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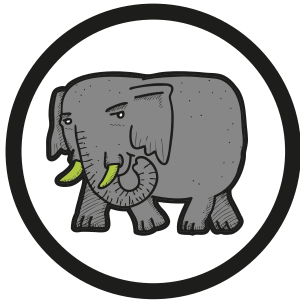

GBP BANK ACCOUNTS + UK PENSION TRANSFERS

THE ELEPHANT IN THE ROOM

Elephants are thought to bring luck and financial success to the home – but for previous UK pension transfers there is an elephant that will bring neither… it's the **"Sterling Bank Account Elephant".**

Traditionally, NZ financial advisors handling inbound QROPS transfers have invested their client's funds into sterling denominated bank accounts inside New Zealand superannuation schemes. This made sense to both advisor and client due to the exchange rate between the New Zealand dollar and the British pound sterling trading at historical lows for the past few years.

Many of these previous QROPS (prior to 6 April 2012) also offered access to up to 40% of the fund value – which was great for the short-term needs of many of these clients. The remaining 60% plus of the funds were put in a sterling bank account held by the New Zealand superannuation fund providers awaiting an improvement in the exchange rate.

This has been a bitter pill for many investors as current interest rates for sterling deposits are approaching (or are) near 0% interest per annum. When annual scheme management and administration charges are taken into account, the members of the scheme are losing money in sterling terms. However, they hold out hope of an exchange rate appreciation – that in recent times has not happened.

In British Sterling terms the value of their investments has been decreasing (due to the administration fees being greater than the interest rates received)

But the situation gets worse once tax issues are considered. Inland Revenue requires that funds be revalued into New Zealand dollars for the assessment of individuals tax on the scheme growth (at their Prescribed Investor Rate "PIR"). The tax is to be paid on unrealized gains not just when funds are actually exchanged into NZD.

This means that when New Zealand dollar weakens, (which is what most people have been waiting for) it triggers a tax liability and any gain will be taxable at the investor's prescribed investor rate. This tax will be levied irrespective of whether or not they have actually changed their funds into New Zealand dollars.

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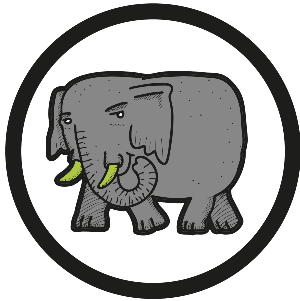

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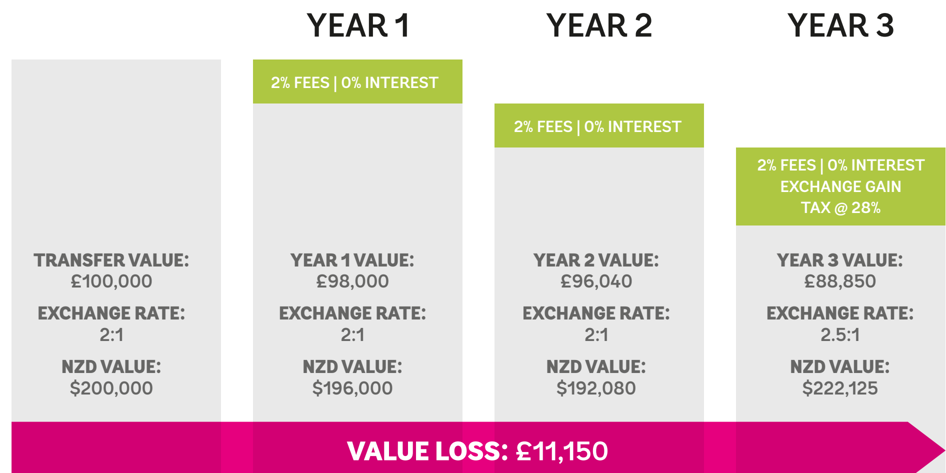
BY WAY OF EXAMPLE, if a transferred fund was worth £100,000 and the exchange rate was 2.00 New Zealand dollars to the pound when the transfer was made this gives a New Zealand dollar value of $200,000. If the exchange rate moves to 2.50 New Zealand dollars to a pound by the end of the tax year then this would be a gain of $50,000 (i.e. the fund is now worth $250,000) and the tax at a marginal rate of 28% would be $14,000. This would be the equivalent of £5,600 (at an exchange rate of 2.50). Therefore the client would be facing a very real loss that would have immediate tax consequences.

