An Introduction to Foreign Pensions - Part 7

OVERSEAS TRUST & PENSION

Part 7 Overview

In this seventh instalment of our Mini-series, we have a look at the taxation of international pensions.

This follows our first six instalments: 'What is a Foreign Pension?', 'Benefits of using a Foreign Pension', 'How to make a contribution to a Foreign Pension', 'Investment Options for International Pensions', 'Taking Benefits from an International Pension' and 'Succession and Legacy Planning'. If you have not seen these instalments, please let us know and we will send them to you.

Did you know?

In Guernsey the Income Tax Authority specifically excludes international pensions from Guernsey tax, reducing the possible complexity of cross boarder tax matters.

Key Facts

- **Taxation of foreign pensions depends mainly on where the client is tax resident and the tax system in that country**
- **Most foreign pension plans are offered from low tax jurisdictions, this does not necessarily mean no tax**
- **Guernsey exempts pension plans from local tax on all sources of income and has no estate duty/ death taxes, capital gains tax or VAT**
- **Benefit payments from a foreign pension, including death benefits, may be subject to tax if the member is a tax payer, the level of tax may be determined by the income or growth of the pension**
- **Foreign pensions can provide a very robust neutral environment for tax**
- **We strongly recommend that independent tax advice is sought before entering into an arrangement**

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7 Taxation of International Pensions

There are a number of points to consider when looking at the taxation of foreign pensions and retirement Plans. To cover this topic in detail would require knowledge of the client's personal situation together with the tax and other laws of the country in which the client is resident for tax purposes.

Therefore, the last part of our mini-series focuses on the principles of taxation and the consideration in respect of international pensions and retirement Plans. This article comes with a caveat: it is not intended to represent tax advice and should not be read or relied upon as such and we recommend that clients seek tax advice before entering into any financial arrangement.

Primary Points of Consideration

1. The Country/ Jurisdiction in which the Plan is Domiciled

The departure point for tax is understanding how the Plan is taxed in the territory from which its being offered. Whilst most international products are offered from low tax jurisdictions, this does not necessarily mean no tax. For example, lump sum payments from Gibraltar pensions suffer a withholding tax by the Gibraltarian tax authority even if the member is non-resident. Other territories like Malta or Mauritius have networks of double tax treaties which dictate the rules and rights in respect of taxation. Such agreements aim to prevent double taxation although it is not uncommon for such agreements to result in more complicated tax outcomes with the member needing to apply for tax credits or deductions in respect of withholding tax. Other taxes such as VAT (sales tax) and/or stamp duty may also apply depending on the territory from which the Plan is being offered.

In order to understand the tax treatment in the jurisdiction from which the Plan is offered, advisers should make sure that the product provider confirms the local tax position before placing clients into a product. A provider should be able to give an explicit answer as to the taxation of their Plan, in respect of local and foreign income within the Plan and any taxation of benefit payments from a domestic perspective.

Overseas Trust and Pension ("OTAP") uses Guernsey as its jurisdiction of choice for pension Plans as Guernsey exempts Plans from tax on all sources of income and has no estate duty, death taxes, local withholding taxes or VAT. Guernsey does not rely on a double tax treaty network which makes Guernsey an ideal location for international pensions, as it creates a tax neutral environment for the Plan. Therefore, your client only need consider tax in their country of residence which is a significant simplification.

2. System for Taxation

After establishing the taxation of the Plan, it is important to identify the system for taxation in the territory in which the member lives and how the tax system deals with foreign source income.

Contact Us

If you have any questions in relation to international personal or corporate pension plans that you are considering please contact your usual OTAP representative.

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Importantly, payments from international Plans are foreign sourced i.e. they don't come from a source in the territory in which the member lives. Countries that adopt a 'residency based' approach to tax typically include income from foreign sources for the purpose of taxation, where countries that have a 'source-based' tax system will exclude such benefit payments for tax. The latter being very tax efficient for the member of the Plan as no further tax generally applies under a source-based system.

3. The Territory in which the Member of the Plan is Resident and their Tax Status

Territories that employ a residency-based system of taxation will a) have specific residency rules, which must be met before a tax obligation applies and b) where resident for tax, the extent of that tax obligation may be determined by factors such as the members age, income tax levels, allowances and in certain instances tax exemptions or tax credits. Under such a residency-based tax system, benefit payments from an international pension must be considered where the member is identified as 'resident' in respect to the countries income tax laws.

4. Local Legislation and the Implications for Tax

If the member of the Plan meets the residency definitions and their foreign source income is taxable, then one must consider what taxes may apply to any benefit payment. This can be complex as each territory will have its own definition and criteria as to what a 'pension' is and how benefit payments are taxed.

Generally speaking, most countries have specific legislation, both tax and regulatory, which needs to be met if a product is to be approved as a pension in that territory. The outcome of qualification under such laws would expect to result in an element of tax efficiency, as governments try to encourage their citizens to make retirement provision, through tax relief on the contribution or tax exemption on future benefit payments.

