of institutions throughout the EEA, they imposed few limits on the type of investments permitted and they were not subject to the high level of regulation associated with other pension structures such as apply to Defined Benefit Schemes. The net effect is a revolution in pension planning which is still ongoing.

The FA99 changes were supplemented by further developments in subsequent years:

- Finance Act 2004 confirmed it was possible for Occupational Pension Schemes to borrow
- The regulations introduced in September 2005 to implement the Institutions of Occupational Retirement Provision Directive (the "IORPs Directive") granted specific exemption for One Member Arrangements from restrictions on Investment and from the prohibition on Borrowing.
- Finance Act, 2006 provided clarity on the whole area of property investment (particularly residential property) and self dealing.

The cumulative effect of these provisions is to convert pensions into an asset.

Pension: Factors affecting Wealth Accumulation

As pensions are now a key part of an individuals wealth the question to be posed is : How do they compare to other assets.

The comparison can be made on the following bases:

Inflows or contributions

Unlike most other assets Pensions are subject to certain restrictions on the amounts that can be contributed to them.

Firstly Personal Contributions are limited to a scale of 15% to 40% of income as follows:

Age	**Contribution**
Under 30	15%
30 – 40	20%
40 – 50	25%
50 – 55	30%
55 – 60	35%
Over 60	40%

This limitation is offset by a number of other factors:

- These contributions are tax deductible
- In relation to Occupational Pension Schemes these amounts can be supplemented by virtually unlimited funding by the employer (subject to the funding cap discussed below)

The second restriction relates to the type of quantum of benefits that can emerge. Finance Act 2006 introduced the notion of a fund cap of €5m: up to that point there was no absolute limit on the level of benefits a pension fund could provide.

In one sense there is still no limit. The fund cap does not prevent an individual building up a fund in excess of that amount: it does however ensure that the excess will be subject to a heavy tax burden with an effective rate of 68%!.

A further limitation exists in relation to the nature of the benefits. Some structures, particularly occupational pension schemes for employees, have benefits emerge in income form. Also in most cases benefits cannot be accessed until age 50 /60.

All of these negatives need to be considered in the light of the positives. In addition to tax relief on contributions pensions are entitled to:

1. Tax free investment growth
2. Up to €1.25m in tax free cash on retirement
3. All or a substantial portion of the fund free from income tax on death before retirement
4. Potential, on death after retirement, for assets to transfer to children free from Capital Acquisitions Tax.

The cumulative effect is that, in the right circumstances, pensions can be the most important tool in accumulating wealth. Whilst surveys of assets at retirement in Ireland, the US and elsewhere would indicate that less than 20% of assets at retirement would currently be in pensions, that number is likely to increase in the future.

Types of Pension

Pensions come in a number of different legal forms and have an array of titles which can be confusing. Coming to the subject from outside it is useful to distinguish State sponsored arrangements from what can be termed private pensions.

The State Sponsored arrangements would include:

1. Social Welfare Pension Benefits

   These are paid for by PRSI contributions and are generally available to most individuals based on their PRSI contribution history. A small number of people continue to apply for pensions on a means tested basis.

   Whilst contributions are paid by taxpayers to the cost of the benefits there isn't a separate fund created for each potential beneficiary. Therefore these benefits are frequently described as being on a Pay As You Go basis with current contributions financing current pensions.

2. Public Sector/Local Authority Pensions

   These are paid to employees working in the Sector and have benefit structures broadly similar to those that apply to Occupational Pension Schemes in the private sector. However they are not fully funded structures and therefore are also known as Pay As You Go Pension Schemes.

Both these schemes are Pensions in the traditional sense – primarily providing an income into the future. However the structure generally doesn't have a capital value and therefore we wont deal with these types of structures further.

The other area of pensions is the privately funded pensions and these are now considered in more detail.

