# The pensions puzzle

Personal tax



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*Rob Goodley* and *Mike Bonner-Davies* consider the pension issues when planning for retirement overseas

## Key Points

## What's the issue?

Individuals with UK registered pension savings now have significant flexibility over how and when they can take their retirement benefits. Choosing the right path can be complex, especially where the pension beneficiary is resident overseas.

## What does it mean to me?

Pension beneficiaries (and appointed advisers) should carefully consider their pensions strategy in the context of their wider financial affairs, retirement objectives and estate planning needs.

## What can I take away?

Individuals can tailor their retirement benefits to suit their financial needs, and so should consider their options well before beginning to take benefits. Individuals may be able to increase their UK pensions Lifetime Allowance from the 2018/19 UK tax year value of £1.03m by making specific HMRC registrations. The drawing of retirement benefits can be complex where the beneficiary and the pension scheme are resident in different jurisdictions.

## Introduction

On 6 April 2011, the government of the day made fundamental changes to the UK pensions landscape, giving individuals greater freedom to choose how and when they took benefits from their Defined Contribution (‘DC’) pension savings. As things stand (following a number of further changes since 6 April 2011), anyone currently over the age of 55 can draw down on their DC pension savings whenever and however they want, with no requirement to purchase an annuity or be subject to annual drawdown limits. This is called Flexi-Access Drawdown.

These pension changes are also of interest to individuals with Defined Benefit (‘DB’, i.e. final salary) entitlements as they can, subject to taking Financial Conduct Authority (‘FCA’) regulated advice, exchange those entitlements for a DC pension ‘pot of money’. With interest rates and gilt yields at historically low levels, the transfer values currently being offered by DB schemes can be attractive, especially when coupled with the ability to flexibly draw down on the resulting DC pension plan and the associated death benefits that are potentially available to beneficiaries.

Whilst these pension freedoms have been welcomed by many pensioners, the commercial and tax implications are generally not straightforward, and things become more complicated where the pension beneficiary is resident overseas or looking to retire abroad, as illustrated by the following case study.

## Roger’s DB entitlement

Roger turned 60 in April 2018, and is looking to retire from his job with Oil & Gas plc having reached that milestone. Roger has worked for Oil & Gas plc, a UK headquartered business, since April 1981.

Roger is a member of Oil & Gas plc’s DB pension scheme. He stopped accruing benefits under the scheme on 5 April 2016, and is entitled to a pension of £75,000 per annum from the age of 60.

With the exception of a seven year period (April 2006 to April 2013) during which he lived and worked in Brunei, Roger has always worked in the UK.

Roger and his wife Debbie have four adult children. The two youngest children live and work in the UK. The other two children live in Switzerland and New Zealand respectively, and each has two infant children of their own.

Roger and Debbie own three rental properties in the UK, and the income from those properties is sufficient for them to live comfortably. Roger and Debbie are both keen to spend time with their grandchildren in retirement, and so are considering moving to either Switzerland or New Zealand. They plan to return regularly to the UK, but don’t expect to ever come back permanently. However, they will not rent out their UK home so that it is continually available for their use.

Roger and Debbie are keen to pass wealth on to their children, who are all struggling financially for various reasons. Roger has been informed that the Oil & Gas plc DB pension scheme would allow him to exchange his £75,000 DB pension entitlement for a transfer value of £2.25m (determined by an actuarial calculation).

Whilst Roger and Debbie are currently in good health, their parents all died before the age of 80, and so neither Roger nor Debbie expect to live beyond that age.

## DB or DC?

Taking a simplistic approach, a DB to DC pension transfer could be an attractive option for Roger. If he assumes that he will live until he is 80 years old, then he would receive £1.5m from his DB pension scheme, being 20 times £75,000 (let's assume that the £75,000 is index-linked, such that £1.5m is a reasonable net present value). This is, of course, less than the transfer value that he has been offered of £2.25m, and taking a transfer would assist Roger with family estate planning – he could draw down on the fund as and when needed, to include making gifts to his children, and anything that he doesn't draw could be transferred to nominated beneficiaries on his death. This compares favourably with the DB pension scheme, which ceases on the later of his and Debbie's deaths.

