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Offshore Pension Plans —
Their Role in Global Pension Programs

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Abstract
One of the interesting aspects of many global pension programs is the offshore pension plan. This paper explores the continuing popularity of such plans and reviews their design and funding. It then considers the practical operation of offshore pension plans from the viewpoint of a practitioner in this specialized field.

1. Introduction
Offshore pension plans have been around for at least as long as the International Association of Consulting Actuaries, but have received little attention at past conferences, despite the fact that two such conferences (Bermuda and Hong Kong) were held in international finance centers where such plans have been established. This paper seeks to remedy this and to indicate why offshore pension plans remain as popular as ever.

The paper is written from the perspective of a practitioner working in Guernsey, Channel Islands, where a large number of offshore pension plans are based. The practical examples are thus drawn mainly from such plans established by multinational companies with head offices in the United Kingdom. However, the concepts should be of application more generally to offshore pension plans, wherever they may be based.

The paper concentrates on trusts established to provide specific pension provision. It does not consider the use of other employee benefit trusts (established for example to deliver share options or awards). Neither does it consider the use of employee benefit captives for the delivery of risk benefits. Both structures are also encountered offshore and merit consideration, but will need to await a further paper.

2. Some Definitions
In order to set the scene it is useful to start with some definitions. While the terminology is not universal, the following definitions would probably be generally accepted:

- An **offshore pension plan** may be described as a pension plan established in an offshore location, which is the home country of neither the employer nor the employees, to provide benefits for the international staff of a multinational group. Thus, a United Kingdom multinational company might establish an offshore pension plan in Guernsey to provide retirement benefits for its international staff working, for example, in Africa or the Far East. The plan can sometimes also be used to encompass locally recruited staff in overseas locations where, by reason of economies of scale or because of the lack of local pensions vehicles, it is efficient to arrange their pension provision through a global offshore pension plan.

- **International staff** might be career expatriates, or may be secondees or permanent transferees from one country to another, while remaining within the multinational's group of companies.

- A **career expatriate** is an employee recruited for international service (probably in a number of countries in the course of a career) or an employee transferred into this category in the course of their service within the multinational group.

- A **secondee** is an employee recruited in one country and seconded from there to another country for a specific period, or to carry out a specific project, with the intention that he or she will return to the original country when the period of secondment is over.

- A **permanent transferee** is an employee recruited in one country and then subsequently transferred permanently to another country.

- International staff are sometimes referred to as third-country nationals (TCNs) although strictly a **third-country national** is a citizen of one country, working in another country for the local subsidiary of a parent company that has its headquarters in yet a third country (for example a Dutchman working in France for the French subsidiary of a U.K. parent company).

In practice, the distinctons between these categories may become blurred at times, and employees may move from one category to another as their careers progress.

3. Reasons for Establishment

But why set up an offshore pension plan? This is usually because the alternatives have been considered and found unsuitable.

It is not generally possible for a multinational group to retain all its global employees in a single pension plan established in its home country. In the case of a U.K. multinational, for example, there are only limited circumstances in which secondees or employees of overseas subsidiary companies (whether locally recruited employees or permanent transferees) may remain active members of the U.K.-exempt approved pension plan, although this may change once the U.K. government's arrangements for pension "simplification" are adopted in 2006. In recent years there has been some discussion about the possibilities of global (or at least pan–European) pension plans, but to date the taxation and social insurance difficulties have proved insurmountable. This may change in time, at least within the European Union, since the pensions directive came into force in 2003 with a requirement generally to adopt its provisions into national legislation by September 2005. However, even if the regulatory, taxation and social insurance obstacles can be overcome within the European Union, this will not provide a complete solution for most multinational groups, as their activities will extend beyond the European Union boundaries.

