

How US citizens can make the most of UK pension changes

US citizens paying UK tax can reduce tax bills by claiming tax relief on a number of investment routes, with the greatest relief usually being from pension contributions. This Insight explains how the changes to UK pensions announced in April 2011 have presented US citizens with an opportunity to reduce their tax burden.

Pension Savings

Pensions can provide a significant benefit through tax relieved contributions and tax-efficient investment growth, particularly for 40% and 50% tax payers. Recent legislation has introduced several changes which are summarised in the sections below, along with examples of how you can use tax relief to your advantage:

Annual Allowance

With effect from 6 April 2011, you now have an annual pension contribution allowance of £50,000, upon which income tax relief is provided at your highest marginal rate (up to 50%). In addition, it may be possible to 'carry forward' notional unused allowance from the three previous tax years to maximise your tax savings.

The following example illustrates how one might use effective pension planning to provide a significant tax benefit.

Scott is a US citizen resident in the UK and has earnings of £300,000. His pension contributions over the past 3 years have been as follows:

Tax year	Notional allowance	Contributions made	Available allowance
2008/09	£50,000	£10,000	£40,000
2009/10	£50,000	£15,000	£35,000
2010/11	£50,000	£25,000	£25,000
2011/12	£50,000	£0	£50,000
Total	£200,000	£50,000	£150,000

In the current tax year, the available allowance for contributions is £50,000 but as Scott has unused allowances in the previous three tax years, he can pay £150,000 (gross) into a pension scheme and will receive tax relief on the total contribution. As he would receive 50% tax relief, the total contribution of £150,000 invested will only cost him £75,000.

Lifetime Allowance

The UK Government places a maximum limit on the total amount an individual can accumulate within a pension before being subject to excess tax charges. This is referred to as the lifetime allowance.

Although the lifetime allowance is currently £1.8 million, this will reduce to £1.5 million with effect from 6th April 2012. If you are likely to be affected by this reduction, you can register for protection. We can provide details on this process if you think it applies to you. You should consider taking action if the value of your total UK pension benefits is already above £1.5m or is likely to increase above this level in the future due to investment growth.

Flexible Drawdown

With effect from 6 April 2011, if you have a minimum guaranteed pension income of £20,000 pa, access to your remaining pension savings is no longer restricted. Flexible Drawdown provides the facility to take out 100% of the value, although any benefits taken above the 25% tax-free lump sum amount will be taxable at an individual's highest rate of income tax.

The following example shows how one might use Flexible Drawdown.

Fiona aged 67, has a SIPP valued at £800,000. She also has a final salary pension paying £15,000 p.a. In addition, she receives a UK state pension of a further £5,300 pa

As Fiona's guaranteed pension income in retirement is above £20,000, she is eligible to use Flexible Drawdown. This allows her to access 25% of the SIPP's value, (£200,000) as a tax-free lump sum, with the flexibility to withdraw the remaining £600,000 as required. She could withdraw this in one lump sum, or over several tax years depending on tax advice and her circumstances.

How these changes interact with US tax

You will not usually be able to claim full tax relief for your UK pension contributions on your US return but it does not usually impact the US liability.

Employer contributions can be taxable on your US return, but are often fully offset by foreign tax credits meaning that little or no US tax is payable.

Depending on the type of UK pension there may be additional reporting requirements on your US return so tax advice should always be sought. It is also recommended you make sure you know whether there are any restrictions on what pension funds you can invest in, from a US tax point of view.

When is a pension not a pension?

Provided employer contributions to a UK employer plan represent at least 50% of total contributions, then investment growth within the pension is protected from UK and US tax until withdrawn.

This is under the terms of the UK/US double tax treaty and there are no additional tax reporting requirements.

However, if you personally contribute more than 50% of the overall contributions to a personal pension or a SIPP, generally the fund is treated as a foreign grantor trust for US tax purposes. This means that you are required to submit forms 3520 and 3520-A each year.

Strictly, the realised income and gains generated within such a plan should be taxed on your US return, as with any other grantor trust arrangement. However there is wording in the US treasury explanation to the treaty that

anticipates situations like this and says that the growth is not taxed. Taking advantage of the explanatory wording in the notes provides an opportunity to widen the investment mandate in some cases.

Win, win?

The benefits of UK pensions, particularly for people who might retire in the US, are:

- UK tax relief on contributions;
- Investment growth is protected from UK (and in some cases US) tax;
- Little or no US tax may be payable currently or in the future when pension benefits are withdrawn;
- Efficient use of surplus foreign tax credits for US tax purposes;
- Ability to use carry-forward rules to make contributions in excess of the £50,000 annual allowance and reduce income tax liability;
- The ability to use Flexible Drawdown to withdraw the pension capital as a lump sum.

Whilst tax is important, you should of course also be comfortable from a liquidity and investment point of view before taking any action.

Our Expatriate Tax Services team would be delighted to help you to explore whether this is appropriate in your situation. Call your usual contact or email expattax@buzzacott.co.uk

IRS Circular 230 disclosure

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