Pension Structures

In general terms, funded pension schemes can be characterised either as:-

(i) Occupational Pension Schemes which are established by an employer for the benefit of employees. A key subset of these comprises Self Administered Schemes (SAPS) which includes Small Self Administered Pension Schemes (SSAPs);

(ii) Personal Pensions which are effected by individuals (either self employed or employees not covered by the first category of funded schemes) for their own benefit. A key element in this area of the market is the type of Personalised Pensions that have been developed in the last few years;

(iii) Personal Retirement Savings Accounts (PRSAs) which are a contract similar to the Personal Pension but with easier access for employees and additional controls in relation to costs etc.

(iv) Approved Retirement Funds (ARFs) which are funded by monies transferred from one or both of the first two structures.

The chart below identifies the main features of the three types of pre retirement schemes and the differences between them.

Feature	**Personal Pension**	**Occupational Pension Scheme**	**PRSAs**
Governing Revenue Law	Chapter 2, Pt30, TCA97	Chapter 1, Pt30, TCA97	Chapter 2A, Pt 30 TCA 97
Structure	Insurance Contract	Trust	Contract
Establishing Entity	Individual	The Employer	Individual and / or Employer
Subject to Fund Cap	Yes	Yes	Yes
Maximum Pension	No Maximum	2/3rds Final Remuneration	No Maximum
Maximum Spouse Benefit	100% of Main Pension	2/3rds of Main Pension	No Maximum
Maximum Lump Sum	25% of Policy Value (max €1.25m)	150% of Final Salary or 25% of Fund Value for certain members (max €1.25m)	25% of Contract Value (max €1.25m)
Tax Relief to Employer	Not Applicable	Full Relief on Amounts reasonably required to provide benefits	Full relief on 15-40% scale

Tax Relief to Individual / Member	15-40% of Net Relevant Earnings	15 - 40% of Salary	15-40% of Earnings
Maximum Contributions By Employer	Not Applicable	Such Amount as is reasonably necessary to provide benefits.	Not applicable
Maximum Contributions by Individual/Member	Not Applicable	15 – 40% of Salary	Not Applicable
Maximum Lump Sum Death Benefit	No Maximum	4 x Salary Plus Value of Employees Own Contributions (incl. Interest)	No Maximum
Typical Target Age for Benefits	60-75	60-70	60-75
Optional Early Retirement	None	From Age 50.	None

Occupational Pension Schemes

The key criteria which define the broad structure of benefits and the method of operation of Occupational Pension Schemes are:-

(i) The benefit structure is established by an employer for the benefit of an employee. Even where the total cost of a particular benefit is being financed in full by an employee (for example through an Addition Voluntary Contribution (AVC) arrangement), the involvement of the employer is still necessary in order to establish the structure.

(ii) An arrangement must be financed in whole or in part by an employer. Whilst an arrangement such as an AVC may be fully financed by the employee this is only permitted where it is supplementary to an employer sponsored benefit structure.

(iii) Benefits are primarily provided under Trust. Thus all the legal and legislative provisions that apply to Trusts will also apply to Occupational Pension Schemes.

(iv) The tax provisions applicable are governed by Chapter 1, Part 30, Taxes Consolidation Act, 1997 which dictates the benefit structures and other practical aspects of the operations of such schemes.

Regulatory Framework and Applicable Law

We have already noted that Occupational Pension Schemes are primarily governed by Trust Law. This in recent years has been supplemented by legislation specifically applicable to Occupational Pension Schemes namely the Pensions Acts 1990 to 2005. The principal regulatory step undertaken by the Pension Act of 1990 was to establish a Pensions Board with responsibility for overseeing the operation and regulation of all Occupational Pension Schemes. Subsequent amendments extended the regulatory regime to include a Pensions Ombudsman.

Structure

The primary legal structure underpinning the provision of benefits to employees is the Trust. The Trust concept is ideally suited for this purpose as it facilitates the holding of assets provided by one party for the benefit of another or others.

Revenue Approval

One of the key features of pension schemes is the tax benefits attaching to such schemes. The full range of these tax benefits are only available to schemes which are "exempt approved" within the framework of Chapter 1, Pt30, TCA97.