Equally, the pension arrangements (if any) of the local overseas subsidiary company are unlikely to be suitable for international staff posted there for a limited period. Such local arrangements will have been designed in the local currency to meet the needs of the local staff, having regard to the available local social security benefits, local expectations and the local cost of living, and may well not meet the requirements of any international staff working in that location. In particular, international staff may not work in any location long enough to build up a full social security contribution record, and may not qualify under any local vesting requirements for occupational benefits either. Moreover, few international staff retire in the country of their assignment and those career expatriates with a series of overseas postings would not wish to accumulate a number of small deferred benefits denominated in a variety of currencies en route (even if the vesting conditions had been satisfied) and overseas transfer payments are not usually available. Additionally, international staffs are unlikely to appreciate retirement benefits denominated in the currencies of certain emerging market economies, or payable from some developing countries.

An additional reason for establishing an offshore pension plan (or more usually for extending the scope of a plan already created for career expatriates) can be to provide pensions (or other leaving service benefits) for local staff where there are no suitable local investment vehicles for pension provision, or in order to gain from greater economies of scale when investing the assets.

4. Possible Locations

When selecting a location, a number of features will need to be considered.

- The location should have political and economic stability, and a good reputation as an international finance center.
- There should be no exchange controls to restrict the flow of income or outgo.
- Regardless of whether the location itself is tax-free, there should be legislation that exempts offshore pension plans from local taxation, both on investment income and on the benefit payments, whether in pension or lump sum form.
- The regulatory authorities should have a helpful approach and be prepared to respond rapidly.
- There should be minimal restrictions on benefit levels, and the ability to take benefits wholly in lump sum form can often be important.
- Assuming that the pension plan is to be established under trust, the location should recognize the concept of a trust and have its own trust law.
- There should be appropriate (but not excessive) regulation of pension trusts and trustees.
- There should be a range of support services to enable the offshore pension plan to be managed effectively.
- There should be good postal and telecommunication links with the home country of the parent company, and ideally

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convenient air links so that corporate executives can visit the location easily.
- Communications are also assisted if the location is in a similar time zone as the parent company and if it shares a common language.

Having regard for these features, there are three types of location generally considered for offshore pension plans.

First, there is the home territory of the parent company. For U.K. multinationals for example, and perhaps surprisingly, the United Kingdom could itself be considered to be an "offshore" location for this purpose, through the facility to set up such funds under the provisions of Section 615(6) of the U.K. Income and Corporation Taxes Act 1988. This has the advantage that the pension plan could be controlled and managed in the United Kingdom alongside the domestic U.K. pension plan. However, the future of such plans is uncertain in the light of the U.K. government's arrangements for pensions' "simplification."

Secondly, there are other "onshore" locations such as Switzerland that may be considered, although the lack of recognition of the concept of a trust in much of mainland Europe is unlikely to make many European onshore locations attractive. One possible exception is Luxembourg, which has recently introduced two new funding vehicles as a possible solution to the pension provision of mobile employees within the European Union. However, these are not trust-based arrangements and it is still too early to say whether they will prove popular.

However, in practice, most offshore pension plans are established in one of the world's international finance centers in order to provide greater flexibility. The choice of location will depend in part upon the location and time zone of the parent company. So far as U.K. multinationals are concerned, while some such plans are established in locations such as Bermuda or the Cayman Islands, the obvious choices are Guernsey, Jersey or the Isle of Man, both because of their respected reputation and financial infrastructure, and also because of ease of communications (having a common time zone with the United Kingdom and convenient air links). Guernsey and Jersey both have a minimum of regulatory requirements, while the Isle of Man has recently introduced a comprehensive regulatory regime (modeled on parts of the U.K. Pensions Act 1995).

5. Benefit Design

Historically, many offshore pension plans were set up on a defined benefits basis, to reflect the benefit design of the multinational's home pension plan. Minor adjustments might be made to reflect the overseas service. For example, benefits might be based upon a notional home country salary or adjustments made for differences in social insurance accruals. As a variation, a "base country" approach has sometimes been adopted, whereby a base country would be determined for each of the international staff and benefits provided on the same basis as local staff working in that base country, regardless of where the international staff are posted from time to time. A further variation has been to determine a special benefit structure for all international staff, perhaps with a higher accrual rate or a lower pension age than for comparable staff in the multinational's home pension plan.