However, such a DB to DC pension transfer should not be taken lightly. Whilst he has his DB pension entitlement, Roger suffers no inflation, investment or longevity risk – that all lies with the pension scheme itself. On taking a transfer, Roger takes on all of the inflation, investment and longevity risk. In a worst case scenario, the whole £2.25m could be lost if it is invested poorly or extinguished if he lives longer than expected. This is naturally why a transfer can only take place if the pension beneficiary has taken appropriate pension transfer advice.

## The Lifetime Allowance

As detailed in Greg Morris' article 'Rocket Science' (May 2017 issue of *Tax Adviser*), the Lifetime Allowance ('LTA') is a statutory limit on the amount that can be accumulated tax efficiently in UK registered pension savings. The default position is that Roger has a LTA equal to the prevailing statutory amount, i.e. £1.03m from 6 April 2018. The value of his pension savings for the purposes of testing against this value are as follows:

- DB entitlement – £1.5m (being the annual entitlement of £75,000 multiplied by the required standard HMRC multiple of 20)
- DC entitlement – £2.25m (being the transfer value, plus any subsequent fund growth (ignored for now))

For individuals who have exceeded the LTA, there is a pension tax charge which can be 25% of the 'excess', and so for Roger the charges could be as follows:

- DB entitlement – £117,500
- DC entitlement – £305,000

This is a significant difference, and should be carefully considered as part of any DB to DC pension transfer.

However, as Roger stopped accruing pension benefits on 5 April 2016, he should be eligible to register for a personal enhanced LTA of £1.25m. Such a registration would lead to a tax saving of £55,000 for Roger in both of the scenarios above. This registration, known as Fixed Protection 2016 ('FP2016'), is relatively well known amongst advisers. However, there is a further registration that Roger should also consider, which is generally not as well known: International Enhancement ('IE').

IE is where HMRC allows pension scheme member to have an increased LTA for periods during which they are a 'relevant overseas individual'. The principle is that if an individual accrues benefits in a UK registered pension scheme during a period of overseas service then, because they would not have enjoyed any UK tax relief on the accrual of those benefits, the slice of benefit that derives from the overseas service should not be subject to a LTA assessment or tax charge. The mechanism for doing this is to increase the individual's personal LTA by an amount reflecting the pension accrued whilst overseas.

So let's assume that Roger had accrued benefits equal to £47,000 per annum when he left for Brunei, and came back to the UK with accrued benefits of £62,000 per annum.

Registering for IE would increase Roger's LTA by £300,000 in this case (this is arrived at by multiplying the increase in his accrued pension of £15,000 by the required standard HMRC multiple of 20).

With Roger registering for both FP2106 and IE, this would see a material increase in his personal enhanced LTA and a corresponding reduction in any LTA pension tax charge.

IE is complicated with a number of conditions attaching to it. However, this does illustrate just how valuable it can be to pension beneficiaries.

## To draw or not to draw?

Let's assume that Roger has chosen to transfer his DB entitlement to a DC plan, having taken the necessary FCA regulated pension transfer advice and made the relevant FP2016 and IE registrations. Net of the LTA pension tax charge, his pension

savings will be approximately £2.1m.

There is then a question about how Roger best uses this pension pot of money for himself and his family. On the one hand, if he retains the funds in the pension scheme, he can benefit from tax exempt pension environment within the DC scheme. If he draws down, then he will have to consider his income tax position on the drawdown (which will be dependent upon where he is tax resident, see next section), as well as taxes on any future income and gains arising on that value which will then be in his own hands (i.e. outside of the tax exempt pensions environment).

Moreover, if Roger were to die before the age of 75, then his UK resident nominated beneficiaries would receive death benefits from his DC pension plan free of any UK taxes. If he were to die after 75 though, any UK resident beneficiaries would suffer UK income tax on amounts received.

So the decision on when and how much to draw is not a simple one.