Section 772(1) provides a mandatory regime under which approval **must** be granted by the Revenue Commissioners to an occupational pension scheme. However, Sub-section (4) then goes on to provide:

> *(a) The Revenue Commissioners may if they think fit having regard to the facts of a particular case and subject to such conditions, if any, as they think proper to attach to the approval, approve a retirement benefit scheme for the purpose of this Chapter, notwithstanding that is does not satisfy one or more of the prescribed conditions.*

This discretionary power of the Revenue Commissioners has been utilised quite extensively. The current edition of the Revenue Pensions Manual runs to some eighty pages.

The benefits of approval or exempt approval status can include :-

- Exemption from Income Tax in respect of income derived from investments or deposits. Also exemption from income tax in respect of underwriting commissions applied for the purpose of the scheme.

- Exemption from Capital Gains tax on investments by the scheme.

- Automatic tax relief on contributions paid by the employer to the scheme.

- Tax relief on employee contributions up to 15- 40% of remuneration.

- No benefit in kind on employee in respect of employer contributions.

- Tax relief at source through the “net pay” arrangement.

Other ancillary benefits flowing from the process are entitlement of the member to a tax free lump sum on retirement or on death.

The powers given to the Revenue are extensive in that Section 772(4)(a) allows the Revenue to breach the prescribed conditions. Section 772(4)(b) goes on to outline specific instances of permissible breaches.

These powers have been used quite extensively by Revenue in the past in the context of regulating investments for self administered schemes. Those regulations have now been put on a statutory footing by Finance Act, 2006.

Self Administered Pension Schemes

These are a particular type of Occupational Pension Scheme.

Self Administered Pension Schemes (SAPS) have existed for as long as pension schemes themselves have existed. For current purposes however SAPS and in particular Small SAPS derive their origins from the Finance Act, 1972.

The growth in the market for SAPS was initially slow. However the market conditions of the late ‘80s and early ‘90s provided a significant boost. This period experienced an equity crash in 1987 followed by a flat market. In addition the high inflation of the late ‘70s and early ‘80s was a thing of the past. As a consequence of these factors individuals began to actively seek out alternative self directed options.

Developments in this context were aided by the example of the UK market which had already developed significantly in this regard. Also the development of specific service providers in the Irish Market fuelled its growth.

All the terms outlined above in respect of Occupational Pension Schemes also apply to Self Administered Pension Schemes. In addition the Revenue have imposed additional restrictions on such schemes. These include:

- Each scheme must have a Pensioneer Trustee

- Annual accounts and triennial funding reviews must be submitted to the Revenue

- Various Investment Restrictions. Whilst many of these have now been put on a statutory footing it would seem that the Revenue Practice Notes would still apply to circumstances not covered by the legislation.

The definition of a small self administered scheme involves two elements:

- Less than 12 members, or

- 65% or more attributable to 20% Directors, their spouses or dependents.

The effect of putting the investment rules on a statutory footing is that they now apply to ALL Occupational Pension Schemes whereas the rules in the revenue Practice Notes were generally only applied to Small Self Administered Schemes.

Investment Restrictions

The new rules put occupation pension schemes on the same footing as Approved Retirement Funds and PRSAs. The new rules apply to the following types of transactions:

- Loans to beneficiaries

- Purchase of an asset from a beneficiary

- Sale of asset to a beneficiary

- Acquisition of residential property or holiday property and the use of same by the beneficiary

- The acquisition of shares in a closed company or overseas equivalent of which the beneficiary is the participator

- Acquisition of property and letting of same to the employer company.

These rules apply not just to transactions involving the beneficiary but also deal with persons connected with the beneficiary. This brings into play the definition of connected persons in the general tax code. Section 10(2) states as follows:

> ***"For the purposes of the Tax Acts and the Capital Gains Tax Acts, except where the context otherwise requires, any question whether a person is connected with another person shall be determined in accordance with sub-sections (3) to (8)***

(any provision that one person is connected with another person being taken to mean that they are connected with one another)."

