

Taxation of non-UK pensions

1 September 2017



Mike Haynes examines the taxation of benefits provided from non-UK pension schemes and recent changes to legislation

What is the issue?

The taxation of pension benefits paid by non-UK pension schemes is a complex subject and has recently changed as a result of government reforms in Finance Act 2017.

What does it mean to me?

Some important tax reliefs are available and it is important that tax advisers are aware of these reliefs and how to calculate them.

What can I take away?

There can be some significant differences in tax treatment depending on when the pension rights were accumulated, the type of pension scheme used and the way benefits are distributed.

For some, working overseas is an important part of their career and they accrue a significant portion of their retirement savings overseas. How are these pension benefits taxed when they retire in the UK? The tax position can vary significantly depending on when that person accumulated those retirement benefits, where they were resident when they accumulated them, the type of retirement provision used and the way benefits are distributed.

The government has also made some changes to the taxation of non-UK retirement benefits which may for some people complicate matters still further.

Establishing the nature of the payments

The first job of the adviser is to establish the nature of what is being paid to their client. This article deals with the taxation of pension benefits earned while working overseas, however it is possible that other types of income might be paid to the individual in retirement.

Different jurisdictions help people save for their retirement in a number of different ways and not all of these involve what we would recognise in the UK as being a pension scheme.

For example, some countries help people provide for retirement through saving schemes, provide end of service awards, or defer the receipt of employment income. All of these different types of income may have a different treatment to the taxation of 'pension benefits'.

The rest of this article assumes that the retirement benefits being provided are from an arrangement that would be regarded in the UK as a type of pension scheme (albeit an unregistered one).

Taxation of lump sums paid by a non-UK pension scheme

The starting point is that an individual who is tax resident in the UK would be liable to pay income tax in the UK on lump sum retirement benefits paid from a non-UK pension scheme.

Generally this lump sum is fully subject to income tax.

Although the starting point is that a lump sum is liable to income tax we need to consider whether there are any exemptions that reduce this liability in recognition of the fact that these benefits were accumulated while the individual was not resident in the UK.

Reduction for Foreign Service

It may be possible to obtain either a complete exemption or partial reduction of the UK income tax liability to account for pension savings accumulated during periods of foreign service.

Changes have recently been made to this relief in FA 2017 and further detail is set out below on how to calculate whether this relief will apply.

Relief using a Double Taxation Agreement

The UK has an extensive network of Double Taxation Agreements (DTAs) and some of these contain an article that governs the taxation of pension income. The pension article in many DTAs can award taxation rights to one State often to the exclusion of another State. It is therefore important to consider where the individual was working when the pension benefits were accrued and whether that State would seek to tax the pension benefits and what the DTA says about taxing rights. See *example 1*.

EXAMPLE 1

An individual works in Hong Kong for part of their career and their employer made contributions to an occupational Hong Kong pension scheme during that time. The individual leaves Hong Kong and retires in the UK. Although the UK may have domestic tax rules that subject these benefits to income tax, it would be necessary to review the UK/Hong Kong Agreement to determine whether UK domestic legislation would be overruled by this agreement. The UK/Hong Kong Double Taxation Agreement contains a pension Article and that can give Hong Kong sole taxing rights on pension benefits arising in Hong Kong. This means the individual would continue to be subject to Hong Kong tax rules on their retirement income rather than the UK rules.

Taxation of pension income paid by a non-UK pension scheme

It can be difficult to determine whether a series of payments is a pension or a series of lump sum payments. There is limited guidance in legislation, case law and HMRC materials to make this determination and explaining the factors that help an adviser make this determination is beyond the scope of this article. Pension income is subject to income tax in the UK even where it was funded by foreign service. Therefore the UK income tax treatment of a pension can be very different compared to a lump sum (or lump sums) in situations where the income derives from time spent working overseas.

Non-UK Domiciles may however exclude a foreign pension from UK income tax where they file on the remittance basis and do not remit the proceeds to the UK. However in many cases it will not be practical to use the remittance basis for a foreign pension if they need the pension to meet their day to day expenditure in the UK.

What's changed?

FA 2017 made several changes to the taxation of lump sums and foreign pension income. The supporting material explained there was a desire to align the tax treatment of UK registered pension schemes with non-UK pension schemes.

Lump sums: There have been significant changes to the partial or complete lump sum exemption that could apply where an individual earned their rights to those benefits as a result of foreign service.

When HMRC announced the changes to the taxation of termination payments it also explained that it would remove foreign service relief for pension lump sums as well.

However, 'grandfathering' of the old relief for lump sums was subsequently introduced such that an individual who receives a lump sum from a non-UK pension scheme after 6 April 2017, may be able to take relief on the element of the lump sum that was earned overseas prior to 6 April 2017. Where all the lump sum was earned overseas prior to 6 April 2017, the relief is relatively straightforward to calculate and the individual should obtain the same relief that would have been obtained had the sum been taken prior to the introduction of FA 2017.

However, where the lump sum was earned as a result of service that occurred both before and after the 6 April 2017, the calculations can be complex and in some situations produce some different results depending on the nature of the non-UK pension scheme. FA 2017 provides new formulae to calculate the amount of relief available for the foreign service. However a different formula applies depending on the type of non-UK pension scheme.

Benefits paid by Overseas Pension Schemes

An Overseas Pension Scheme (OPS) is a type of non-UK pension scheme that has met certain conditions. The conditions are detailed but it will need to be regulated or provide benefits in a prescribed manner. An OPS will also need to meet a tax recognition test. FA 2017 gives special treatment to lump sums paid from an OPS. A lump sum from an OPS may benefit from a reduction in the taxable amount of 25% in the same way that it would be available if the pension scheme were a UK registered pension scheme.

A pension scheme which is not an OPS may not benefit from this 25% reduction although it could still benefit from a reduction for foreign service (there are also specific non-UK pension schemes that are not an OPS that would benefit from a 25% tax free lump sum but these pension arrangements are beyond the scope of this article).

Pension income: It used to be the case that foreign pension income was subject to a 10% abatement from income tax, meaning that only 90% of the pension was taxable. This rule has been removed by FA 2017 and 100% of foreign pension income is subject to income tax.

Compliance

The entity paying the pension benefits will, in many cases (due to the pension scheme being located outside the UK), have no requirement to operate Pay As You Earn and withhold any tax from the payment.

This means that, unlike benefits paid from UK registered pension schemes, the individual may need to settle UK income tax when filing their UK self-assessment tax return.

Reporting this income correctly is important and clients may need help estimating their liability so they can budget for a liability arising on their tax return. Reporting the income will be more complex because the adviser will need translations of foreign payslips and will need to apply correct exchange rates.

Even if another country has sole taxing rights on the pension benefits individuals will still need to report the income and claim the protection of a double taxation agreement if appropriate.

Conclusion

Clients who have been living overseas but are considering a retirement in the UK should give consideration to the taxation of their retirement benefits and the reliefs available.

If they are still overseas they should consider the treatment before they re-establish UK tax residence. Retirement needs to be planned carefully and they may need to budget for the UK income taxes due on their retirement savings.

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