The domestic legal requirements are typically prescriptive and usually exclude most international retirement and pensions arrangements i.e. International Plans do not meet the domestic criteria and therefore fall outside of the specific rules for the taxation of pension.

There are some exceptions where there is domestic income tax legislation. Certain territories e.g. South Africa and the UK, will make specific provision for the treatment of international pensions under certain circumstances, but such rules are rather specific. Therefore, the taxation of international pensions generally follows the rule of international law and this is covered in the next point.

5. Taxation of Benefits

Where the pension meets the relevant domestic definition of a pension it should result in the international pension being taxed in the same manner as a domestic Plan or earned income subject to any exemptions or double tax treaties that may apply.

However, if the Plan does not qualify under domestic pension rules, which is the norm, the nature of any benefit paid becomes critically important as it is this 'nature' that will drive the outcome for taxation.

In other words, if the benefit payment represents other forms of taxable income such as capital gains, interest, dividends etc. then the portion of benefit that is made up of such income may become liable to the corresponding tax in the country where the member is tax resident.

The reality is that much of this complexity can be removed by simply using roll up investments within an international pension, thereby restricting potential taxation to capital gains tax on that portion of the benefit, subject to any allowances and/or tax relief available to the client in respect of such income.

To further simplify matters, OTAP products return capital contributions first, and most progressive tax systems do not define capital as a form of income as their tax systems conform to international practise. This means that international pensions can return their contributions i.e. the capital, with no tax but subsequent payments will be liable to the relevant tax.

Annuities can be tricky and are one to watch out for. This is because different territories treat annuities differently with some taxing them fully to income and others not which can result in the taxation of capital leading to a possible double tax position. Certain countries tax annuities favourably resulting in very low tax rates.

6. Taxation of Death Benefits

One of the significant advantages of foreign pensions is that the death of the member does not necessarily trigger death duties or taxes in the territories that the investments are held. Furthermore, they alleviate the need for foreign wills and mitigate foreign probate laws or laws of succession which is covered in detail in Mini-Series Part 6.

However, the payment of a death benefit to a beneficiary may result in taxation based on the principals noted in point 5 above. So as a general rule, the beneficiary can expect to be liable to tax on the income or growth element of the benefit payment but not the capital. It's worthwhile noting that in Guernsey there are no withholding taxes on death benefits and the full value of the benefit is paid to the member's beneficiaries.

7. Tax Reporting

When selecting a provider, it will simplify your clients' affairs if the Plan provider can produce tax certificates to confirm the nature of any benefit payment. At OTAP, it is standard practice to provide such certificates where a client requests it.

Conclusion

As a general rule, the benefit payments from international pensions, including death benefits, will be subject to tax if the member is a tax payer. However, the level of tax may be limited to the actual income or growth portion of a benefit payment with capital excluded. Naturally exceptions apply to this principle including benefits from an annuity (see Mini-Series Part 5 for detailed information on benefit payments).

Pension benefit payments can be simplified by using tax roll-up investments such as certain funds, life and capital redemption bonds to hold investments. In a few limited instances, income from foreign pensions is excluded from tax by virtue of the Country's income tax act.

Tax relief on contributions is typically excluded, unless the foreign Plan is approved under domestic laws and tax on gains becoming payable on distribution.

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The myth that international pensions offer a TAX-FREE solution is just that, a myth. They can provide a very robust neutral environment for tax, which means that an adviser can utilise them for a host of reasons such as asset protection, seamless succession planning, diversification of investments and currency and to provide additional financial certainty in retirement to clients with tax considerations being reserved to local ones.

Tax considerations for International Pensions

The following diagram gives a simplified schematic of the tax considerations when using an international pension plan. Ultimately advisers should encourage their clients to get tax advice as tax treatment differs from country to county and is dependent on a client's own circumstance. The points of consideration are i) the territory in which the plan is based ii) the method of taxation in the territory which the client resides and iii) the client's own position in respect of tax in that country.

Taxation of the Plan in its place of domicile

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Is the Plan itself subject to any taxation in the territory it is established? E.g. in Gibraltar lump sums are subject to a 2.5% withholding tax whereas in Guernsey, no such tax applies.

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Determine how the tax system in your client's territory deals with foreign source income.

↓	↓
If Foreign Source Income is not taxable.	**If Foreign Source Income is taxable.**
↓	↓
Expectation: No tax payable when taking benefit.	**Expectation: To pay tax when taking benefit. This is subject to how tax authorities define the nature of the benefit e.g. income, gains, annuity etc. Also depends on any exemptions and allowances.**

CONTINUING PROFESSIONAL DEVELOPMENT MARK cpd

THIS MINI-SERIES QUALIFIES AS 20 MINUTES CPD

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