However, defined benefit structures are often too inflexible to provide for all the variations encountered in the employment conditions for international staff and one can end up with as many variations from the standard benefit package as there are members in the offshore pension plan. In addition, defined-benefit structures can be complex in practice to administer. While it may be equitable to allow for the effect of differing social insurance accruals for each member, it can prove exceedingly difficult in practice to determine just what those accruals may be in some countries. This can be a problem for funding calculations, but a major concern for benefit calculation purposes, where benefits are to be brought into payment (or a transfer payment made) before the social insurance benefits fall due.

Thus, a defined contribution structure is particularly suitable for international staff, since it is easier to design a defined contribution arrangement, with contribution rates determined to fund a target level of benefits (where this is desired), than to have a rigid defined benefit structure. Such an approach also streamlines the documentation required, since there is no longer any need to draft detailed schedules of benefit rules. Instead, standard defined contribution documentation can be adopted, supplemented by individual member letters setting out any target benefits to be provided on a case-by-case basis.

Accordingly, in common with trends elsewhere in the United Kingdom and North America, most new offshore pension plans are set up on a defined contribution basis and some existing defined benefit arrangements are being converted to defined contributions.

Another trend is to establish offshore pension plans on a "master trust" approach, so that a number of different plans (with different benefit designs, or perhaps funded by different companies within the multinational group) can be provided within a single trust. This can prove more cost effective than setting up separate trusts. It can also provide a central-funding vehicle for local pension plans operated by subsidiaries within the group who do not have suitable investment vehicles in their particular locations.

Flexibility of plan provisions should be aimed for wherever possible, in order to cope with the unexpected. This can often be more readily achieved with a pension plan in an offshore location than in heavily regulated onshore locations, for example to permit the payment of retirement benefits in lump sum form when required, and to permit the accumulation of unallocated (surplus) reserves and/or for their return to the employing companies as agreed from time to time.

6. Funding

Conventional defined benefit offshore pension plans would typically be funded using the attained age or projected unit methods of valuation and using similar assumptions as for the equivalent onshore pension plans of the parent company. The attained age method may be more often used, in view of the relatively small numbers of members usually found in offshore pension plans, and hence the greater variability of the experience. Equally, the size of membership would not normally enable scheme-specific actuarial assumptions to be adopted.

The general absence of complex solvency requirements for defined benefit offshore pension plans gives welcome flexibility for the employer, but can result in some concerns about security of benefits, particularly in small plans.

Accounting standards on pension costs are unlikely to be a factor in determining the funding plan, as offshore pension plans are unlikely to be material to the reporting entity, so the cash contributions made during the reporting period would then be used for accounting purposes.

Where the offshore pension plan has been established on a defined contribution basis, but with a target level of benefits, a current unit method of calculation may be more appropriate. Thus the funding objective would be to provide for the leaving service benefits at any time, but no more, in order to prevent surplus arising in the event of leaving service. This would be expected to lead to an increasing funding requirement with age and service.

Indeed, provided that the sponsoring employer understands the increasing funding commitment over time, there is an argument that a current unit valuation method would be appropriate for conventional defined benefit offshore pension plans with only a handful of members, to avoid the need to dispose of surplus in the event of the members leaving service.

7. Trusteeship and Administration

Central to the establishment and operation of a successful offshore plan is the appointment of a suitable trustee and administrator. The trustee should be based in the chosen offshore location in order to demonstrate control and management there (and thus not, for example, in the home country of the multinational) and to avoid taxation or regulatory problems in the home territory. Several international finance centers specialize in the provision of trustee services, although most trustee services are geared to the provision of private discretionary trusts for high net worth individuals, and the number of trustees with meaningful experience in pension trusts remains limited. The better-regulated international finance centers have not only introduced their own trust law but have also introduced legislation to regulate professional trustees (or are planning to do so). Thus, a check should be made to ensure that the intended trustee is fully licensed in the chosen territory.

