UK pensions simplification: Implications for overseas employees

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Abstract The Finance Act 2004 (the 'Act') set the parameters for a number of pension reforms, which finally came into full effect on 6th April 2006. Although the Act has simplified certain aspects of pension provision for the majority of UK employees, for other groups, such as overseas employees, the rules have become more complicated. This paper considers how the new regime affects, first, UK employees working abroad who are members of a UK-registered pension scheme and, secondly, UK employees in foreign plans, looking in each case at tax relief and allowances for the employer and for members (including the new lifetime allowance). It also considers the transfer of rights between arrangements.

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Introduction

The shake-up of the UK tax regime for members of pension schemes that was introduced in the UK with effect from 6th April 2006 was not limited to UK-based individuals, and their employers, who are members of a UK pension scheme. The changes also have significant ramifications for internationally mobile individuals who have a UK pensions connection, either as a UK-based employee with membership of a foreign pension arrangement or as an overseas employee with membership of a UK pension scheme.

While in some ways the position of such international individuals has been simplified, for example by making it easier for overseas-based workers to remain members of a UK pension scheme, the overall new tax regime that is applicable to them remains complex. New criteria

must be met for internationally mobile individuals and their employers in order to benefit from UK tax relief on pension contributions. Any such UK tax advantage is protected in a way that may mean that internationally mobile pension scheme members could become liable for UK tax charges, such as the unauthorised payments charge or the lifetime allowance charge.

This paper outlines how the new tax regime applies to UK-based employees who are members of an overseas pension arrangement, overseas-based employees who are members of a UK-registered pension scheme and transfers between a UK-registered pension scheme and an overseas pension arrangement.

Retaining membership of an overseas scheme while working in the UK

Prior to 6th April 2006, corresponding relief was available to an individual who met the relevant conditions; broadly, that they were in receipt of foreign emoluments and the Inland Revenue accepted that the overseas scheme

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‘corresponded’ to a UK exempt approved scheme. An individual who was eligible for corresponding relief was eligible for UK tax relief on their own contributions, and was not taxed on any contributions made by their employer.¹ An employer could also claim a deduction on contributions in respect of such an individual.

Corresponding relief has been replaced by migrant member relief with effect from 6th April 2006, although individuals and employers who were eligible for corresponding relief in the year prior to the change may remain eligible for corresponding relief under the transitional protection afforded by Schedule 36 of the Act and the Taxation of Pension Schemes (Transitional Provisions) Order 2006.

This paper focuses on the new requirements that must be met in order to obtain migrant member relief and does not consider other forms of relief that may be available to members of overseas pension arrangements, for example, under a relevant double-tax arrangement.

Migrant member relief

Migrant member relief will be available in a given tax year where the pension scheme member:

- is a relevant migrant member (see below);
- is a member of a qualifying overseas pension scheme (see below);
- has relevant UK earnings chargeable to income tax that year;
- is resident in the UK when the contributions are paid; and
- has notified the scheme manager that he intends to claim migrant member relief.

In order to be a relevant migrant member an individual must satisfy all the following conditions:²

- they were not UK tax resident when they became a member of the overseas scheme to which the contributions are made;
- they were a member of the scheme at the start of the period of UK residence in which the contributions are paid;

- they were entitled to tax relief on contributions made to the scheme either in the country where they were resident immediately prior to coming to the UK or in another country in which they were resident in the ten years prior to becoming UK tax resident; and
- the scheme manager has notified them that information regarding their benefit crystallisation events will be given to the HMRC.

In certain instances, the scheme referred to in the first three bullet points may be to a scheme that is not the scheme to which the contributions are paid.³

An overseas pension scheme is, broadly, one that is established outside the UK and is both regulated (or meets certain prescribed conditions) and recognised for tax purposes in the country where it is established.⁴

A qualifying overseas pension scheme is an overseas pension scheme that has completed the relevant HMRC notification requirements.⁵

The maximum value of contributions in a tax year on which an individual who is entitled to migrant member relief can claim relief is 100 per cent of their relevant UK earnings chargeable to income tax for that tax year. When determining whether the maximum relief is available, any UK tax-relief on contributions to other schemes, including any registered pension schemes, in the same tax year will need to be taken into account.

