SIPPs and pension planning for US taxpayers in the UK

About pension planning

In the UK, the government promotes saving for retirement by encouraging people to contribute money into a pension to be used at retirement. In general, money contributed into a pension is not taxed. However, the growth is tax-deferred and distributions are taxed as income when taken in retirement (except the tax-free cash element). For US taxpayers living in the UK, things are not that simple because there are also US tax implications to be considered.

There are many areas open for debate in the professional community when it comes to UK pension planning for US taxpayers.

If understood, properly considered and executed correctly, UK pension planning for US taxpayers using a Self-Invested Personal Pension (SIPP) can be a very worthwhile and sophisticated wealth planning tool.

This whitepaper outlines the features, benefits and applicability of SIPPs as a pension planning solution for US taxpayers living in the UK.

What is a Self-Invested Personal Pension (SIPP)?

A SIPP is a type of personal pension plan. It generally works in the same way as other UK personal pensions for contributions, tax relief and eligibility. However the main difference is that the SIPP has a more flexible approach to investments. A conventional personal pension generally involves the plan holder paying money to an insurance company for investment in an insurance policy.

Most personal pensions have a wide range of investment funds to choose from, however a SIPP would typically offer more flexibility with the type of investments you can choose.

A SIPP allows the plan holder much greater freedom in terms of what to invest in and for the plan to hold these investments directly. The plan holder can have control over the investment strategy or can appoint a fund manager or stockbroker to manage the investments.

Who is eligible to invest in a UK SIPP?

Nearly everyone in the UK is eligible to establish and contribute to a SIPP (or can transfer an existing pension into a SIPP) and benefit from tax relief on contributions. A person must be under age 75 and a resident in the UK or a Crown Servant stationed overseas (or their husband, wife or civil partner). The account can run alongside an employer's pension scheme if you want to make additional contributions or serve as a standalone alternative for self-employed individuals.

SIPPs and their investment flexibility

An important feature of SIPPs is their investment flexibility. The SIPP itself is merely a tax-efficient wrapper over your investments. You can make many different types of investment within the wrapper, including funds, shares, bonds, gilts, futures and options, commercial property and more. In this respect SIPPs are considered superior to many Occupational pensions and Stakeholder plans in the investment choices they offer. Occupational and Stakeholder pensions generally have low charges but tend to offer only a limited choice of funds. Traditional personal pensions tend to offer a wider choice of funds than Occupational or Stakeholder but may carry higher charges on older plans.

SIPPs offer possibly the widest choice of investments, allowing investors to select funds and investments from across the market. SIPPs come in many different guises and costs vary as well. Care should be taken to assess the fees and costs of SIPPs as well as any extra fees SIPP providers may charge in drawdown.

Is a SIPP right for you?

SIPPs are not for everyone. Some investors do not want the investment choice, while others may already have adequate pension provision through an Occupational plan. But for many US citizens who will be retiring back in the United States and therefore do not wish to be holding sterling denominated fixed income when their long-term liabilities are in dollars, investing in a SIPP can provide flexibility around the currency denomination of the investments and be structured as a dollar or sterling based portfolio. It may also be that some additional US tax filing liabilities may be negated if the SIPP is set up correctly.

Before starting a personal pension for the first time with a small contribution, all options should be considered, as a Stakeholder pension may be a cheaper option than a SIPP.

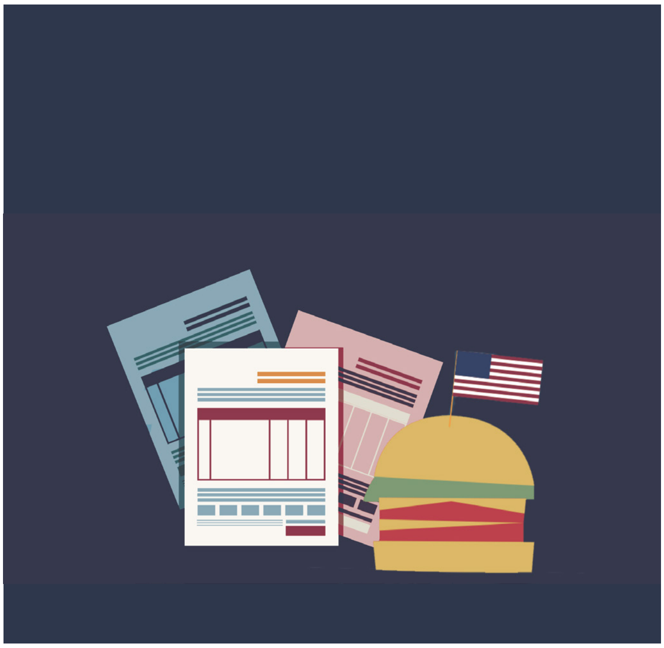
Investing in pensions is a complex area. Professional advice should always be sought before making complex financial decisions.

