Looming large

International Tax Personal tax

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Joshua Ashman provides guidance on what US expats living in the UK should know about the US taxation of UK SIPPs

Key Points

What is the issue?

Unlike almost all other countries in the world, the United States taxes its citizens on their worldwide income no matter where they reside.

What does it mean to me?

As a result, UK residents with US citizenship must essentially navigate two systems of taxation simultaneously. This can have important tax and reporting implications.

What can I take away?

A common activity in the UK with potential US tax implications is participation in a UK pension plan. One such plan enjoying a recent increase in popularity is the UK self-invested personal pension (SIPP). The prevalence of SIPPs, including amongst US expats, warrants a review of the US tax implications of SIPP participation.

For US expats living in the UK, the spectre of US taxation looms large due to the unique citizenship-based taxation system in the United States.

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A more than common activity in the UK with potential US tax implications is participation in a UK pension plan. One such plan enjoying a recent increase in popularity is the UK self-invested personal pension (SIPP). The prevalence of SIPPs, including amongst US expats, warrants a review of the US tax implications of SIPP participation.

A quick background on SIPPs

A SIPP is a pension that is designed to holds investments until retirement, when participants can start to draw retirement income either in the form of a lump sum or annual payments. Unlike other standard personal pensions, a SIPP typically allows more flexibility with respect to choosing the underlying investments.

UK tax law affords SIPPs special treatment on a number of fronts. First, the UK government adds to participating individuals’ contributions at a percentage based on their marginal tax rate. Second, the pension fund can grow tax-free until retirement. Third, when withdrawing funds from the SIPP at retirement, individuals can take up to 25% of their funds tax-free.

A fundamental rule about international taxation

The US treatment of non-US pensions requires elucidation from both a tax and reporting perspective.

But first, it's important to emphasise a fundamental rule about international taxation – the rules that apply in one tax system do not necessarily apply, or apply in the same manner, in another tax system. The US tax rules on pensions differ greatly from the UK rules, so it's crucial to understand the similarities and differences between the systems.

It's also important to determine the extent to which each system helps taxpayers avoid the double taxation of their income, either through their own taxation provisions (e.g., foreign tax credits) or through the provisions of an income tax treaty between the two countries.
US taxation of non-US pensions

From a tax perspective, non-US pensions generally do not qualify for the beneficial tax-deferral treatment afforded to qualifying US pensions under Section 401 of the US Internal Revenue Code (e.g., a so-called '401(k) plan'). As such, employer contributions and plan earnings may be subject to US tax on a current basis and required to be reported on the individual's US income tax return, even though these items may not be currently subject to tax in the local country. In the case of a pension plan that qualifies as a so-called 'employees' trust' within the meaning of Section 402(b) of the Internal Revenue Code, employer contributions are taxed currently but plan earnings may be tax deferred until retirement assuming certain conditions are met.

Fortunately for US expats living in the UK, the US-UK income tax treaty will often exempt UK pension plan contributions and earnings, assuming that the plan qualifies for beneficial treatment under the treaty.

With respect to pension distributions, the US-UK treaty generally does not prevent the US from taxing such income, although outcomes may vary under the treaty depending on whether the payments are periodic or paid as a lump sum.

US tax reporting of non-US pensions

From a reporting perspective, there are three tax main form requirements that can be triggered by virtue of ownership in a non-US pension (other forms may also be required depending on the underlying investments within the pension):

(1) IRS Form 3520 and 3520-A (trust reporting):

A US person who is treated for tax purposes as the owner of a foreign trust is required to annually file the Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts) and the Form 3520-A (Annual Information Return of Foreign Trust with a US Owner).

UK pensions are often held under trust, which can trigger this trust reporting obligation. According to US Treasury regulations, the participant in a foreign pension treated as an ‘employees’ trust’ will be considered its owner (or more precisely, the owner of the portion of the trust attributable to his or her contributions) if the participant’s contributions exceed his or her employer’s contributions to the plan.

(2) IRS Form 8938 (FATCA reporting):

A US person who holds an interest in one or more specified foreign financial assets, and the value of those assets is more than a certain reporting threshold, is required to annually file the Form 8938 (‘Statement of Specified Foreign Financial Assets’).

The IRS specifically includes non-US pensions within the definition of a specified foreign financial asset.

(3) FinCEN Report 114 – also known as the FBAR (foreign bank account reporting)

A US person must file the FBAR form if the maximum values of his or her foreign financial accounts exceed $10,000 in the aggregate at any time during the calendar year. There is some uncertainty as to how and when FBAR reporting should apply to a non-US pension, but to the extent a US person is considered to own the pension account, FBAR reporting may be required.

It should be noted that penalties for non-compliance with respect to the above forms can be quite steep, with penalty amounts beginning at US$10,000 per form per year, assuming that the individual's delinquency is considered non-wilful by the IRS. Wilful violations can result in much higher penalties and criminal prosecution.

Putting it all together – the US taxation of SIPPs

With the above background, we can now focus on the US taxation of SIPPs in particular. While there are a number of facets potentially at play, the following are the key US tax considerations.

First, from a substantive tax perspective, the US-UK treaty should seemingly exempt plan contributions and earnings from US taxation. It is important to note, however, that in certain situations, the utilisation of treaty benefits may not be as advantageous as utilising foreign tax credits to reduce or eliminate the US tax liability. The latter approach generates 'basis' in the pension, thereby reducing the US tax hit on the eventual distribution from the SIPP which, as mentioned above, may not be exempted under the treaty. In this regard, the best strategy will depend greatly on the specific circumstances of the taxpayer.

Second, from a reporting perspective, SIPPs can trigger the requirement to file the FATCA (Form 8938) and FBAR (FinCEN 114) forms discussed above, depending on whether the individual passes the applicable account and asset value thresholds. Additionally, because SIPPs are generally held under trust (with the provider acting as the trustee), they may trigger a trust reporting obligation (Forms 3520 and 3520-A), particularly in the case that the participant's contributions exceed his or her employer's contributions to the plan.

Given that the penalties for non-compliance can quickly reach significant amounts, it's imperative for US owners of a UK SIPP to fully understand the tax and reporting implications of such ownership. The nuanced systems of taxation in both the United Kingdom and the United States require a careful analysis within the context of the specific circumstances of the SIPP participant.