An individual who is entitled to migrant member relief will also be exempt from UK tax on any employer contributions to the qualifying overseas pension scheme.⁶

An employer who makes contributions to a qualifying overseas pension scheme in respect of an individual who is a relevant migrant member can claim a tax deduction for the contribution in the same way as for contributions to a registered pension scheme.⁷

UK tax charges on non-UK scheme benefits

Where an individual accrues benefits in a non-UK pension scheme that have benefited from a UK tax relief or an exemption from UK tax, then

the individual potentially becomes liable for one or more of the following tax charges:

- member payment charges;
- taxable property unauthorised payment charge;
- annual allowance charge; and
- lifetime allowance charge.

These tax charges are applied in a way that is intended to place members of non-UK schemes who have benefited from a UK tax relief or exemption in a broadly analogous position, in respect of those UK tax-relieved funds, with members of a registered pension scheme. There are, however, a number of differences between the UK tax charges that may apply to members of the non-UK scheme compared with members of a registered pension scheme; for example, the member payment charges will not apply if the individual was not UK resident when the payment was made, earlier in that tax year or any of the five tax years immediately preceding that tax year.⁸

Member payment charges

The member payment charges are those set out in paragraph 1(3) of Schedule 34 of the Act. Broadly, they are payable on unauthorised payments (except taxable property unauthorised payments) and on certain lump sums.

In order for the member payment charges to apply, all the following conditions must be met:

- (a) the payment is made (or is treated as made) to or in respect of a relieved member or transfer member;⁹
- (b) the payment is made from a relevant non-UK scheme;¹⁰
- (c) the payment is referable to the member's UK tax-relieved fund or relevant transfer fund;¹¹
- (d) either when the payment was made (or treated as made), the member was UK resident or was so resident earlier in that tax year or any of the five preceding tax years.¹²

Central to the first three conditions is whether the payment is referable to assets that accrued in

the scheme or were transferred to the scheme after 5th April 2006 that are referable to the member and which have benefited from one of the following UK tax reliefs or exemptions:

- tax relief under Schedule 33 of the Act, 'Schedule 33 relief', which includes migrant member relief and transitional corresponding relief;
- UK tax relief under the terms of a double-tax arrangement, 'DTA Relief';
- exemption from tax under Section 307 of the Income Tax (Earnings and Pensions) Act 2003 in respect of provision for any retirement or death benefits under the scheme while it was an overseas pension scheme, 'the Section 307 Exemption'; and
- a transfer from a registered pension scheme or a relevant non-UK scheme to the scheme, while it was a qualifying recognised overseas pension scheme (QROPS), of assets representing accrued rights or a transfer lump sum death benefit, 'a Transfer'.

The UK tax-relieved fund is the sum of the pension input amounts for the relevant tax years,¹³ calculated in accordance with Sections 230–238 of the Act, that have benefited from Schedule 33 Relief, DTA Relief or the Section 307 Exemption. The relevant transfer fund is the sum of:

- amounts crystallised on a direct or indirect transfer after 5th April 2006 from a registered pension scheme to the scheme while it was a QROPS; and
- any UK tax-relieved fund or relevant transfer fund that is transferred after 5th April 2006 from another relevant non-UK scheme that have not been subject to the unauthorised payments charge.

The scheme assets that are referable to a given member may have originated from a number of different sources, some of which have benefited from UK tax relief and are part of the member's UK tax-relieved fund or relevant transfer fund,

and some of which that have not benefited from UK tax relief.

When a payment is made from the scheme, the part of the scheme's assets that is used for the payment (ie whether it is referable to the UK tax-relieved fund or relevant transfer fund) is determined in accordance with the Relevant Non-UK Schemes Regulations.¹⁴ The member is not free to designate which part of the assets a particular payment will be made from so as to provide the best tax advantage. Broadly, payments will be deemed to be paid out of the member's UK tax-relieved fund in priority to another fund.

Notwithstanding this, the conditions at (c) and (d) above potentially present a member with tax planning opportunities depending on their circumstances; however, a discussion of these is beyond the scope of this paper.

Where the member payment charge applies, it is the member and not the scheme administrator that is liable for the charge.