The section proceeds to outline a range of connected persons including relatives of the individual concerned and those of his spouse.

A key impact of the new rules, therefore, is that the range of people with whom an affected transaction could occur is significantly increased.

Personal Pensions

The key features of a Personal Pension are as follows:-

- Benefits are provided by means of an insurance policy effected by an individual. The only exception to this are group schemes established under trust.

- All contributions to these structures are paid for by the individuals themselves.

- All the structures are on a Defined Contribution basis.

Regulatory Framework and Applicable Law

The primary legislative and regulatory rules governing the operation of Personal Pensions are Revenue law as enunciated in Chapter 2, Pt30, TCA97 and general principles of Insurance Law. In the main the radical changes to funded Occupational Pension Schemes brought about by the Pensions Act 1990 have not applied to Personal Pensions. Recent developments in the Family Law area, however, do apply equally to Personal Pensions.

Structure

Most Personal Pensions are provided under contracts of insurance. Only in relation to certain group schemes is the legal requirement for insurance contracts removed. This means that developments such as Small Self Administered Schemes have generally been confined to Occupational Pensions. My colleague will look at some structures that remedy this.

Revenue Approval

A key feature of the entire structure of Personal Pension contracts is that they must be approved by the Revenue Commissioners. In this regard the discretionary powers of the Revenue are contained in Section 784(3) as follows:

> *"The Revenue Commissioners may, if they think fit and subject to any conditions they think proper to impose, approve a contract otherwise satisfying the conditions referred to in Sub-section (2), notwithstanding that the contract provides for one or more of the following matters …".*

The legislation then provides a list of the areas in which the Revenue Commissioners have the power to exercise their discretion. Unlike the position that applies with occupational pension schemes the Revenue Commissioners have not felt the need to publish a detailed set of guidance notes as to how their discretion will be exercised. This difference in treatment seems to be a direct result of the wording of the two provisions. Section 772(4)(a) contains an wide power on the part of the Revenue to vary the terms of the actual legislation itself. By contrast, section 784(3) limits the exercise by the Revenue Commissioners of their discretion to the instances specified in that section.

The main criteria which the Revenue are required to bear in mind in approving an annuity contract in respect of retirement income is that it is a contract under which the main benefit is a life annuity for the individual in his old age. This requirement is now subject to the options that an individual has on retirement to transfer to an ARF.

It is important to note that none of the conditions in relation to Personal Pension contracts refer, directly or indirectly, to the type of investments that an insurer can effect.

Despite this a number of Insurers have sought and been granted approval for funds consisting of stockbroker portfolios. This concept first appeared in the mid '90s and was developed by Davy Stockbrokers.

In recent years these products have been extended to include property.

Approved Retirement Funds

Approved Retirement Funds (ARFs) were created by the Finance Act of 1999. They are intended as a replacement for annuities. Essentially they permit an individual to transfer pension benefits into an ARF and manage it on a drawdown basis. The assets in the ARF are held on behalf of the beneficial owner by a Qualifying Fund Manager (QFM).

Tax Treatment of ARFs

Such funds are exempt from Income Tax and Capital Gains Tax in the same manner as other pension funds.

Income Tax is imposed on most withdrawals under the PAYE system.

Exemption from Inheritance Tax applies where the proceeds of an ARF are inherited by a child over the age of 21.

Structure of an ARF

An ARF is held by a QFM separate from its own assets. For example, where the ARF provider is an insurance company the assets do not automatically form part of the assets of the insurer. In practice however the assets that a QFM tends to manage are those that are issued by the QFM itself.

Personal Retirement Savings Accounts (PRSAs)

The legislation in relation to PRSAs provides for the management of the assets of the PRSA by an Investment Manager knowa as a Qualifying Fund Manager (QFM).

