A Guide to Pension Funding

via an Executive Pension Arrangement

Transferring Wealth Efficiently

Executive Pension arrangements are perhaps the most tax efficient way of providing pension benefits for Company Directors, family members employed in the business and other key employees.

In the case of Company Directors and spouses employed in the business, employer pension contributions to an executive pension are an extremely effective mechanism for tax efficiently transferring profits from their business into personal wealth.

Where a company has excess profits which the company directors wish to transfer into personal wealth, it is often more tax efficient for the employer to make an employer pension contribution to an executive pension. This has the advantage of not creating a personal tax liability for the member which would be the case when using other profit extraction methods such as increasing salary/ bonuses or taking share dividends. Another plus is that the company can get tax relief on its contribution at the corporation tax rate of 12.5%.

There are further tax advantages as any contribution made is invested in a pension fund which enjoys tax-free investment growth with no DIRT, Exit Tax or Capital Gains Tax applicable to any investment return achieved by the contribution. It can also provide a Retirement Lump Sum which is tax-free up to €200,000.

How does it work?

Employer contributions are not restricted by age related limits unlike member/employee contributions, but instead are related to the cost of providing retirement benefits based on “two thirds” of salary (where there is at least 10 years service at retirement). This can result in very generous contribution amounts.

Contributions are allowable as either Ordinary Annual Contributions or Special Contributions.

The maximum allowable ordinary annual contributions to a scheme include all Employer, Employee and Additional Voluntary Contributions made to the scheme in the company accounting period. It is worth noting that it is possible to pay an ordinary annual contribution by either regular monthly, quarterly or annual payment or by way of single premium.

Special Contributions are normally paid by single premium and can be used to backdate periods of salaried service which were previously not pensioned.

Example: Ordinary Annual Contribution Calculation

Mary is 35 and married and has a salary of €50,000. She has a Personal Pension currently valued at €100,000. She has no definitive plan for a retirement date but wants to maximise pension contributions now to the best arrangement available

The Revenue limits around personal contributions mean that the maximum personal contribution she could make to a pension would be €10,000 (20% X €50,000).

However in Mary's case, her salary comes from her company. As a result the company itself can make contributions to an Executive Pension arrangement on Mary's behalf.

The maximum contribution that the company could make on an annual basis is known as the Ordinary Annual Contribution and is calculated as follows:

1. Calculate maximum pension and capitalise* it
   2/3 X €50,000 X 30 = €1,000,000
2. Deduct current value of scheme funds and retained benefits €1,000,000 - €100,000 = €900,000
3. Divide remaining fund by the number of years to go to NRA (assumed to be Age 60)
   €900,000/25 = €36,000

* As Mary is a married female planning to retire at age 60, the relevant capitalisation factor is 30. Revenue introduced a standard methodology in September 2008 along with a set of capitalisation factors to be used to calculate the maximum allowable contribution. The Basis for these calculations can be found in the Revenue Pensions Manual (Chapter 5).

As you can see the company can make a far greater contribution on Mary's behalf than Mary could make personally under the personal age related limits. For the purpose of the calculation we have assumed Mary's NRA to be age 60 as she has no specified retirement date and wishes to maximise contributions.

Example: Special Contribution

There is also the potential for companies to make pension contributions on behalf of employees for previously unfunded service with the company. These contributions are known as Special Contributions.

John is 50 and has his own company from which he takes a salary of €40,000. John set up his company fifteen years ago, taking a salary for each of these years but has no previous pension funding in place. John wishes to retire at age 60.

There is therefore an opportunity to fund for this previous service via a Special Contribution

1. Calculate maximum pension, capitalise* it and deduct any retained pension benefits (2/3 X €40,000 X 32.4) - €0.00 = €864,000
2. Determine how much of this maximum fund relates to the service accrued to date €864,000 X 15/25† = €518,400
3. Deduct the current value of scheme assets to determine the scope for Special Contribution €518,400 - €0.00 = €518,400

* As John is a married male planning to retire at age 60, the relevant capitalisation factor is 32.4.

† The fraction 15/25 in step 2 represents John's service to date divided by his total potential service at NRA.

Revenue limits around personal pension contribution do allow that prior to the 31st October in the current year, John could make a contribution and offset against last years income tax bill but limited to age and earnings attained in the previous year. Assuming earnings were the same this would equate to 25% of €40,000 or €10,000.

However, Revenue also allows that contributions may be made in respect of previous service by an employer using an Executive Pension arrangement. The calculation is based on the member's current salary and all previous years with the company where they took a salary. This can be particularly beneficial for late starters to pension funding.

As you can see the company can make a far greater contribution on John's behalf in respect of previous service than John could make personally under the age related limits. The employer could immediately make a very large Special Contribution for John from the outset. They do not have to make this contribution in one payment. They could seek to make a smaller Special Contribution this year and allow for the remainder in future years. They could also look to make Ordinary Annual Contributions. Where a special contribution is made, a revised calculation for the scope for Ordinary Annual Contributions should always be completed thereafter as the current value of scheme assets (Step 2 - OAC calculation) will change as a result.

Tax Relief for Employer Contributions

Employers get tax relief on allowable contributions at the prevailing rate of Corporation Tax which is currently 12.5%. Tax relief may always be attained on Ordinary Annual Contributions in the year in which they are made. Tax Relief on Special Contributions can also always be attained in the year in which the contribution is made where the Special Contribution is equal to or less than the corresponding ordinary Annual Contribution made in the same year. No employer PRSI is paid on employer pension contributions to an occupational pension scheme.

Take the next step

If you have a query on any of the information contained within this booklet, please feel free to contact our Technical Services Team or your Zurich Broker Consultant.

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