21 August 2012

Taxation of foreign superannuation
c/o Deputy Commissioner
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington 6140

Dear Sirs,

Submission on the taxation of foreign superannuation

The Policy Advice Division of Inland Revenue and the New Zealand Treasury have prepared an officials issues that was paper published in July 2012 in respect of taxation of foreign superannuation. The paper invited submission this is the formal submission of Charter Square Services Limited.

Background

Charter Square Services Limited has been involved in the transfer of pensions from the United Kingdom to New Zealand since 1999. In that time we have seen a plethora of complicated tax rules that have sought to determine whether or not tax should be paid on receipt of lump sums, transfers and growth on foreign pension funds. These have been set against a backdrop of increasing regulation in the way and purpose that pensions can be moved from one country to another (including the development of QROPS legislation out of the United Kingdom in 2006 and then the subsequent amendments in April 2012).

This has led to the whole area of pension transfers and taxation on them becoming extremely complicated when considering the majority of overseas pension interests have been built up in service with an employer either through a final salary scheme or a group personal pension (defined contributions).

Notwithstanding the above legislative complexities there has also been the issue of financial market conditions that have had the following consequences over the last 5 to 10 years:

- Declines in the value of most defined contribution pension schemes (whether personal or work related) particularly since 2007. Although depending on when investment was made people may have experienced a roll coaster ride of either gains and losses (indeed since 2000 the FTSE 100 has shed roughly 10% in value)
- Theoretical large value increases in defined benefit (final salary) schemes as the level of funding required to support the future annuity has dramatically increased on an actuarial accounting basis. The knock on consequence of this is that a significant number of final salary schemes are massively underfunded and therefore requiring a significant contributions to meet future payment obligations (the deficit as at October 2011 was estimated at £196.4bn in the UK alone). Perversely in these circumstances it can argued that the value of the benefits has actually decreased, as the ability for them to be paid is actually diminished, despite the fund valuations having increased
- The increasing use of the Pension Protection Fund in the United Kingdom as companies with final salary schemes fail and cannot fund the liabilities mentioned above

Against this backdrop the Inland Revenue Department is considering the introduction of a new taxation regime on foreign pensions designed to capture tax on any movement in the funds, either in the form of a transfer or payment of pension benefit for any one who is a tax resident of New Zealand.

The proposed regime as we see it goes some way toward simplifying what is currently a very complicated set of tax rules in respect of tax on foreign superannuation and that overarching principle should be maintained. However, we have four areas that we wish to comment on in respect of the issues paper:

- The principles of the proposed tax regime
- The execution of the proposed tax regime
- The calculation methodology of the proposed tax regime
- Getting industry onboard with the proposed changes

Within each of these sections we believe that there are fundamental questions that remain unanswered in the proposals put forward by the Inland Revenue Department and we would seek that these are clarified.

The principles of the proposed tax regime

The proposed tax regime is certainly simple in nature on a going forward basis – the longer you leave your pension overseas the greater weight of tax is accrued in any future lump-sum payments or transfers out of the overseas fund (we comment on the calculation methodology at a later point in the paper). The proposals seem designed to encourage early transfer of funds to New Zealand upon a member becoming resident in New Zealand – which is excellent from a New Zealand fund management perspective, particularly when one considers the average value of a United Kingdom pension transfer (which is probably in excess of £100,000 and with around 3,000 eligible migrants arriving/returning a year this is in excess of $600million, at current exchange rates, available for the New Zealand fund industry).

So while we agree with the principles of the regime and the fact that it should lead to a vibrant local fund management economy, the main areas of concern that we have with the proposed tax regime are as follows:

- The retrospective nature of the tax legislation being proposed
- The lack of clarity around transferring a lump sum
- The calculation of years since migration
- Exemptions for small value funds and frozen funds

The retrospective nature of the tax legislation being proposed – the political time bomb

There has been a tangled web of tax rules in relation to pension transfers to New Zealand and lump sum payments and whether or not tax was owing or not (indeed the question of whether a UK pension represented a FIF or not has only been questioned since the introduction of QROPS rules out of the UK). In many instances, the pensions that are transferred to New Zealand are UK schemes, and the beneficiaries of those schemes accrued the rights whilst living and working in the UK. Upon moving to New Zealand many have not sought tax advice on their UK pensions and where they have there have been many and varied opinions given. In most instances, these tax payers have moved from one PAYE environment in the United Kingdom to another in New Zealand and were unaware of any potential tax liability or not.