The legislation on PRSA contracts is detailed in Section 3 and Section 4 of the Pensions (Amendment) Act, 2002. S3PAA 2002 inserted a new Part X into the Pensions Act, 1990. Much of the terms of s.3 contained details of the terms of the PRSA contract. S.4 PAA 2002 inserted a new Chapter 2A into Part 30 of the Taxes Consolidation Act, 1997.

Under the legislation two different types of PRSA were created namely a Standard and a Non-Standard PRSA. The tax legislation divides these into two further units namely, ordinary PRSAs and AVC PRSAs.

Legal Structure

A PRSA is defined in the legislation as a Personal Retirement Savings Account established by a contributor with a PRSA provider under the terms of a PRSA contract.

The key feature of a PRSA therefore is that it will be based on contract law. This is similar to Personal Pensions but differs from Occupational Pension Schemes which are primarily based on trust law.

The PRSA Provider utilised can be an investment business firm authorised under the Investment Intermediary Act 1995 (or its equivalent in other EU States), a stockbroker, an insurance company or a credit institution.

A PRSA provider is obliged to create a default investment strategy for each PRSA product. This strategy is implemented for every contributor who has not elected in writing for an alternative strategy. This obligation applies to both standard and non standard PRSAs.

In relation to non-standard PRSAs it is possible to offer a range of additional investment options which include investments that are not within the definition of pooled funds. For standard PRSAs however only investments in pooled funds is permitted -even as an alternative to the default investment strategy.

It is an explicit condition of approval of any PRSA contract that the charges shall not be expressed in cash terms. The only method by which charges can be calculated are:

- As a percentage of contributions, and/or

- As a percentage of PRSA assets.

There is provision for variation in the charges between different PRSA contracts from the PRSA provider depending on issues such as the method of payment, the type of assets held, the term of the contract etc.

The legislation imposes limits on the type of charges that can be made in respect of a standard PRSA. The maximum charges are:

- 5% of contributions.

- 1% per annum of PRSA assets.

In relation to all types of PRSA contracts no charges can be imposed in respect of transfers received from other pension arrangements. Also no charges can be imposed in respect of termination.

The pensions legislation prohibits the imposition of any penalty or charge in respect of suspension, variation or recommencement of a contribution.

The legislation allows contributions to be paid either by the individual himself or by his employer.

Effecting a PRSA Contract

Prior to effecting a PRSA contract the PRSA provider is obliged to furnish the potential contributor with a preliminary disclosure certificate. On entry into the PRSA contract a statement of reasonable projection must be provided. Where money is being transferred from an occupational pension scheme to a PRSA it is necessary for the PRSA provider to furnish the individual with:

• A certificate of comparison of benefits.

•A written statement of the reasons why such a transfer is or is not in the interest of the person making the transfer.

Benefit Structure

Section 787K TCA 97 sets out quite specific rules to apply to PRSA contracts. It does this by means of two separate lists of criteria, namely those which are prohibited and which cannot be allowed by the Revenue and those which may be included by the Revenue in an approved contract if they so desire. In its approach it adopts a similar structure to that used for Personal Pensions. However, a key distinction is that a PRSA is not necessarily an insurance contract.

Other than that however the benefits as outlined for Personal Pensions above can apply other than for employer based PRSAs.

For Employer PRSAs certain benefit limitations similar to Occupational Pension Schemes apply. Specifically the tax free lump sum applicable is subject to the 1.5 times salary limit.

Transfers

A key advantage of PRSAs is its ability to accept transfers from both Personal Pensions and Occupational Pension Schemes.

Borrowing

The legislation provides that no legal or equitable charge can subsist over the assets of the PRSA for so long as the contributor is the beneficial owner of them.

Thus, unlike Occupational Pension Schemes or Personal Pensions, direct borrowing by a PRSA is not permitted.

Estate Planning Issues

The array of issues that can arise in relation to Pension Benefits is extensive. This paper seeks to highlight the common ones.

Locating the Benefits

Although it may seem obvious, actually locating benefits can be difficult. Clients will have worked in various roles for different employers, possibly in different countries. All of these scenarios could have triggered pension entitlements and tracking them is an exercise in itself.

