Tax treatment of Foreign Superannuation

Many people who have transferred foreign pensions to New-Zealand, or who have the intention of transferring their foreign pensions to New-Zealand are unaware of their tax obligations.

The IRD has estimated that 70% of people who have transferred their foreign pensions to New-Zealand, or who have made a withdrawal on their foreign pensions, are non-compliant.

This paper summarises why a revision of the tax treatment for foreign pensions was required and what the new rules are.

The new rules were developed in consultation with The Treasury. IRD has also consulted with The Ministry of Social Development and The Ministry of Business, Innovations and Employment.

Disclaimer:

The author, Alison Renfrew, is not an accountant and is unauthorised to provide taxation advice. This paper is a summary of various papers issued by the IRD on the new taxation rules for foreign superannuation plans.

For more detailed reading refer to the following sources:

Taxpolicy.ird.govt.nz/publications/2013-ris-arfsrm-bill/taxation-foreign-superannuation
Taxpolicy.ird.govt.nz/publications/2012-other-foreign-super-fact-sheet/overview-0
Taxpolicy.ird.govt.nz/publications/2013-commentary-arfsrm/taxation-foreign-superannuation-tax-treatment

The existing IRD policy to tax foreign superannuation is continued under the new rules which are designed to make the rules easier to comply with rather than collect any additional revenue.

The status quo:

New-Zealand residents with interests in foreign superannuation schemes (who have a superannuation scheme set up in another country) are liable to pay tax on those interests.

The current tax rules are complex. Foreign superannuation is taxed either annually under the FIF (Foreign Investment Fund) rules or at the time the person received the income (started to receive a pension or a lump sum withdrawal).

The FIF regime is the default method for taxing interests in foreign superannuation schemes unless a statutory exemption applies to an individual's circumstances.

How the FIF rules work:

1) The FIF rules:
   Option one: FDR method (Fair Dividend Rate method). Essentially this is calculated as 5% of the opening value on the first of April of the tax year and this is taxed at your marginal tax rate.

For example: If the opening value is $100,000 and your funds grew by 7% you would pay tax on 5% of the opening value, $5,000, at your marginal tax rate (your top tax rate). If this was 33% the tax payable would be $1,650.

Option two: The CV method (Comparative Value method) the closing value at the end of the tax year, 31 March, less the opening value plus or minus any buys or sells over that period.

For example: If the closing value is $107,000 and the opening value is $100,000 then the $7,000 difference would be taxed on your marginal tax rate. Obviously you would be better off to choose the FDR method but if your funds made less than 5% then you would choose the CV method.

You can choose which method to use each year depending on the performance of your funds.

Practical problem: If superannuation is locked in to retirement age savings are not accessible so the FIF liability needs to be paid from other income. A key exemption relates to locked in employment related schemes.

Tax treatment of New-Zealand residents' interests in domestic and foreign superannuation schemes

New-Zealand	Foreign retirement savings held by New-Zealand residents – FIF rules	Foreign retirement savings held by New-Zealand residents – FIF exemption
T T E – Taxed Tax Exempt This means tax is paid on an accruals basis. Contributions to super are taxed, the super fund is taxed, the withdrawal or maturity value is exempt from tax	The default method. The individual calculates the income or loss of his foreign scheme on an annual basis. Distributions from the scheme are tax free. This is in line with domestic savings; the gains are taxed and withdrawals are tax free. Many foreign countries tax foreign super on receipt of the superannuation which is double taxation as New-Zealand does not provide foreign tax credits for tax paid on receipt.	When FIF rules are exempt foreign superannuation is still taxable but under different rules. The individual does not need to calculate tax on an annual basis. Withdrawals, transfers and pensions are taxable on receipt. The amount of tax to be paid on a lump sum depends on the legal structure of the scheme: Is it a company or a trust? It is difficult to identify the correct tax treatment. The ultimate tax liability may be very different from those resulting from the FIF rules.

The above table show that the rules for taxing interests in foreign superannuation schemes are complex, lack consistency and cohesion.

Tax liability can differ based on whether the FIF rules apply or how a distribution is taxed under dividend or trust rules.