The taxable property unauthorised payment charge

The taxable property charges that were introduced for registered pension schemes by the Finance Act 2006 also apply to a transfer member of a relevant non-UK scheme, with certain modifications. The taxable property provisions only apply to payments that are referable to the relevant member's 'taxable asset transfer fund'.¹⁵ The taxable asset transfer fund is the assets that are transferred directly or indirectly from a registered pension scheme to a QROPS.¹⁶ In some circumstances, taxable property unauthorised payments do not reduce the value of the taxable asset transfer fund held by the scheme.¹⁷ As for the member payment charges, the part of the scheme's assets from which a given payment is made is determined in accordance with the Relevant Non-UK Schemes Regulations,¹⁸ and not through member or scheme administrator choice. Where taxable property charges apply to a relevant non-UK scheme, it is the relevant member and not the scheme administrator who is liable for the charge.¹⁹

Annual allowance charge

The annual allowance charge applies to currently relieved members of a currently relieved non-UK pension scheme.²⁰

Where in a given tax year contributions are paid into a non-UK scheme that have benefited from Schedule 33 Relief, DTA Relief or a scheme member has benefited from the Section 307 Exemption then the scheme will be a currently relieved non-UK pension scheme and the member in respect of which the benefits accrued will be a currently relieved member.

As for a registered pension scheme, the annual allowance charge will only apply if the increase in value of rights under the scheme for the tax year exceeds the prescribed amount. Although the pension input amounts are calculated on a similar basis to that for a registered pension scheme, the calculation is modified to allow for the fact that some increase in value of the member's rights may not relate to income that has received a UK tax relief or exemption.²¹

Lifetime allowance

A relieved member of a relieved non-UK scheme will need to test any benefit crystallisation events in respect of their membership of that scheme against their lifetime allowance in accordance with paragraph 14 of Schedule 34 of the Act.

A relieved non-UK scheme is one in which benefits have accrued that benefited from Schedule 33 Relief, DTA Relief or the Section 307 Exemption.²² A member in respect of which any such tax-advantaged benefits have accrued will be a relieved member of a relieved non-UK pension scheme.

Charges and double-tax arrangements

An individual who is liable for one or more of the member payment charges, taxable property unauthorised payment charge, annual allowance charge on lifetime allowance charge will not be exempted from payment of the charge(s) by virtue of a double-tax arrangement as they are not charges on income.

Members of UK-registered pension schemes working overseas

The pensions simplification changes have also relaxed the requirements that an individual must meet in order to retain membership of a registered pension scheme while working overseas. For example, the old IR12 requirement where the member was temporarily working abroad for an overseas employer, the period of overseas service should not exceed ten years has been removed.

Although it has become easier to remain an active member of a UK-registered pension scheme while working overseas, the UK tax benefits enjoyed by UK resident and UK employed members of a registered pension scheme may not be available to the internationally mobile employee.

In order for an individual to receive UK tax relief on their contributions to a registered pension scheme, they must be a 'relevant UK individual' and be making 'relievable pension contributions'.²³

In order for an individual to be a relevant UK individual in a given tax year, they must fulfil one of the requirements set out in Section 189 of the Finance Act 2004:

- have relevant UK earnings chargeable to income tax for that tax year;
- be UK resident at some point during that tax year;
- be UK resident both when they become a member of the scheme and at some point in the five tax years immediately before the tax year being considered; or
- have (or their spouse/civil partner have) general earnings from overseas crown employment that is subject to the UK tax for that tax year.

In order for the contributions to be relievable pension contributions for an individual, they must be made by or on behalf of that individual (although Section 188(3) of the Act restricts certain contributions from falling within the definition). Additionally, the value of contributions on which relief can be claimed is

capped at the amount of the individual's relevant UK earnings that are chargeable to UK income tax that tax year, or if the pension scheme provides relief at source the cap is raised to £3,600 if that provides a higher cap.²⁴

The tax treatment of an employer's contributions to a registered pension scheme in respect of the overseas individual is the same as that of its contributions in respect of UK resident and UK employed individuals; that is, an employer with trading profits will be able to claim a deduction against those trading profits if the contribution is made wholly and exclusively for the purpose of the employer's trade.²⁵ Although the legal restrictions placed on an overseas individual's eligibility for membership of a UK-registered pension scheme have been relaxed, the rules of many pension schemes that were drafted pre-6th April 2006 are likely to restrict the membership of overseas employees and the rules may, therefore, need to be amended if such individuals are to be active members of the scheme.