Clearly this is most easily done with the assistance of the actual client. Thus a comprehensive fact find is recommended.

If this is not available accessing data from someone who did do such a fact-find could be an alternative. For example, A financial advisor, or pension consultant is required to do this for regulatory reasons. Equally funding cap rules is likely to mean that each pension providers is required to track benefits held by other providers.

Consider options in respect of the benefits

Possibilities in this regard include:

1. ARF Option. Has it been exercised by the beneficiary? Is it available to a survivor?

2. Death's Door concession – does it apply?

3. Annuity options- who qualifies as a dependent? What benefits are available?

4. Does a continuation option apply? – this allows life cover to be carried over from a pension scheme to an ordinary life policy.

Consider factors affecting asset values

Possible factors in this regard include:

1. Pension Adjustment Orders. These can be applicable to the benefits and will thus affect the amounts in the estate. Alternatively they can also affect the amounts that an individual can receive from a scheme. For example the lump sum receivable on retirement will be restricted if

a portion of the benefit has previously been transferred out on foot of a pensions adjustment order.

2. Borrowing. Certain assets of the scheme can be subject to debt and as with any encumbered asset care needs to be taken to ensure the asset is preserved.

Consider unfunded benefits

Although it is a requirement of legislation that benefits be funded and document it can happen in practice that individuals have entitlements that aren't documented. Frequently this arises due to contract terms, letters of offer, course of dealing or similar documents or events. Queries in this regard, particularly in relation to older benefits can lead to surprising results.

Planning Approach

The following are the key areas where additional planning opportunities can arise:

Moving to the OPS regime

The more generous funding available to occupational pension schemes can make this attractive. Ideas to consider in this regard are:

a. Incorporation for self employed persons

b. Use of service companies for those that cannot incorporate.

c. Employment of spouse

Accessing the ARF regime

This is particularly relevant to employees. Ideas in this regard include:

a. Utilising a Personal Services company prior to retirement. Benefits built up as an ordinary employee can be transferred to the new company and (assuming the individual is a proprietary director of the new company) will qualify for an ARFOption.

b. Transferring to a PRSA. Access to an ARF is automatic. However certain restrictions exist, for example, the option may not be available to those with more than 15 years service. Also transfers can in certain circumstances require sign-off from an actuary. To deal with these issues consider the terms of the deed or other governing document carefully to see if the 15 year restriction actually does apply.

Also actuarial sign- off can be avoided if a scheme is liquidated. Therefore consider transferring the individual into a personal arrangement first.

Maximising Benefit Entitlements

The manner in which benefits are taken can affect values. Thus transfers out prior to retirement from A defined Benefit Scheme can be significantly reduced due to the application of normal actuarial factors or additional adjustments due to under funding.

Similarly With-Profit contracts can be subject to Market Value Adjusters generally. However this may not apply if an individual is drawing down benefits at a specified date.

Another factor to consider is the possibility that guaranteed annuity rates might apply depending on the terms of the original contract issued by the Insurer.

Consideration also needs to be given to the possibility that discretionary enhancements may apply. Careful reading of the documentation will assist in this regard.

Conclusion

Pensions are now, in one sense, an asset just like any other that an individual may have in their estate. In another sense pensions are not like any other asset – locating details of them, ascertaining the exact amount, decision how to deal with them etc. all require careful consideration.

This process can be greatly aided by taking a practical approach. Knowledge is power. When you are asked to draw up a will or prepare an estate plan do a comprehensive schedule of assets and include details of pension entitlements and past employments.

Occupational Pension Schemes by virtue of their status as trusts are clearly within the purview of STEP Members. However, I have (hopefully) illustrated that pensions are now to be regarded as an asset of an estate and their importance is likely to increase in future years. It is therefore important to be aware of the problems and possibilities that come with this development. I would encourage you to acquire as much knowledge as possible in this area.

Thank you for listening!