The above scenario would be compounded by the reduction in the balance from no interest growth and account administration costs. We illustrate this below with the hypothetical example of a member that transferred their funds into a sterling account when exchange rates were 2.0 New Zealand dollars to the British pound and then waited three years until the exchange rate hit 2.50 New Zealand dollars to the British pound.



Most members would not be expecting this outcome, as many do not understand the structure of taxation within New Zealand superannuation funds. Most would have expectations that the £100,000 they transferred would be worth $250,000 at the end of the three years. That expectation and the reality are quite different as shown in our example as the funds would only be worth $222,125 a difference of $27,875.

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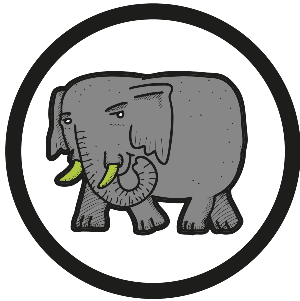

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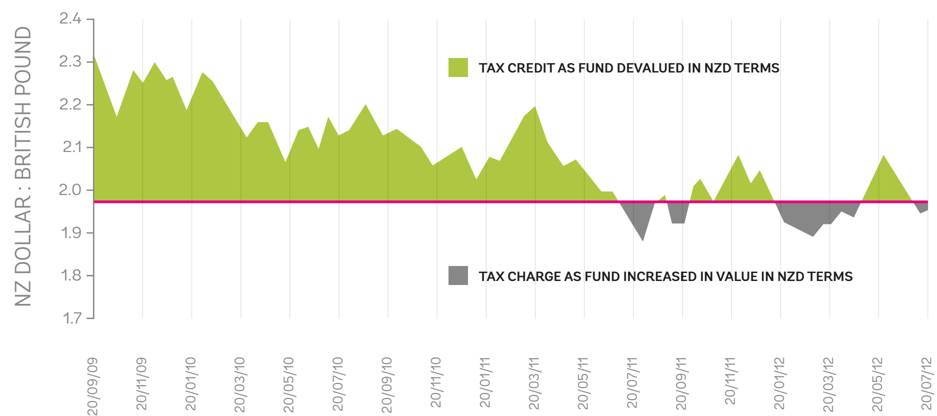
THE ELEPHANT IN THE ROOM

The good news is that the tax is not only one-way – however advisors should understand when members transferred into a sterling bank account to ensure clients are correctly advised.

The tax charges are not unidirectional – this means that if the member has retained their funds in a sterling bank account and the New Zealand dollar has appreciated since their transfer then they would receive a tax rebate on the loss that they would have suffered under the revaluation (because their pounds would be worth less in New Zealand dollars now than when transferred.)

The tax consequences for clients can best be demonstrated by showing the exchange rates between the British pound and New Zealand dollar (as shown in the diagram below). Any member that has a sterling bank account fund and transferred when the exchange rate was above the red line will have a tax credit owing to them. Conversely, a member having transferred when the exchange rate was below the red line will have a tax charge.



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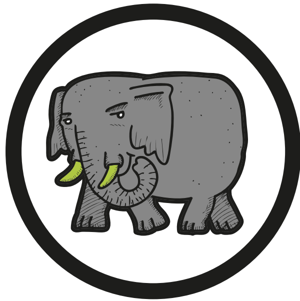

GBP BANK ACCOUNTS + UK PENSION TRANSFERS

THE ELEPHANT IN THE ROOM

Financial advisors can still proactively assist their clients by switching their funds from schemes that offer only GBP bank accounts into schemes that offer managed sterling funds.

