Frozen pension funds in the UK

How to unlock them.

On 6 April 2006, Her Majesty's Revenue and Customs (HMRC) introduced the Qualifying Recognised Overseas Pension Scheme (QROPS).

This is a scheme that allows transfers of UK pension funds to overseas providers that meet certain requirements.

For a transfer to a non-UK-based pension scheme to occur, it must meet all the requirements laid down by sections 150(7), 150(8), and certain criteria within section 169 of the Finance Act 2004 of the United Kingdom.

HMRC maintains a list of non-UK pension schemes which qualify as QROPS.

One of the requirements is that no less than 70% of the transfer must be used to create a lifetime annuity for the member. Effectively, this means that a lump sum of up to 30% may be taken out at the time of the transfer.

In the United Kingdom, the QROPS regime offers the ability to transfer a pension benefit without incurring an unauthorised payment or the scheme sanction charges that would otherwise apply. New Zealand tax residents are therefore able to unlock pension funds from previous employment in the United Kingdom.

This QROPS regime might have an impact on New Zealand tax residents – significantly widening the tax implications if the underlying scheme rules allow a transfer of a pension to a QROPS.

The New Zealand Foreign Investment Fund (FIF) rules explicitly cover rights to benefit from foreign superannuation schemes as a beneficiary or member. Section YA 1 of the Income Tax Act 2007 (the Act) defines a "foreign superannuation scheme" as a superannuation scheme constituted outside of New Zealand. A superannuation scheme is defined (in section YA 1 of the Act) as:

- the trustees of a trust or unit trust established mainly for the purpose of providing retirement benefits to beneficiaries who are natural persons
- a company that is not a unit trust, is not resident in New Zealand, and is established mainly for the purpose of providing retirement benefits to members or relatives of members who are natural persons
- an arrangement constituted under an Act of Parliament of New Zealand, other than the Social Security Act 1964, mainly for the purpose of providing retirement benefits to natural persons
- an arrangement constituted under the legislation of a country, territory, state, or local authority outside New Zealand mainly for the purpose of providing retirement benefits to natural persons.

The FIF rules will only be applicable if the New Zealand tax resident is not a transitional resident, has more than $50,000 cost of FIF investments (is not a de minimis investor) and the foreign superannuation fund is not exempt from the FIF rules under the new resident's accrued superannuation entitlement exemption (section EX 42) or the non-resident's pension or annuity exemption (section EX 43).

There are a number of requirements to be met to satisfy

the FIF exemptions. I will only concentrate on sections EX 42(8) and EX 43(3).

Both sections deal with the ability of the resident to alter the future benefits from the scheme. To satisfy the exemption from the FIF regime, the resident must not have the ability to convert the future benefits for a current receipt of cash. Both sections limit the ability to certain circumstances.

EX 42 (8): The person's future benefits under the scheme must not be able to be assigned, or exchanged for a current receipt of cash, or other property, except:

(a) if the person becomes physically incapacitated; or
(b) if the person is transferring the benefit rights into another, similar, scheme; or
(c) when or after the person retires at normal retiring age; or
(d) if the person is assigning the benefit rights to a spouse under a relationship agreement; or
(e) at the cost of a substantial decrease in the present value of the benefits.

EX 43 (3): The person's future benefits must not be able to be assigned, or exchanged for a current receipt of cash, or other property, except:

(a) if the person is assigning the benefit rights to a spouse under a relationship agreement; or
(b) at the cost of a substantial decrease in the present value of the benefits.

Assuming that the individual scheme rules allow for the transfer of the beneficial rights in a UK pension scheme, the resident can unlock the frozen fund to a QROPS without triggering an additional maximum tax levy of 55% which would otherwise apply. That transfer enables the resident to transfer into another scheme which is not a transfer into a similar scheme as required by both sections.

The convertibility of future benefits from a UK scheme into an equivalent interest in a new but not similar scheme (with or without a tax-free cash withdrawal) in another jurisdiction disables section EX 42(8). Accordingly, the foreign superannuation scheme would fall within the FIF regime for New Zealand tax purposes.

> In the United Kingdom, the QROPS regime offers the ability to transfer a pension benefit without incurring an unauthorised payment or the scheme sanction charges that would otherwise apply.

As mentioned previously, the QROPS rules only require that a minimum of 70% of the pension fund be used to purchase the future annuity. Therefore, the resident has the ability to unlock an amount up to 30% at transfer into a QROPS without any additional levy imposed. This appears to mean that sections EX 42(8) and EX 43(3) are not complied with.

For the above reasons, it is Inland Revenue's view that from 6 April 2006, the exemption from the FIF rules can not apply to all resident investors to whom the de minimis does not apply or who are not transitional residents and who have a beneficial interest in a UK pension scheme which will allow the transfer into a QROPS. All such investors have been required to account for income under the FIF regime since 6 April 2006, or since the 2006/7 income year.

One key exception to this statement is if the individual scheme rules do not allow a transfer (impose significant "penalties" for transferring interests out of the UK scheme) or if there is a substantial decrease in the present value of any benefits on transfer to a QROPS. In these cases, the FIF exemption could still apply. In these scenarios, the beneficial interest in the UK pension scheme is exempt from the FIF rules. While there will be no taxation before a distribution is made, the tax consequences of any potential transfer or subsequent pension payment will depend on the underlying nature of the pension scheme.

From a New Zealand tax perspective, the UK pension scheme could be an interest in a foreign unit trust, an interest in a foreign company, a right to benefit from a trust (complying, non-complying or foreign trust), a right to benefit from a statutory arrangement, or a right to benefit from a pension.

The transfer of a UK pension scheme which is exempt from the FIF regime, or subsequent pension payments could therefore trigger New Zealand tax implications (as a dividend, distribution from a non-complying trust, pension etc).

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