Pension Contributions

From a UK perspective, SIPPs have the same tax benefits as other personal pensions, with up-front basic-rate tax relief added by the government. For every 80p paid into a pension, the government adds another 20p, boosting it to a 'gross contribution' of £1. This basic-rate tax relief is claimed by the SIPP provider, and will be added into the pension account automatically. Almost everyone under 75 years old who contributes to a SIPP qualifies for this tax relief, even children and other non-taxpayers (within the limits described below). Higher and additional rate taxpayers can enjoy a greater rate tax relief as they can claim back up to a further 25p of every £1 gross contribution through the filing of their UK tax returns.

Example:

- A basic-rate taxpayer contributes £8,000 into a pension.
- The government add £2,000, to make a total investment of £10,000
- Higher-rate and additional-rate taxpayers can claim back more via their tax return. As of April 2016 additional-rate taxpayers are restricted on the amount of tax relief they can receive. This is detailed in the next section.
- Therefore, £10,000 into a pension could cost a 40% rate taxpayer as little as £6,000 and a 45% taxpayer as little as £5,500.



How much can be saved annually?

For earnings in excess of £3,600 per annum unlimited contributions are allowed, but tax relief will only be given on the higher of £3,600 or an amount of 100% of "relevant UK earnings" up to a maximum of £40,000 (for tax year 2020/21). If less than £3,600 per annum is earned, the individual can contribute up to £3,600 gross. Tax relief on contributions in excess of the annual allowance can be obtained by using any unused annual allowance from the previous three qualifying tax years as long as the individual was a member of a qualified UK registered pension scheme in those earlier years. Any contributions paid for 2017/18, 2018/19, 2019/20 will be based upon the £40,000 annual allowance limit that applied in each of those years.

The annual allowance available for additional rate taxpayers is tapered down from £40,000 on earnings between £240,000 and £312,000 and once earnings exceed £312,000, the annual allowance is £4,000 . The rules on exactly how much can be contributed depends on individual circumstances and, as with all rules, they may change in the future.

US tax perspective

A large number of US taxpayers earning a living in the UK pay more income tax to the HMRC than they would otherwise pay to the IRS and the surplus taxes are referred to as excess foreign tax credits (Ex-FTCs). These Ex-FTCs are only valuable if they can be used to reduce US taxes, and a SIPP can be one way to do this. Essentially, SIPP contributions lower the individual's UK taxable income but depending on the level of contribution are usually not fully off-settable against US taxable income (as the US does not recognise all contributions into UK pensions as tax deductible).

The most tax-efficient SIPP contribution from a US perspective is whereby the individual's UK income is reduced to the point where the UK and US taxes become equivalent. For many investors this may be a difficult calculation, so we would strongly recommend discussing this with a tax adviser. For a US taxpayer the correct amount of contribution can essentially eliminate Ex-FTCs and provide 'tax basis' in the SIPP from the IRS perspective. Tax basis represents dollars within the SIPP that are after-tax. Any after-tax dollars will not be subject to US tax when distributed. This is extremely valuable, as will be seen later in the section on distributions.

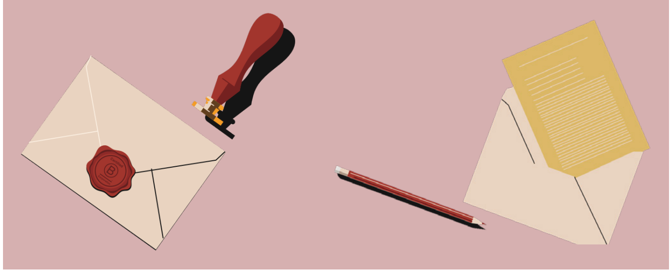
SIPP growth from a UK and US perspective

In addition to up-front tax relief, growth on investments within a SIPP grow tax-deferred (and some tax-free if the 25% tax free cash sum is taken) - free of UK capital gains and income tax. For US taxpayers however it is not that simple:

Foreign Grantor Trust

It may be that a SIPP would be treated and thus taxed as a foreign grantor trust by the US and that the pension treatment in the "US/UK Income Tax Treaty" is not elected. If this is the case, then growth would be taxed in the same way as any other investment and subject to long-term capital gains, short-term capital gains, dividend and income tax, etc. If so, 'basis' is acquired not only on contributions but also on any growth within the pension. For some, it may be more helpful to pay a lower rate of tax annually (such as long-term capital gains currently up to 20% as opposed to deferring growth until it is distributed and paying income tax currently as high as 37%). For those with excess foreign tax credits they may be able to offset the growth against the credits. For those that expect to draw benefits in the UK, care should be taken to avoid double taxation (annually based on the growth in the US and again on drawdown in the UK). Planning should be discussed with a tax and wealth adviser.