Tax on FIF income is likely to be less than 1.65% p.a.

For example: $100,000 pension. Tax on 5% at 33% tax rate is 1.65% p.a. of the market value of the interest (the current value of the superannuation scheme).

BUT

Tax on a distribution from a trust may equal the full 30% of the lump sum. Obviously there is inequity between people in similar circumstances.

The complexity and lack of clarity on the current tax rules have resulted in significant levels of non-compliance. Some people had been advised that since they were exempt from FIF rules they were exempt from paying tax.

The estimation of non-compliance is 70%.

The status quo is unsustainable and non-compliance would remain prevalent. This is inconsistent with IRD's focus on voluntary compliance. The IRD would be obliged to resume compliance activity on people who have not paid tax on past transfers. The expected use of money interest and late payment penalties would place many people in financial difficulty.

Objectives:

To establish a coherent set of results for the taxation of foreign superannuation held by New-Zealand resident and have the following characteristics:

1. Equity. To ensure the tax treatment does not differ significantly from one person's individual circumstances to another. That is:

   a) Foreign or domestic superannuation asset
   b) If income is received as a lump sum or as a pension. Domestic savings are taxed on an accrual and are exempt on withdrawal.

2. Efficiency. To not discourage people from migrating to New-Zealand or transferring their superannuation here.

3. Simplicity. To make the new rules as simple and compliance friendly as possible without the current complexity which should result in a reduction of non-compliance.

4. Certainty. To enable people to determine their expected New-Zealand tax liability in advance or transfer or migration so that they can make informed decisions.

The preferred approach:

To tax lump sum withdrawals and transfers on receipt (in the tax year that the funds are first transferred). Keep pension rules as they are: fully taxable.

Lump sums will be taxed in the year they are received but pension payments will remain the same. They will be fully taxed (100%).

This is called the inclusion approach and taxes lump sums on receipt and approximates the tax that would have been paid on accrual (to have similar taxation to a New-Zealand based superannuation scheme).

Transitional rules:

These will affect people who transferred or withdrew their foreign superannuation funds in a prior year and did not properly comply with their tax obligations.

Advantages:

The distinction between foreign superannuation interests that are subject to FIF rules and those that are not will be removed.

The tax consequences will not depend on if a scheme is locked in.

Systematic over-taxation should be avoided by tax being payable if it had been on an accruals basis plus a factor for the deferred benefit.

Full taxation of lump sums, which has the potential to occur under the current rules was not considered as fair. The new rules are considered to be fair.

The taxation of lump sums will no longer be assessed under the existing rules that apply where there is a FIF exemption.

The rules that apply where there is a FIF exemption are highly complex and depend on factors such as: is the distribution from a company or a trust.

The new rules are simple, easier to apply and less information intensive for individuals.

There will not be a disincentive to transfer superannuation to New-Zealand compared to leaving savings overseas and this will achieve the objective of efficiency.

Provisions in the new rules:

Transitional residents' rules provide an exemption from New-Zealand tax (including FIF and tax on receipt) for most sources of foreign income during the first four years of residence.

Trans Tasman portability of superannuation between New-Zealand and Australia comes into force on 1 July 2013. This ensures qualifying transfers from certain Australia schemes into Kiwisaver schemes are not taxable. The 2010 double tax agreement between New-Zealand and Australia also provides a similar result for lump sums.

Transitional residents receiving lump sums will only be taxed on investment gains that would accrue after the end of their four year exemption for foreign income.

Transfers from Australia are exempt so the revenue risk (loss of tax income from IRD) provides that tax will be payable on foreign superannuation transfers into either New-Zealand or Australian schemes.

Assumptions from above options:

The amount of accrued gains and use-of-money interest charged which are to be payable on receipt of funds use interest and growth rates of 5%.

It is further assumed the investment gains that accrue in the foreign scheme are not taxed (EET).

The new rules mean there will be equity, efficiency, simplicity and certainty.

The advantages are the targets on reform and problem areas

1. FIF and lump sums
2. Retains current tax treatment of pensions. They are intuitive, simple and well understood.
3. Resolves practical issues with FIF rules of liquidity, valuation and lack of information.
4. They are less complex than FIF rules which means that there will be a reduced risk of non-compliance.