Additionally, if the scheme is an occupational pension scheme and it is envisaged that individuals who work in another EU member state are to have membership and their employer is to contribute to the scheme, then the implications of the cross-border provisions of the Pensions Act 2004 should be considered.²⁶

Overseas-based or employed members of a UK-registered pension scheme may be liable for the annual allowance, lifetime allowance or other tax charges such as an unauthorised payment charge. An overseas individual who has scheme benefits that have not benefited from a UK tax relief or exemption may be, however, eligible to enhance their lifetime allowance to reflect this using the non-resident individuals' lifetime allowance enhancement and/or the recognised overseas scheme transfer factor.

Lifetime allowance enhancement factor

The non-resident individual's lifetime allowance enhancement factor is available to individuals who after 5th April 2006 have been a 'relevant overseas individual' at any point in an 'active

membership period' of a registered pension scheme.

An individual will be a relevant overseas individual for a tax year if they:²⁷

- are not a relevant UK individual; or
- are a relevant UK individual, but
 - are only a relevant UK individual by virtue of the fact that they were UK resident at some point during the previous five tax years and when they became a member; and
 - they are not employed by a UK tax resident employer during that tax year.

An individual's active membership period of a scheme is the period between:²⁸

- the later of 6th April 2006 and first accruing benefits in the scheme; and
- the earlier of immediately before the first benefit crystallisation event and the individual ceasing to accrue benefits under the scheme.

Recognised overseas scheme transfer factor

The individual's non-residence factor is calculated in accordance with Sections 222 and 223 of the Act. The exact form of the calculation depends on the type of scheme (defined benefit, etc) of which the individual is a member.

An individual can claim a recognised overseas scheme transfer factor if after 5th April 2006 they transfer benefits from a recognised overseas pension scheme that have not benefited from the UK tax relief to a registered pension scheme.²⁹

The transfer factor is the value of the assets transferred, less the relevant relievable amount, divided by the standard lifetime allowance as at the date of the transfer.³⁰ The relevant relievable amount is broadly that portion of the transfer that has not benefited from UK tax relief after 5th April 2006, and is calculated in accordance with Sections 225 and 226 of the Act. It is calculated in respect of the period in which the member was not a 'relevant overseas individual' but which was part of the 'overseas arrangement active membership period'.

The definition of relevant overseas individual is outlined above and the overseas arrangement active membership period is the period between:³¹

- the later of 6th April 2006 and the date that the individual starts to accrue benefits in the recognised overseas scheme; and
- the earlier of immediately prior to the transfer and the member ceasing to accrue benefits in the scheme.

Individuals who wish to take advantage of either the recognised overseas scheme transfer factor or the non-resident individual's lifetime allowance enhancement factor must notify HMRC within prescribed time limits.

Transfers

The remainder of this paper briefly outlines the tax treatment of transfers between a registered pension scheme and an overseas pension arrangement. Other issues relating to transfers, for example, whether they are permitted under the relevant rules, and the fiduciary duties that any trustees may have, should also be considered, but such considerations are beyond the scope of this paper.

Transfers from a registered pension scheme to an overseas pension scheme

The tax position that applies if rights are transferred from a registered pension scheme to an overseas pension scheme depends on whether the overseas pension scheme is a QROPS. In order to be a QROPS, the scheme must fulfil certain conditions relating to the country in which it is established, its regulation, the payment of benefits and notification of HMRC by the scheme manager.³²

A transfer to a QROPS is a 'recognised transfer' and is an authorised member payment.³³ A recognised transfer to a QROPS is a benefit crystallisation event and, therefore, will be tested against the individual's available lifetime allowance. If the available lifetime allowance is exceeded, tax will be payable at a rate of 25 per cent; the 55 per cent rate is not applicable since the transfer

payment is not to the individual.³⁴ When benefits relating to the transferred amount are subsequently taken from the QROPS, they will not be tested against the individual's lifetime allowance.

Conversely, a transfer to an overseas scheme that is not a QROPS will be an unauthorised member payment for which the member will be liable for tax on the amount transferred at a rate of 40 per cent. The member may also be liable for an unauthorised payment surcharge and the scheme administrator may be liable for a scheme sanction charge.³⁵ Such a transfer to an overseas scheme that is not a QROPS will not, however, be a benefit crystallisation event.