Structuring the pension as a foreign grantor trust would result in the obligation to complete annual trust filings to the IRS (form 3520 and 3520a). It is advisable to also complete an SS4 form to obtain an Employee Identification Number in order for the IRS to keep track of the foreign grantor trust/SIPP. For a US taxpayer in this scenario, it would be important to avoid investing in non-US registered mutual funds or other collectives as these are considered by the US as Passive Foreign Investment Companies (PFICs) and are tax-inefficient from a US perspective.



Investing a SIPP in a Deferred Variable Annuity (DVA) may make sense for some investors, particularly those who are very young or those who will be in a lower tax bracket at retirement. In general, due to the additional cost and illiquidity characteristics of a DVA, a young investor would need to maintain above average rates of return for many decades for this option to be cost effective. Care should be taken before adopting this strategy if the intention is to take retirement benefits outside of the US as it may be that portfolio returns could be taxed twice if disposals are not timed correctly.

Foreign Pension

To the extent that the SIPP is structured as a foreign pension the individual may elect under the treaty to defer taxation of growth, or untaxed contributions until the point of distribution.

If an investor expects to be in a lower tax bracket when a distribution is made, then this option may be more attractive. Under this scenario, investors can invest in PFICs, US Mutual Funds, Offshore Funds, etc. Within this structure most investors would likely custody their portfolio offshore and therefore have to file a FBAR form annually. This requires individuals to capture the highest value of the portfolio in dollar terms annually for the form. The investor would additionally have to file Form 8938 that highlights to the IRS what foreign assets are held by thetaxpayer. The investor (and the pension trustee) might also have to file Forms 3520 & 3520a annually.

Careful planning can reduce the annual requirement to file some of the US tax forms. Investors should speak with their tax advisers to determine which of these options is relevant to their own personal situation.

Distributions from a SIPP

In the UK, pension funds including the tax-free lump sum of up to 25% can be taken beginning at age 55. Generally, the remainder of the fund can be drawn down in one of the following forms:

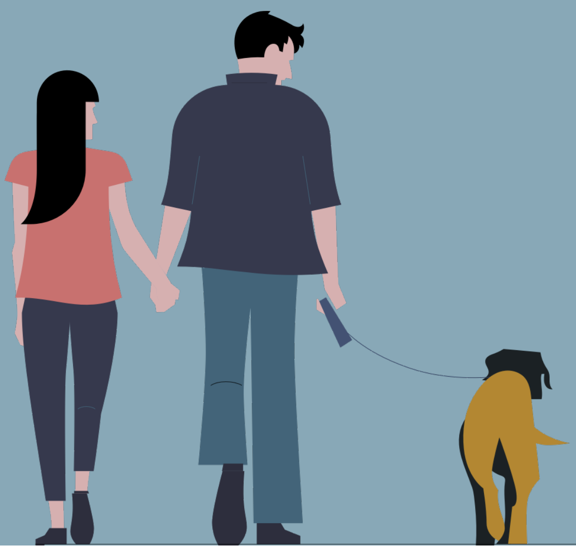
Lifetime Annuities, Flexi-access Drawdown, Phased Retirement and Uncrystallised Funds Pension Lump Sum (UFPLS). These options are outlined in more detail below.

US Tax Forms

FinCen 114 or FBAR - The Foreign Bank Account Reporting form identifies if the investment account within the SIPP is domiciled outside of the United States. If so then the FBAR form should be completed for these accounts.

3520 - This is the annual information return of a foreign trust with at least one US owner. Under certain circumstances UK pensions could be considered foreign trusts and in those cases it can be argued that the 3520 and 3520-A form should be filed.

8938 - If you meet the thresholds to file the specified foreign asset form you will need to include your SIPP on this form regardless of whether the investment account is held (one might be able to avoid duplicate reporting through filing the 3520 and 3520-A form).



Income Tax

From the IRS's perspective, you will most likely have 'basis' on your contribution (if you franked your FTCs when making contributions) and potentially the growth in your SIPP while you were UK resident (see section above) and you would need to pay income tax only on the value above your 'basis' at your regular income tax rate. With the new flexible drawdown options, some of the restrictions on the annual withdrawal limits will provide tax planning opportunities for Americans whether they remain in the UK or decide to return to the US in retirement. You should ensure that you are not taking pension distributions in the UK at your marginal rate and also have complete US basis as that would mean you would have paid tax twice on the growth of the pension.