The disadvantages:

1. Inconsistent tax treatment between taxation of lump sums and pensions may encourage pensions to be converted to lump sums.
2. Pensions will be fully taxable and may be taxed on capital amounts and gains derived while non-resident.

The gains accrued during the four year grace period will not be taxed on receipt.

The new rules mean only people who file a tax return including FIF income or loss in respect of a foreign superannuation interest before the introduction of legislation (1 April 2014) may continue to use the FIF rules after a April 2014. This is not restricted to any particular tax year.

Low cost option for past transfers

Full amnesty was not recommended as it would create an unfair advantage for non-compliant people over people who have complied with the law and fulfilled their tax obligations.

15% inclusion will reduce the potential tax liabilities facing people who did not comply with the tax rules in respect of past transfers.

The eligibility for the 15% inclusion option has been extended to 31 March 2014.

In the absence of this 15% inclusion option IRD's compliance (pre-audit) activity, which was deferred pending this policy review, would re-commence. The application of existing law plus use of money interest and late penalties. This would be expected to result in significantly higher tax burdens for most people.

The 15% inclusion option is a concessionary and voluntary alternative to the existing law.

The new rules are designed to approximate the tax that would have been payable on accrual under FIF rules, in conjunction with an interest charge that recognises deferred payment of tax until receipt.

A person who received a lump sum in a prior year but did not comply with their tax obligations may apply the law which existed at the time or included 15% of the lump sum in their assessable income.

To use the 15% inclusion rate a person will need to return the income in a tax return on or before 31 March 2016. Where the 15% inclusion rate is used, use-of- money interest and late payment and filing penalties will generally not be applied.

Losses from a foreign superannuation scheme:

A person may elect to continue to use the FIF rules by including their FIF income or loss in their tax return until their rights in their foreign superannuation scheme cease. Or, they can apply the new rules rather than the FIF rules by not including the FIF loss or income in their tax return. Once the election is made the person cannot apply the FIF rules in respect of that interest. Any income received from that interest will be taxable on receipt.

The levels of voluntary compliance in relation to past transfers will be assessed through the uptake of the 15% inclusion option before 31 March 2016.
Conclusion: From 31 March 2014 the current rules on the taxation of foreign superannuation schemes will no longer comply unless the owner was complying already.

A lump sum withdrawal or transfer to another scheme would be taxed depending on how long you have been in New-Zealand before you withdrew or transferred your pension funds. Only a portion of the lump sum would be included in your taxable income. The remainder would not be taxable. This is called the inclusion rate approach.

The amount of the lump sum that would be included in your annual tax return, on which you apply your marginal tax rate, depends on how long you have been a New-Zealand tax resident before you received the lump sum. The longer the duration the greater the amount that would be included in your taxable income.

The proportion of the lump sum to be included would range from 0% in the first four years when you are considered to be a transitional resident to 100% after 25 years.

The table below illustrates the taxation increments.

Schedule Year	Schedule Year Fraction		Schedule Year	Schedule Year Fraction
1	4.76%		14	60.27%
2	9.45%		15	64.08%
3	14.06%		16	67.84%
4	18.60%		17	71.53%
5	23.07%		18	75.17%
6	27.47%		19	78.75%
7	31.80%		20	82.28%
8	36.06%		21	85.74%
9	40.26%		22	89.16%
10	44.39%		23	92.58%
11	48.45%		24	95.58%
12	52.45%		25	99.08%
13	56.39%		26+	100%

Details on how to make the disclosure will be provided once the policy has been finalised.

Under the new rules two methods are proposed to determine the taxable income that arises on the withdrawal or transfer of a lump sum from foreign superannuation.

1. The schedule method. (The inclusion rate method discussed above). The portion of a withdrawal or transfer that will be taxable will increase yearly.
2. The formula method. Tax gains while a person is resident in New-Zealand are only available for withdrawals from a defined contribution scheme.

If you would like to transfer your British pension to New-Zealand please contact Alison on 04 471 0662, or e-mail alison@LYFORDS.co.nz

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