## Resident abroad

Should Roger receive pension benefits whilst he is tax resident in New Zealand or in Switzerland, then we must look to the relevant Double Tax Treaty ('DTT') between the UK (where the pension scheme payer is) and Switzerland/New Zealand (where the pension beneficiary is) to establish where Roger needs to pay tax.

It is generally the case that DTTs award taxing rights to the individual's country of tax residence when it comes to pensions, rather than the source country. However, there are many exceptions to this rule.

The New Zealand/UK DTT has a relatively simple pensions article:

> *'Pensions ... and similar remuneration in consideration of past employment or services paid to a resident of [New Zealand] ... shall be taxable only in [New Zealand]'.*

So essentially, if Roger receives any retirement benefits from his employment sourced pension savings, then these should be taxed only in New Zealand if he is tax resident there.

If Roger moved to Switzerland instead, then the relevant DTT says something very different:

- *‘Subject to the provisions of paragraph 2…pensions and other similar remuneration paid to an individual who is a resident of [Switzerland], shall be taxable only in [Switzerland].*
- *Notwithstanding the provisions of paragraph 1, a lump sum payment…. shall be taxable only in [the UK]’.*

So, interestingly, the tax outcome for Roger in Switzerland would depend on how he receives his retirement benefits. Clearly if he retains his DB entitlement, he is in receipt of a pension and taxing rights reside with Switzerland. If he instead transfers to a DC plan, then he has the flexibility to take benefits either in the form of a lump sum (or a collection of lump sums) or as a pension – in the former case, the UK will have taxing rights, in the latter, Switzerland will have taxing rights. This leads to the very ethereal question … what is a pension, and what is a lump sum?

As always with international tax matters, there are many related complications, such as:

(i) **The tax free cash lump sum**
The UK tax free cash lump sum is just that – UK tax free. Where taxing rights in respect of lump sum retirement benefits do not lie with the UK, then the other country will in most circumstances tax the UK tax free cash lump sum. For Roger, this might mean considering a drawdown of his UK tax free cash lump sum amount before leaving the UK.

(ii) **Ongoing residence**
In order to rely on the terms of any DTT, Roger needs to know where he is tax resident. Even if he becomes tax resident in New Zealand or Switzerland, Roger may not necessarily lose his UK tax residence status, especially if he and Debbie maintain a home in the UK and come back regularly. If Roger is, for example, resident in both the UK and New Zealand, then he would have to consider the treaty residence tie breaker rules in the DTT, which significantly complicates matters and could completely change the tax outcome.
Moreover, the UK understandably has rules in place to prevent pension beneficiaries from leaving the UK for a short period of time in order to avail of a lower tax rate on pension drawdowns in a different country. Broadly speaking, if an individual leaves the UK for anything less than five UK tax years, any pension drawdown undertaken in the non-resident period will still be taxable in the UK. Moreover, the taxing point is when the individual returns to the UK, meaning that the relevant DTT will not

override the application of this anti-avoidance rule.
So this means that Roger does not only need to be concerned with his residence status in the year of any pension drawdown: it is something that he needs to monitor on an ongoing basis. His pattern of residence will of course need to fit in with his other lifestyle objectives and may be unpredictable, and so this is unlikely to be a trivial matter.

(iii) **Compliance**
Even if pension benefits that Roger receives are not taxable in the UK under the terms of a DTT, the pension scheme administrator will need to withhold income tax under PAYE unless Roger can obtain a No Tax coding notice from HMRC, which requires an application to be submitted and some coordination between the relevant tax authorities. Moreover, Roger will need to continue submitting UK tax returns to disclose his pension drawdowns to HMRC even if ultimately there is no UK tax to pay.

## Conclusion

This article provides a high level tour of the common issues faced by internationally mobile pensioners. There are of course numerous other factors to consider, such as the possibility of Roger transferring his pension savings to a Qualified Recognised Overseas Pension Scheme, the implications of being a non-resident landlord and the domestic tax framework in the country of residence.

However, this article demonstrates that pension drawdown remains a complicated matter, and that individuals with material UK registered pension savings should take specific pensions tax and investment advice tailored to their circumstances well before proceeding.