If one is no longer a UK resident when the distributions are taken, it may be that UK taxation on the distributions does not apply.

This will depend on the double tax agreement between the UK and the country of residency. Advice should be sought from a tax adviser to understand the relevant liabilities.

US citizens living in the UK should check with a tax adviser as to whether the UK 25% tax-free lump sum is considered tax-free in the US when distributed. This can sometimes be an area of dispute with practitioners. If it is not considered tax-free by the US, then calculations should be performed to see what the level of 'basis' is within the pension, as this will reduce the effective tax rate on distributions. It is therefore of vital importance to keep records of contributions to UK pensions and what the individual's level of 'basis' is for US tax purposes. US citizens should review their foreign tax credit position as these credits could potentially be used against the US tax liability on distributing the 25% tax-free lump sum in the UK.

What is the lifetime allowance?

There is a current lifetime allowance that applies to an individual's entire pension savings of £1,073,100 for 20/21. When calculating the size of an individual's UK pension any defined benefit plans must be included in the calculation. In general the pension entitlement under the defined benefit scheme is multiplied by 20. In addition, you need to add to this amount the amount of any tax-free cash lump sum if it is additional to the pension. This figure is added to the value of all other pension savings to calculate the current balance. If total pension benefits taken exceed the lifetime allowance, they will be taxed with a lifetime allowance charge of up to 55% on the excess amount when distributed.

Options for taking benefits from a SIPP

From April 2015, individuals aged 55 and over with a UK defined contribution pension have the ability to drawdown their pension however they wish. Under the new rules, the government does not mandate a particular way in which pension savings need to be accessed. It is up to the individual to decide whether they want to access the funds as a lump sum or through some other financial product. One distribution option can be chosen for the entire pension fund or different distribution options can be chosen for segments of the pension fund. Up to 25% of the pension fund is still available to be taken tax-free in the UK. The changes increase tax planning opportunities as individuals now have the potential flexibility to manage both their liquidity needs and taxable income in any given tax year.

Distributions can generally be accessed in the following forms:

1. Lifetime annuities

An annuity is an income for the rest of the individual's life. Annuities come in two main varieties: conventional, where income is fixed, inflation-linked, or set to increase by a fixed percentage each year; and investment-linked, where income rises or falls depending on the performance of underlying funds. Conventional annuities are secure, however investment-linked annuities are like other products that are exposed to the equity markets and are therefore more risky.

An individual also has a choice to purchase a single-life annuity or a joint-life annuity. A single-life annuity may suit individuals who do not have a spouse, partner or any other dependant relying on them for financial support. Under this arrangement, in general, annuity payments will cease after the annuitants death. A possible exception is if your pension has a guarantee period – in that case, if the individual dies within the guarantee period the income will continue to be paid out to named beneficiaries until the guarantee period ends.

A joint-life annuity may suit individuals who have a spouse, partner or any other dependant, who hasn't made their own pension arrangements, or whose pension payments won't be sufficient to meet their financial needs. Under this arrangement, a spouse, partner or financial dependant will receive payments for the rest of their lives. If financial dependants are children, the retirement income will usually be paid until they reach a certain age, which may vary. At death, the income paid to your spouse, partner or financial dependants will be a proportion of the income you were getting just before your death. Individuals must choose the proportion when buying their annuity. It could be, for example, 100%, two-thirds or half of their retirement income at the time of their death. The higher the proportion chosen, the more it will cost, leaving retirement income lower.

2. Flexi-access drawdown

This is the new term for income drawdown from 6 April 2015 which allows an individual to place their pension funds in a flexi-access drawdown plan and withdraw as much or as little as they want over any period of time. Up to 25% of the fund can be taken as a tax-free lump sum when the fund is placed in drawdown and any income taken will be taxed as pension income. In this respect it is very similar to an IRA.

This option has replaced the capped drawdown and flexible drawdown options which were subject to annual withdrawal limitations. However, anyone with a capped drawdown plan in place before 6th April 2015 can continue with it and add further uncrystallised funds into it after 5th April. As long as withdrawals remain within Government Actuary's Department (GAD) limits the reduced money purchase annual allowance will not apply.

From a US standpoint it is worth discussing with a tax adviser how the income distributions would be taxed if you are a US tax resident at the time.

3. Phased Retirement

With Phased Retirement there is no requirement to convert the pension fund into an annuity or income drawdown in one go.