Where a member is exposed to these potential tax issues on revaluation of the fund upwards in New Zealand dollar terms the member (through their advisor) should switch their:

- Invest in FUNDS that are denominated in GBP and offer real investment growth rather than merely a bank account, which is only really suitable for short term 'investment' and is not a prudent long-term investment for a pension. This will ensure that the client funds will have the best possible opportunity to generate real investment returns that outpace inflation and fees.
- Ensure their funds are invested in a fund that is subject to the Fair Dividend Regime (FDR) rules and whereby the tax on any gain by way of foreign exchange gains and investment growth is capped.

The FDR rules provide that the client pay tax at their marginal rate on an assumed gain in value of 5% a year. Therefore, should the investment gains AND the currency move by greater than 5% in a year (this would mean moving from 2.00 to 2.10 at current rates) then the client would benefit. However, the client would also pay tax at an assumed gain of 5% in the event that the fund performance was less than 5%.

Consider the same member as discussed previously, invested in a sterling account for three years before the exchange rates reached a position conducive with converting into New Zealand dollars. If that same member was invested in an offshore asset denominated sterling fund returning 7% a year at the end of three years their fund would be worth £117,759 – an increase in New Zealand dollar terms of $72,272. The majority of the increase (80%) comes from switching into a positive yielding investment while the remaining gain (20%) is by virtue of eliminating the exchange rate tax exposure.

(See the graph on the next page)

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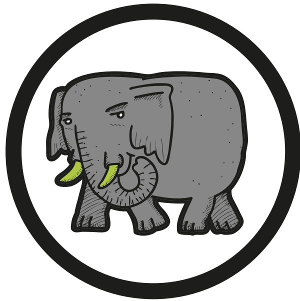

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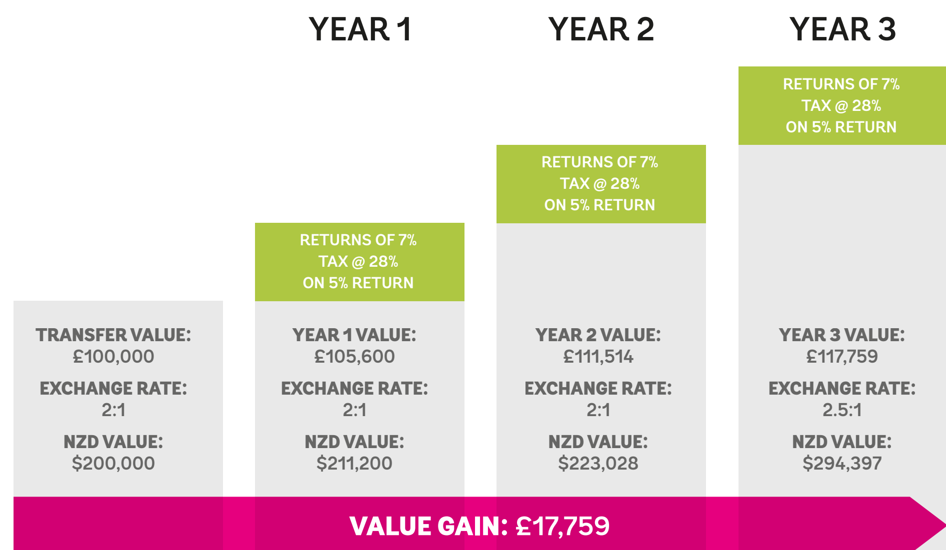

So the simple steps that a financial advisor should take are:

1. Identify their member clients who are currently invested in sterling bank accounts
2. Assess at what exchange rate the members transferred into the sterling bank account to understand if there is any tax credit that can be accessed for the member
3. Outline the exchange rate situation to the client and the consequences of it as well as the investment performance of those funds that they are currently invested in
4. Transfer their superannuation funds into sterling denominated funds that are held 100% in offshore assets

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