Finance Bill 2017 and the reform of the UK taxation of non-UK pensions

Employment Tax Tax voice

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Eleanor Meredith talks non-UK pensions

Introduction

The 2016 Autumn Statement included a relatively short paragraph regarding the potential reform of the UK taxation of non-UK pensions for UK tax residents, starting thus “*The tax treatment of foreign pensions will be more closely aligned with the UK’s domestic pension tax regime by bringing foreign pensions and lump sums fully into tax for UK residents, to the same extent as domestic ones.*” The Finance Bill clauses released on 5 December put considerably more meat on these bones and for many with pension savings in non-UK schemes they will have made unwelcome reading. HMRC has also made some further comments on the current intent of the proposals in subsequent correspondence. This article attempts to pull together a summary of what we anticipate the proposed changes will mean in practice and who is most likely to be adversely impacted.

Reforms to overseas pension schemes, pension transfers and pension accrual

For UK entities that act as host employers for individuals assigned to the UK from associated companies, the most significant changes are likely to be those related to relevant non-UK pension schemes. Many employees assigned to the UK will remain members of non-UK pension schemes and may be able to claim UK tax relief on their own and/or their employer's pension contributions into the scheme, depending on their circumstances and the characteristics of the scheme.

The definition of an Overseas Pension Scheme (OPS), which is relevant in deciding whether contributions into schemes may be eligible for UK tax relief is to be amended, with the requirement for at least 70% of savings in certain pension schemes to be used to provide a pension for life being dropped.

The less favourable news is that the look back test applied where an individual is drawing a benefit from a non-UK pension pot that includes UK tax relieved pension contributions is to cover a longer period. By law, any UK tax relieved contributions forming part of a non-UK pension are deemed to be used up first in any withdrawal. Under current law, an unauthorised payment charge can apply, if at the time that any UK tax relieved funds are used, the individual has not been non-resident for a period encompassing at least five full UK tax years.

Under Finance Bill proposals, the look back period will extend from five to ten years for UK tax relieved savings accruing on or after 6 April 2017, but it is not entirely clear how this will work in practice where the taxpayer's UK tax relieved pension saving spans 6 April 2017. For example, if part of a fund is withdrawn after, say, seven years of non-residence, the determination of which set of savings the employee is accessing may also determine whether or not an unauthorised payment charge could be in point.

We understand from correspondence with HMRC that the intent is for this to be clarified in secondary legislation, which has yet to be issued at the time of writing, but it is clear that those wishing to access pension savings post departure from the UK will need to consider this aspect in detail. It will also be a concern to employers, as many will tax equalise employees on unauthorised payment charges, and so will need to track pension withdrawals and their implications over a much longer period than at present, both to ensure that the charges are paid and that all relevant reporting obligations (for example for the employee and the pension scheme administrator) are met.

The longer ten-year look back period will also apply where the individual transfers pension savings to a qualifying recognised overseas pensions scheme (QROPS) on or after 6 April 2017, regardless of when the actual pension savings accrued. This may make it harder to access pension savings of this sort in a tax efficient manner.

Taxation of lump sums from foreign pension schemes for UK tax residents

Under current law, individuals whose foreign pension savings relate wholly to periods of non-UK residence with no UK working can usually draw them in a single lump sum (assuming this is permitted by the scheme) with no UK tax applying to the lump sum withdrawal. However, a significant change is set out in the draft Finance Bill clauses, such that from 6 April 2017 any lump sum paid to a UK tax resident is potentially to be liable to UK tax in full.

HMRC has indicated in separate correspondence that the policy intent is for the change to apply to lump sums paid out of funds that are built up from 6 April 2017 only. This is welcome news, and will prevent some of the “cliff-edge” taxation that might otherwise adversely affect those unable to retire on or before 5 April 2017, but planning to retire early in the new tax year. It is not, however, consistent with the draft law. HMRC has confirmed that there are no plans at present to publish revised draft law outside the normal Finance Bill timetable, so quite how the policy intent is to be achieved in the legislation remains a little unclear.

The reform is likely to have a significant impact on individuals who have spent most of their working life outside the UK but intend to retire here, as they may find that the pensions saving on which they intended to rely is lower than they had anticipated because of UK tax becoming due. This will obviously be mitigated for those currently approaching retirement, assuming that the change in law is only applied to lump sums paid out of funds built up on or after 6 April 2017, but where retirement is further off, individuals may wish to defer their return to the UK, or even to retire elsewhere, depending on any host location tax obligations.

Taxation of pension income from non-UK pensions for UK tax residents

At present, those UK resident individuals who draw their foreign pension as regular income enjoy a 10% abatement, such that they pay tax on only 90% of the pension income they actually receive. This was originally introduced as an easement when the Government enacted law that prevented UK domiciled individuals from being taxed on non-UK pensions on the remittance basis in 1974; this is a long-standing tenet of the UK tax system.

The draft Finance Bill clauses include law to repeal this abatement, which is admittedly something of an anomaly, with origins that are by now probably as obscure to current pensioners as they would be to most practitioners. That said, additional taxation is rarely welcome, especially where it will affect those on a fixed income with limited opportunity to supplement their income. Affected pensioners may feel particularly aggrieved by the speed with which the reform is being applied, as it will apply from 2017/18 onwards and no suggestion of any potential reform was made prior to 23 November 2016.

Employers paying non-UK pensions to former employees may wish to alert them to this reform, so that they do not suffer an adverse reaction when affected pensioners find their net income is reduced from 6 April 2017 onwards.

HMRC may have considered this area as ripe for reform, as there have undoubtedly been instances of individuals with no “international” connection transferring their pension savings from UK registered pension schemes to QROPS, so as to benefit from the 10% abatement available for pension income from overseas pension funds. However, if HMRC perceived this as abusive, law with a narrower application could have been considered without detriment to pensioners whose pension savings have always been held in pension funds outside the UK.

Interestingly, there currently appears to be no intention to prevent the remittance basis from applying to foreign pension income where paid to non-domiciled taxpayers, but in practice it may be difficult to claim the remittance basis in these circumstances for the longer term. Eligible individuals will have to convince HMRC that they remain non-domiciled, despite having apparently retired in the UK, and will need to be outside the extended scope of the deemed domicile law, which will also come into effect from 6 April 2017.

Closure of s615 pension schemes

Employers who have a discrete population of employees who work wholly outside the UK may have set up special pension arrangements for them, known as s615 schemes, because the related, long- established tax law is in s615(3) ICTA 1988. It was announced at Autumn Statement that these would be closed to new contributions from 6 April 2017, and draft legislation to do this and prevent any new s615 schemes from being established on or after that date is included in the Finance Bill clauses released on 6 December 2016.

This will give employers who have historically offered these to eligible employees a dilemma, as employees working wholly outside the UK are unlikely to see much benefit in membership of a UK registered pension scheme if they have no UK taxable employment income which could benefit from UK tax relief. In addition, the most appropriate vehicle is likely to be dependent on the regime applying in the host location and bespoke advice may be needed in each case.

Conclusions

Provision for retirement remains a hot topic as life expectancy increases, but the pace of fiscal change in this area is challenging especially compared to the period over which individuals generally have to think about their future retirement. Proposals likely to be enacted as part of Finance Act 2017 will make choices for those retiring thereafter, with pensions accrued in non-UK schemes simpler because alternatives are likely to be more limited going forward. The choices will be starker as the increased simplicity is also likely to come with an increased UK tax cost.