

# HR & Tax Alert



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## **United Kingdom – HM Revenue & Customs publish guidance on how to claim relief on contributions to a US pension scheme under the UK/US double tax treaty**

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### **Executive summary**

On 2 February 2007, HM Revenue & Customs (HMRC) published formal guidance on how to claim UK tax relief on contributions to a US pension scheme under the provisions of the current UK/US double tax treaty (“the treaty”). The guidance is applicable to the 2006/07 UK tax year (which runs from 6 April 2006 to 5 April 2007) and subsequent tax years and summarises the interaction between claims for relief under the treaty and the UK’s new pension regime which came into force on 6 April 2006.

Importantly, the guidance outlines the potential application of certain penalty type charges to members of US pension schemes which may arise as a result of the UK’s new pension regime.

This Alert summarises the procedures for claiming relief, the amount of relief that may be claimed and the circumstances in which the penalty charges could apply.

### **Claims for UK tax relief under the UK/US double tax treaty**

The treaty contains provisions which allow relief to be claimed in the UK in respect of contributions to a US pension scheme. Relief may be claimed by employees provided contributions were made to the plan prior to their employment in the UK and provided the plan to which the contributions are made ‘corresponds’ to a UK pension plan. Most qualified

US plans will be regarded as corresponding, including so-called 401(k) plans and IRAs. If relief is claimed, the employee will receive a tax deduction in the UK in respect of his or her contributions and they will not be taxed on any employer contributions to the plan. In addition, the UK employer is able to claim a corporate tax deduction in respect of contributions to the plan.

Prior to 6 April 2006, relief for employee contributions would be restricted in cases where the employee was regarded as resident but not ordinarily resident (RNOR) for UK tax purposes. Such employees are liable to UK tax on earnings for duties performed in the UK irrespective of whether or not these earnings are paid in or remitted to the UK. However they are liable to UK tax on earnings for duties performed outside the UK only to the extent that these are paid in or remitted to the UK. Previously, contributions to US pension plans were deducted from total earnings before apportionment between UK and non-UK workdays, meaning that some of the contribution would be deducted from income that may not be UK taxable. However, with effect from 6 April 2006, HMRC has confirmed that, subject to the limits outlined below, the whole of the employee contribution in a tax year may be deducted from the amount of earnings apportioned to UK workdays. This will reduce the amount of UK tax payable for RNOR individuals compared to the relief previously available.

Employees who wish to claim relief under the treaty will be able to do so via their self-assessment tax return although they will be required to include certain information on their return including, where possible, confirmation of the amount contributed by their employer in the case of a defined contribution plan or their increase in entitlement in the case of a defined benefit plan. In year relief will also be available either by means of a Pay As You Earn (PAYE) coding adjustment or via the employer's modified payroll, as appropriate.

### **The amount of relief that may be claimed**

One of the features of the UK's new pension regime is the increased flexibility it gives for making tax effective contributions to a pension plan. UK tax relief may be claimed against 100% of UK taxable earnings up to an absolute maximum known as the annual allowance which has been set at £215,000 for 2006/07. Unlike the old regime, taxable earnings include share related income such as share option gains which increases the scope for claiming UK tax relief significantly.

### **Potential penalty type charges**

Another but less welcome feature of the new pension regime is the application of certain penalty type charges. Three principle charges apply:

- The annual allowance charge which applies if total contributions (employer and employee) exceed the annual allowance for the tax year (£215,000 for 2006/07)
- The lifetime allowance charge which applies if total funds accrued during an individual's lifetime exceed the lifetime allowance (£1.5M for 2006/07)
- Unauthorised payment charges which apply if funds are used to provide benefits in a manner or at a time which is not authorised under UK legislation

As outlined in HMRC's guidance note these charges apply to members of US pension plans in a similar

way to that which applies to members of UK registered plans.

In general, members of US pension plans are more likely to be caught by an unauthorised payment charge than by either the annual allowance charge or the lifetime allowance charge. Such charges will apply if a payment which is unauthorised for UK tax purposes is made during a tax year in which the individual is UK resident or during the five full tax years after they leave the UK permanently. Unauthorised payments would include making a hardship withdrawal, certain transfers of accrued benefits to a new plan, taking a loan from a 401(k) plan or the withdrawal of lump sum benefits in excess of 25% of the accrued funds.

Employers who have employees in the UK who contribute to US pension plans are advised to consider the implications of the above for their tax equalisation policies. Individuals working in the UK should be made aware of the potential UK consequences of withdrawing benefits from the plan whilst they are in the UK or shortly after leaving.

### **The sting in the tail**

HMRC's guidance note implies that the penalty type charges referred to above are in point *because* the employee has claimed relief under the treaty. The implication is that if relief is not claimed, the penalty type charges will not apply. Unfortunately this is not the case. As currently drafted, UK legislation provides for penalty type charges to apply even if relief is not actively claimed under the treaty if there are employer contributions to the US plan. The result of this is that any member of a US pension plan who comes to work in the UK and who continues to receive employer pension contributions is exposed to UK penalty type charges for the period of their assignment to the UK and for five full tax years following departure. What is more, the same provisions apply to any member of any overseas pension plan who comes to work in the UK.

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