Some multinationals will have a natural wish to retain more control of the trustee function than is possible with the appointment of an independent professional trustee. In such cases, a suitable solution can be to form a separate trustee company in the offshore territory as a subsidiary of the multinational which would act as a single purpose vehicle for the trusteeship of the offshore pension plan, and then to delegate the management of that trustee company to a suitable independent professional trustee company based in the offshore territory.

While the trusteeship should be performed in the offshore territory, it is still possible to delegate some administrative functions back to the multinational's pensions department in the home territory. It would be advisable for the accounting functions to be performed in the offshore territory, but the membership administration (being the more technically complex part of the operations) can, where desired, be delegated back, though an appropriate administration agreement should be put in place to

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demonstrate that ultimate control remains with the trustee.

Similarly, investment management need not be carried out in the offshore territory. It is increasingly common for offshore pension plans to invest in the pooled funds of major financial institutions. In the case of defined benefit plans this is because most such plans are of a size that direct investment into securities is at best only of marginal advantage relative to pooled fund investment. In the case of defined contribution schemes this is to simplify the unit-allocation process between plan members.

8. Establishment and Operation

The offshore pension plan would be established by means of a trust deed and rules (and an interim deed approach could be used where required if there is a particular urgency in the establishment timetable, with a definitive deed and rules to follow at a later date). It is normally advisable for the documentation to be reviewed by a lawyer in the offshore territory to ensure compliance with local laws. The documentation should be submitted for approval (or confirmation of exemption from local taxation, as applicable) to the offshore territory's income tax office and any other relevant regulatory body there, and the usual procedure would be to submit a draft for clearance before execution if the provisions are at all non-standard.

Before proceeding, it would also be advisable to check out the taxation and regulatory position for the offshore pension plan in each of the locations where the intended members are based. In particular, employee contributions to an offshore pension plan are not usually tax deductible, and so it is usual to make the plan non-contributory. If employer contributions would be taxable on the employee as a benefit in kind then it may be necessary for such tax to be recompensed by the employer.

Offshore pension plans will often include life assurance benefits that will require reinsurance, because of the level of cover required for the generally senior nature of the membership or the relatively small number of members involved. This can prove to be a practical problem if cover is needed in excess of the available free cover limits, as it can prove difficult to persuade hard pressed international staff to attend a medical examination. In such circumstances a degree of self-insurance or limitation of cover may be needed unless the problem can be avoided entirely by including such international staff in the group life policy of the multinational parent company.

Disability and medical benefits are not usually included in an offshore pension plan.

Member communication is important to the success of any pension plan, and is particularly important for offshore pension plans, where the members are physically remote both from head office and from the trustees and administrators. In addition to the usual member statements and scheme booklets it is therefore useful to set up other communication lines. Telephone help lines can sometimes be useful, though time-zone differences sometimes make that impractical. A more common substitute nowadays is an e-mail help line to the administrator's offices. This may well be supplemented (at least in the case of the larger offshore pension plans) by Internet access to a dedicated-plan website with secure access to membership information and (for defined contribution schemes) details of individual account balances.

9. Summary

I hope that this paper has provided a useful introduction to this specialized field, and will encourage other actuaries to explore the offshore pension-plan opportunities with their clients.

In my opinion, offshore pension plans have a continuing and expanding role in global pension programs. While the initiatives of the European Union in encouraging cross border and pan-European pension provision are to be commended, it seems unlikely that they will replace the need for well-designed and targeted offshore pension plans. It should be borne in mind that most multinational companies do not confine their operations to European Union countries, and so the adoption of the E.U. Pensions Directive is unlikely to see the demise of the offshore pension plan. In fact, the demand for such plans is expected to continue as companies increasingly find the need to conduct their businesses internationally. ☐

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