Instead it can be split into segments and the segments converted gradually, receiving a series of tax-free cash payments and an increasing income, until the fund is fully converted. From a US tax perspective the income drawn would be US taxable and the UK tax-free distribution should be the subject of discussions with a US/UK tax accountant.

4. Uncrystallised funds pension lump sum (UFPLS)

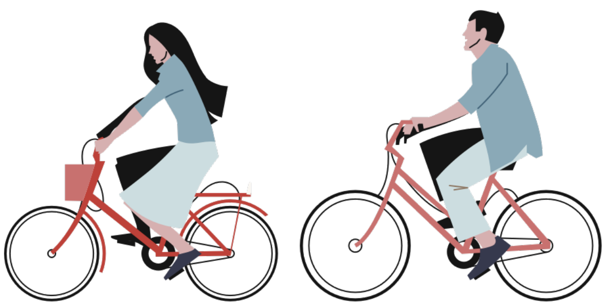
An individual can withdraw a single or series of lump sums from their pension without the need to move the funds into a drawdown plan first. 25% of the fund (or 25% of each payment of UFPLS if less than the total fund is withdrawn) may be taken tax-free with the balance taxed at the individual's marginal rate of income tax. Not all pensions will offer this flexibility so if this is something that an individual wants to take advantage of it is possible that they may need to transfer to an arrangement with more flexibility.

Additionally, in order to take advantage of UFPLS there will also be a number of conditions that need to be met including the need to have some lifetime allowance remaining. If you want to take advantage of this option, it is best to check with your tax adviser to ensure that the required conditions are met.

From a US tax perspective the income drawn would be US taxable and the UK tax-free distribution should be the subject of discussions with a US/UK tax accountant.

Money Purchase Annual Allowance (MPAA)

If an individual accesses their defined contribution pensions flexibly post April 2015, either by taking the UFPLS, by taking more than the tax-free lump sum from a flexi-access drawdown plan or by exceeding the income limit from their pre-April 2015 capped drawdown plan then the annual allowance is reduced to £4,000 for future contributions to defined contribution pension plans. Individuals will not receive tax relief on any contributions that are made in excess of this amount. It is important to note that this reduced allowance does not apply to anyone who purchases a lifetime annuity.



Estate planning considerations for a UK pension

For a US taxpayer it is worth looking at both the US and the UK estate tax considerations on a UK pension. Under the new pension rules, the Lump Sum Death Benefit tax of 55% disappeared. A UK pensioner has the ability (regardless of age) to nominate a beneficiary to inherit their pension at death, rather than pay the 55% charge. There is no requirement for the named beneficiary to be an immediate family member or dependant.

There is slightly different treatment on inherited benefits depending on whether the individual dies before or after reaching age 75. The treatment is outlined below:

1. Death before age 75

An individual can pass on the remaining defined contribution pension to anyone as a tax-free lump sum, regardless of whether it is in drawdown or uncrystallised. The beneficiary will pay no tax on the money they subsequently withdraw from the pension, whether it is taken as a single lump sum, or accessed through drawdown. It is important to note that this is only applicable to defined contribution schemes that have not been used to purchase an annuity or are being paid through a pension scheme.

2. Death at or after age 75

If an individual dies with uncrystallised pension funds or while in drawdown, the beneficiary will be able to access withdrawals from the pension flexibly over time and there are no restrictions on the amount that can be withdrawn at once. As funds are withdrawn, the beneficiary will pay tax at their marginal rate of income tax. If they choose to receive the pension as a lump sum payment., the distribution will be taxed based on the individual's marginal rate of tax.

This change was a welcome development for Americans as the UK Lump Sum Death Benefit tax was not considered to be an inheritance tax and was unable to be offset against US estate tax. Therefore, any US citizens who were subject to a US estate tax liability would have potentially been subject to a double tax at death on their UK pension assets. This is no longer the case.

The flexible drawdown rules and the elimination of the 55% death tax allows more funds to pass on to beneficiaries for their use as they see fit. When determining the most appropriate distribution options and embarking on a SIPP distribution strategy it will continue to be important for US taxpayers to consider their US estate tax position and legacy goals accordingly.

Advice customised for you

At MASECO, we are experts in providing bespoke solutions to meet the needs of US taxpayers based in the UK. We have worked with people like you for many years and understand the key issues, opportunities and difficulties you face.

Our process of working together begins with a Discovery Meeting. This meeting helps to create clarity around your aspirations so that we can focus on creating a strategy to achieve your objectives. Please get in touch to arrange a convenient time to meet and answer your questions or discuss your financial concerns as a US taxpayer living in the UK.

Risk Warnings and Important Information

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