To now suggest that all transferees of pension benefits must go back and work out their prior position (which is as previously mentioned not clear depending on the type of scheme, when they moved, what the regulations were, and potentially statute barred) and compare that with what their outcome might be under the retrospective law introduction certainly looks like a land grab.

To retrospectively determine their tax position through a maze of prior tax legislation puts significant onus on the individual (and not to mention cost particularly considering most would need to retain

the services of expensive tax practitioners to determine their position). Furthermore, the unintended consequence of this is the creation of a political time-bomb as angry British expats suddenly face a large potential tax bill – not to mention no way to fund it (as the funds could be locked in). Such a situation would certainly not be helpful when New Zealand is facing acute skills shortages in areas many immigrants fill (see http://glossary.immigration.govt.nz/NR/rdonlyres/063ECB35-F5D5-44D8-8325-7041A727A9D5/0/INZ109330July2012.pdf) and where substantial pension rights may have accrued, for example:

- NHS pensions for health workers from the UK (6 pages of skills shortages for health workers)
- Local Government and Company pensions for planners, engineers and construction workers

New Zealand cannot afford the negative press relating to a sudden massive pension tax shock when it is working hard to attract workers from abroad. The expat community is strong and will communicate the message loud and clear to anyone thinking about coming on Internet bulletin boards.

The complicated and varied nature of past legislation is not the fault of immigrants to New Zealand and if they have done the right thing and transferred their funds to New Zealand as part of their resettlement here they should not suddenly be penalized (in fact they should be applauded for whole heartedly committing themselves to New Zealand).

For these reasons we believe that any retrospective element should be eliminated from the legislation and that:

- The individuals responsible for the legislation should talk to Immigration New Zealand about the impacts of the proposed legislation
- If the legislation is to be retrospective set the inclusion rate at 0% rather than 15%
- The legislation should put a stick in the sand for a future date to introduce the legislation (we propose 30 June 2013) and any transfer up unto that point would receive the 0% inclusion rate (this we believe would give sufficient time to diffuse the time-bomb and get industry on board to assist in the introduction of the legislation – we discuss this point further at the end of the paper).

The lack of clarity around the transferring of a lump sum

The official issue's paper does not define a transfer. For example, does a transfer from one United Kingdom scheme to another United Kingdom scheme crystallise the tax consequence proposed under the paper? This would have a significant impact if it did (which the paper seems to suggest it would) as:

- What happens when a company scheme is wound up and moved to a generalist provider?
- What occurs if a UK scheme is taken over by the pension protection fund as mentioned previously?
- Does the Inland Revenue Department consider any transfer to another overseas scheme, such as a scheme in Malta, a relevant transfer for the purposes of the proposed legislation?

In many of these instances a tax liability on the transfer would potentially be created (unless the liability is limited to transfers only to New Zealand schemes) and the tax payer in New Zealand would have no ability to pay the consequent tax bill as there would be no cash flow in most instances from such a transfer.

However, in making such a transfer, whether consciously or not, the member is not remitting their pension assets to New Zealand, where the New Zealand fund management industry cannot enjoy the benefit of such assets.

Can the Inland Revenue Department please provide a framework for relevant transfers? This is defined in the UK where they refer to Benefit Crystallisation Events (we attach a summarized version of these in Appendix A for your reference)

The calculation of years since migration
This is not a simple matter as there are many complicating factors, including, for example:

- What if the individual has gone overseas as part of a secondment and accrued a pension while on secondment, yet not been non-tax resident of New Zealand? Would 100% of the fund be taxable as the individual had never migrated to New Zealand?
- What happens in the instance of someone coming/returning to New Zealand and then leaving after 1 year, then returning again after a further three years. Is that individual:
  - In their first year again?
  - In their fourth year (as that was the number of years since the initial migration)?
  - Starting in their second year?
- These rules seem to supplant the Transitional Residence rules, as someone can have migrated but still are within their transitional residence period. Is it the intention of these rules to supplant the transitional residence rules?
- When does a year of arrival start? Do the periods coincide with the tax years or are they aligned with physical whole years or simply based on a number of days since arrival/migration?

It would seem that paper does not consider this issue, yet, it is crucial in determining the tax liability of an individual, without clear guidance the system will be open to interpretation and therefore possible abuse.

Furthermore, the passages that relate to this in the Issues Paper use the terms: New Zealand resident; Years since migration; length of time when an individual arrives in New Zealand, and: when they withdraw or transfer. These terms are extremely loose and we certainly trust that they will be more clearly and robustly defined in future drafts of any legislation.

