

THE MERITS OF SMALL SELF-ADMINISTERED PENSION SCHEMES

A small self-administered pension scheme allows individuals to manage their pension assets personally rather than having them invested in a pension policy with an Insurance Company.

Small self-administered pension schemes have advantages over other forms of pension funding in certain circumstances. This note explains what they are and outlines the situations in which they can be used.

What is a small self-administered pension scheme?

A *self-administered* pension scheme is one which invests directly in the open market as opposed to holding a pension policy with a life assurance company. The term *small self-administered pension scheme* then refers to such a scheme with only a small number of members, usually taken to be less than twelve but often can be just one or two.

Who can set one up?

A pension scheme can be established wherever an employer / employee relationship exists. The employee must be in receipt of some form of income from the employer which is taxable under Schedule E - this could include director's fees.

Self-employed people are therefore excluded, unless they establish a company to run their business and become an employee or director of it. The Revenue will also refuse to set up a scheme where contributions come exclusively from the employee - the company must make a reasonable contribution (generally at least one-tenth of the total cost of the scheme).

For reasons that will become apparent, small self-administered pension schemes are best suited to owners or directors of private companies who wish to make some pension provision for themselves. They can also be used by senior personnel of larger companies who either have an interest in investment matters or who simply wish to be set apart from the main company pension scheme on grounds of confidentiality.

What are the advantages of such schemes?

These pension schemes enjoy the normal tax advantages of all pension schemes, i.e., tax relief on contributions, gross roll-up in the fund and a tax-free lump sum at the end.

The main advantages over other forms of pension funding are the flexibility and control that can be exercised over the scheme's affairs.

(a) Investment control

Firstly, the scheme member will usually have control over the investment strategy to be followed. This has several benefits, e.g.:

- It allows him to invest in areas of particular interest. This can even include investments not normally considered by small schemes such as property, unquoted shares etc. It can also be used as an umbrella fund to invest in a spread of unit funds managed by different institutions - this reduces the risk of under-performance by one manager.
- Many individuals prefer to invest directly in stocks and shares rather than through managed-type funds. Because of their size, managed funds cannot extract themselves easily from some markets when required, whereas a small scheme has much more flexibility and can act more quickly. If decisions are timed well, the potential for higher returns is substantial.
- The investment strategy can be adjusted as time goes by to suit the individual's requirements. This means for example that the fixed-interest content of the fund can be increased as retirement draws near to protect the fund's gains to date. This contrasts for example with a typical unit-linked fund which invests to suit the needs of all its investors rather than a particular individual.

(b) Confidentiality

A second advantage is confidentiality over the scheme's affairs. This particularly applies to senior employees who would otherwise be included in the main company pension fund.

Larger pension funds now have to have some form of elected membership representation on trustee boards, which is not perhaps a satisfactory situation for the many senior personnel who like to maintain confidentiality.

(c) Control over timing and form of benefits taken

The member will usually have control over the time of retirement, the form of benefits to be taken and other issues which might otherwise be subject to the discretion of a board of trustees.

(d) Control over contributions

In the case of a private company, the pension contributions can be varied from year to year (within limits) to suit the company's results, its cash flow or other financial requirements. There is no need to be tied down to a set contribution level.

(d) Borrowing

“One-man” schemes retain the facility to borrow to secure assets. Such schemes must be established solely for the benefit of one member and may not include any other members.

The following rules apply to scheme borrowing:

1. Only assets purchased by borrowing may be used to provide security to the lender.
2. Assignment of rental income to the lender is not permitted
3. Life cover on the amount of the debt may only be provided outside the scheme.
4. No cross collateralisation.

5. Interest only loans and loans for a period of over 15 years are not permissible. The loan should be repaid in full prior to normal retirement age.
6. Use of other scheme assets to clear residual debt is not permissible.

Can investment be made back into the company?

The short answer is no. The Revenue Commissioners are concerned that small pension schemes might be used for tax avoidance purposes, e.g., leasing property to the company at artificially high rates, buying assets from the company at low prices to avoid CGT, etc. They will not approve any scheme with less than 12 members which acquires assets from the sponsoring company, or lends to, or otherwise invests in, the company.

There are some exceptions however. The Revenue will always listen to a reasonable case where they are satisfied that transactions are effected at an arm's length basis. They will also consider short-term loans where the employer is in financial difficulties.

Are there any drawbacks?

There are some minor drawbacks associated with these schemes.

The scheme will obviously need management and will therefore absorb some time. This can be a greater or lesser amount depending on the form of investment made and extent to which outside advisers are used.

The Retirement Benefits Division of the Revenue Commissioners will seek annual accounts and three-yearly actuarial reports to be happy that the scheme is being run properly and is not being used for tax avoidance.

The investment income and gains of the fund may be subject to tax if the Revenue consider that the scheme is being used for active short-term investment trading as opposed to prudent and bona fide long-term investment. It is not clear how active the trading would have to be before tax might become an issue, but it is something to be borne in mind.