Transfers from an overseas pension scheme to a registered pension scheme

When a transfer payment is made from an overseas scheme (that is not a registered pension scheme) to a registered pension scheme, it will not count as a contribution to the registered pension scheme for tax purposes. As discussed above, the member may be eligible to have their lifetime allowance enhanced in respect of the transferred funds.

The transfer will not be an unauthorised payment, nor will it constitute a benefit crystallisation event. Consequently, when the member later takes benefits relating to the transfer from the registered pension scheme they will need to be tested against the member's lifetime allowance.

Notes

- 1 Paragraph 15.15 IR 12.
- 2 Paragraph 4(1) Schedule 33 and The Pension Schemes (Relevant Migrant Members) Regulations 2006.
- 3 The Registered Pension Schemes (Extension of Migrant Member Relief) Regulations 2006 (SI 2006/1957).
- 4 Section 150(7) Finance Act 2004 and the Pension Schemes (Categories of Country and Requirements for Overseas Pension Schemes and Recognised Overseas Pension Schemes) Regulations 2006 (SI 2006/206).
- 5 Paragraph 5, Schedule 33, Finance Act 2004 and the Pension Schemes (Information Requirements — Qualifying Overseas Pension Schemes, Qualifying Recognised Overseas Pension Schemes and Corresponding Relief) Regulations 2006 (SI 2006/208).
- 6 Section 308A Income Tax (Earnings and Pensions) Act 2003.
- 7 Paragraph 2(1) Schedule 33 Finance Act 2004.
- 8 Paragraph 2 Schedule 34 Finance Act 2004.
- 9 Paragraph 1(1) Schedule 34 Finance Act 2004.
- 10 Paragraph 1(5) Schedule 34 Finance Act 2004.
- 11 Paragraphs 3(1) and 4(1) Schedule 34 Finance Act 2004.
- 12 Paragraph 2 Schedule 34 Finance Act 2004.
- 13 Paragraph 2 of The Pensions Schemes (Application of UK Provisions to Relevant Non-UK Schemes) Regulations (SI 2006/207).
- 14 The Pensions Schemes (Application of UK Provisions to Relevant Non-UK Schemes) Regulations (SI 2006/207).
- 15 Regulation 4A of The Pensions Schemes (Application of UK Provisions to Relevant Non-UK Schemes) Regulations (SI 2006/207).
- 16 Regulation 3A of The Pensions Schemes (Application of UK Provisions to Relevant Non-UK Schemes) Regulations (SI 2006/207).
- 17 Regulation 4 of The Pensions Schemes (Application of UK Provisions to Relevant Non-UK Schemes) Regulations (SI 2006/207).
- 18 The Pensions Schemes (Application of UK Provisions to Relevant Non-UK Schemes) Regulations (SI 2006/207).
- 19 Regulation 4B of The Pensions Schemes (Application of UK Provisions to Relevant Non-UK Schemes) Regulations (SI 2006/207).
- 20 Paragraph 8 Schedule 34 Finance Act 2004.
- 21 Paragraphs 10 and 11, Schedule 34, Finance Act 2004.
- 22 Paragraph 13 Schedule 34 Finance Act 2004.
- 23 Section 188 Finance Act 2004.
- 24 Section 190 and 191(7) Finance Act 2004.
- 25 Section 196 Finance Act 2004.
- 26 Sections 287 to 295 Pensions Act 2004 and the Occupational Pension Schemes ((Cross-border Activities) Regulations 2005 (SI 2005/3381)).
- 27 Section 221(3) Finance Act 2004.
- 28 Section 221(4), (5) Finance Act 2004.
- 29 Sections 224–226 Finance Act 2004.
- 30 Section 224 Finance Act 2004.
- 31 Section 224(7) Finance Act 2004.
- 32 Sections 150(7), 150(8) and 169(2) of the Finance Act 2004 and the Pension Schemes (Categories of Country and Requirements for Overseas Pension Schemes and Recognised Overseas Pension Schemes) Regulations 2005 (SI 2006/206).
- 33 Section 169 Finance Act 2004.
- 34 Section 215 Finance Act 2004.
- 35 Sections 209 and 239 Finance Act 2004.