International pensions

Employment Tax Tax voice

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Matthew Fox reviews where we are currently in the international treatment of pensions and retirement benefits.

In the last 15 years there have been many fundamental changes to the UK tax treatment of contributions to and distributions from pension schemes and it has become an increasingly complex area of taxation for both employers and employees. The UK is not alone as countries seek to reduce the tax reliefs available to high earners as well as increasing penalties for compliance failures.

For employers, understanding all costs and tax compliance risks for their pension plans has become a key focus. When sending employees on an international assignment they should assess whether relief is available for contributions paid to home country schemes as any tax due on pension contributions in the host country can add to assignment costs. Added to that is the impact of an assignment on the future treatment of distributions. There are ever increasing numbers of employees who have worked overseas for some or large parts who are now reaching retirement. It is not uncommon for such retirees to have accrued benefits in a number of jurisdictions and consequently have multiple sources of retirement income from past employment. It is critical that employers and their retired employees understand the tax treatment as the risk of significant penalties for getting it wrong have become more severe in recent years. These employees need advice on the treatment of distributions from pension plans, sometimes covering several countries.

Background

When employees go overseas on assignment, they often prefer to retain their membership of their home country plans whilst working temporarily overseas. One of the reasons for maintaining contributions to the plans is to ensure that they have continuity of pension coverage and to avoid fragmentation of their benefits. Some causes of fragmentation include:

1. Localisation – some assignees eventually settle and become local employees and join locally provided plans.
2. Acquisition – the employer may be acquired by another and, as a result, its employees join new plans
3. New employment – individuals may move cross border to take up new employment that provides benefits to employees in that country including pension

Retirement plans can take multiple forms. They range from state social security through to registered pension schemes which generally qualify for tax breaks to encourage pension savings and, lastly, to supplementary, top-up or other forms of savings plans which may be mere promises to provide additional retirement income to executives. Before providing advice to an individual client, the tax adviser first needs to identify what plans their client are a member of and how they operate, when and in what circumstances distributions occur and the type of vehicle used, e.g. a trust.

UK tax treatment of contributions and distributions – international aspects
As highlighted above there have been many changes to the tax rules over the years. The UK pensions tax regime was overhauled in 2006 to merge various tax rules and simplify the tax position. There have been many changes since then, as shown in the following table:

6 April 2006	‘A’ day – a ‘simplified’ regime for the ‘long-term’

6 April 2011	Disguised remuneration introduced with some exceptions for pension Annual allowance reduced to £50,000 Carry forward of annual allowance Flexible drawdown rules introduced
6 April 2012	Lifetime allowance reduced to £1.5M
October 2012	Auto-enrolment introduced
6 April 2014	Annual Allowance reduced to £40,000 Lifetime allowance reduced to £1.25M
6 April 2015	Pension Flexibility for Defined Contribution Schemes
6 April 2016	Annual Allowance taper introduced for high earners reducing the Annual Allowance from £40,000 to as low as £10,000
6 April 2017	Lump sums from overseas schemes paid to UK residents fully taxable, grandfathering provisions for foreign service relief Abolition of 10% abatement from income tax on foreign pensions
6 April 2020	Increase in income thresholds by £90,000 for the annual allowance taper, annual allowance restricted to £4,000 for high earners

All of the above have had an impact of the UK tax treatment of contributions and distributions and have impacted the treatment of pension contributions and distributions in the international context.

Contributions to Overseas Schemes and future distributions

There are four ways individuals can claim relief from UK tax for contributions to an Overseas Pension Scheme. The first step is to assess if the disguised remuneration rules set out in Part 7A ITEPA 2003 apply to contributions, and if so there is likely to be a tax charge on the earmarking of funds. If these rules do not apply, relief can be claimed using one of the following:

- Migrant Member Relief (FA 2004, Schedule 34)
- Transitional Corresponding Relief
- Treaty relief
- Exemption of employer pension contributions under s307 ITEPA 2003 where the scheme is an Overseas Pension Scheme (as defined in UK law).

If relief can be claimed, the relief is subject to the Annual Allowance and Lifetime Allowances limits.

The drawback of claiming the relief is that where an individual subsequently leaves the UK and, within 5 (for pre-6 April 2017 tax relieved funds) or 10 years (for tax relieved funds on 6 April 2017 or later) of ceasing to be UK tax resident, takes a distribution in a manner that would not be allowed from a UK registered scheme, there could be a member payment charge. Broadly the charge is a clawback of the tax relief claimed whilst in the UK and that part of the distribution may be subject to a 55% charge. If this applies the former assignee needs to report it on a self-assessment return. This could happen, for example, where an employee returns home and leaves the employment and then receives a lump sum from the plan as a result of leaving the job.

With the potential limited relief available for contributions and this associated future cost and compliance risk many individuals and their employers are becoming increasingly reluctant to claim any reliefs in the first place.

Employee retires in the UK, receives a pension or lump sum from an overseas plan

A pension from any non-UK pension scheme paid to an individual resident in the UK for tax purposes is fully taxable in the UK (s573 ITEPA 2003). If the pensioner is not domiciled in the UK then the pension is only taxed in the UK to the extent that it is remitted to the UK (assuming the pensioner claims to be taxed on the remittance basis).

The individual may also be taxable in the source country in respect of the pension. However, where the UK has a double taxation treaty, this often gives exemption from tax in the source country provided the pension is taxed in the UK. There can be exceptions, and the treaty must be checked in each case. Some treaties will not give exemption from source country tax if UK tax is not charged because, for example, a non-domiciled individual claims the remittance basis and does not remit the pension to the UK.

The UK tax treatment of a lump sum from an overseas plan to a UK tax resident can be more complex as a result of the FA 2017 changes. Unless the remittance basis applies, generally the starting point is to treat the lump sum as taxable and then consider reductions for amounts accrued in respect of foreign service prior to 6 April 2017.

Furthermore, a lump sum from an Overseas Pension Scheme that meets certain conditions may qualify for a reduction in the taxable amount of 25% in a similar way to the payment of a lump sum from a UK registered scheme.

Employee retires overseas, received a pension or lump sum from a UK registered plan and a pension from his former UK employer’s top up plan

Pensions from a UK source are taxable in the UK regardless of the residence position of the recipient. The payer of the pension will usually need to apply PAYE. If there is a double taxation treaty between the UK and the country of residence of the pensioner the treaty will often give sole taxing rights to the country where the pensioner is living, in which case a claim can be made to HMRC for authority for the pension scheme to pay the pension without deducting UK income tax. However, tax treaties vary and the exact terms of the relevant treaty need to be checked. Advice should also be taken in respect of any tax-free lump sum from a UK plan which may be liable to tax in the country of residence.

Summary

Individuals planning to retire in the UK with pension accruals for overseas service should be considering the UK tax position of their retirement benefits before they become UK tax resident again to ensure that they are fully aware of the UK tax position on their UK retirement benefits. There are many nuances and it would be unwise to rely on generic advice. Pensions remain a key topic of discussion at the Joint Expatriate Forum as there remain several areas of uncertainty where practical clarity would be helpful.

It is essential that any pension income is correctly reported in the UK. This is especially important for those with foreign pensions as there can be significant penalties associated with any ‘offshore’ non-compliance. With this landscape, employers may wish to help support employees in the lead up to their retirement by pro-actively encouraging them to seek tax advice.