Exemption of small funds and frozen funds
Currently, the FIF rules provide for an exemption where the total holding of funds does not exceed $50,000. Is it proposed that such an exemption continue under the proposed regime? It would seem that this value is significant and that perhaps the size of the exemption could be scaled back to define a level of triviality for New Zealand schemes. In the United Kingdom, for example, where an individuals pension assets have a collective value of less than £15,000, these are considered trivial and can be treated differently. In would seem appropriate that the New Zealand tax authorities take a similar approach in determining triviality. Our view is that the upper threshold for triviality would lie somewhere between $20,000 and $30,000.

We believe that in the interests of consistency and fairness with the existing FIF regime that an exemption limit should apply. We would welcome comments on this point.

The execution of the proposed tax regime

The paper calls for submissions on how the proposed tax regime could be implemented we consider that the issues are as follows:

- Reporting – who is responsible for reporting the transfers
- Paying the taxation due on transfers

Reporting – who is responsible for reporting the transfers
The Issues paper does not outline how the Inland Revenue intends to capture information on when tax is payable or introduce the taxation into the individual taxpayer regime. Despite best efforts to make the legislation simple there needs to be a considerable amount of support given to individual tax payers to ensure that they get it right. In particular, concerns raised above, such as the calculation of years since migration, create uncertainty when it comes to tax time?

Second to that is when is a transfer deemed to have taken place. Under UK rules for example a UK scheme is considered to have transferred the funds when they send payment (whether by cheque or

telegraphic transfer). Therefore, it would seem that New Zealand rules should align with when the payment is made rather than received by the New Zealand scheme. The reason for this is that:

- If a UK pension scheme sends a cheque this can take 2 weeks before arrival in New Zealand and then might take up to an additional 4 weeks before the funds are cleared in the New Zealand scheme. This means despite the transfer having taken place (and this is defined under Benefit Crystallisation Event 8 from the HMRC in the UK which states "The effective date of the event is the date the assets/funds leave the scheme (not when they are received overseas)" – see http://www.hmrc.gov.uk/manuals/rpsmmanual/rpsm11104860.htm)
- These happenstances are not unique to cheques, with many international telegraphic transfers going into a black hole before being found and resent (due to the nature of banks and correspondent banks)

The above point is important as it could be crucial in respect of timing as to when a transfer was deemed to have occurred and therefore the calculation of the inclusion rate.

Following on from above the conclusion that one must draw is that from a compliance perspective a New Zealand scheme must issue to its members a compliance certificate that states the effective date of the transfer of their pension from overseas into the New Zealand scheme. Typically, the New Zealand scheme will receive a letter from the overseas provider that outlines the relevant date of the transfer (the payment date). This date should be used for the date of the relevant transfer.

It would also seem that New Zealand schemes should have reporting forms to indicate to the Inland Revenue when a transfer of an overseas pension fund has occurred. However, we do not consider it the responsibility of the scheme to understand when the member arrived/migrated/became a tax resident of New Zealand. Therefore, the scheme is not required to play the role of collection agent for tax for the Inland Revenue.

Paying the taxation due on the transfers

The issues paper poses an open question in terms of how the taxation (where a transfer occurs subject to inclusion rates) is collected. There are a number of issues that present themselves here, which we are analyzing from a United Kingdom QROPS pension transfer scenario. Firstly, transfers of UK pensions to a New Zealand superannuation scheme are only allowed where the receiving New Zealand scheme is registered as a QROPS.

The rules relating to a QROPS mean that the New Zealand scheme must either be a KiwiSaver scheme or a locked-in scheme whereby 70% of the transferred value must be used to provide an income for life (to be paid only on reaching age 55 at a minimum). Therefore, the member who transfers to such a scheme has limited access to funds until 55 years old (or 65 in the case of KiwiSaver) so they could have a significant tax liability with no means of paying for it. The table below outlines the potential position for the client on a $500,000 transfer:

Years since migration to NZ	Percentage of transfer that is income	Example of $500,000 fund - income	Estimated tax at 33%
0 – 2	0%	$0	$0
3 - 5	15%	$75,000	$24,750
6 – 8	30%	$150,000	$49,500
9 – 12	45%	$225,000	$74,250
13 – 16	60%	$300,000	$99,000
17 – 20	75%	$375,000	$123,750
21 – 24	90%	$450,000	$148,500
25+	100%	$500,000	$165,000

As rightly pointed out in the Issues Paper this could create a significant tax liability position for the taxpayer without the ability to actually fund/pay that tax liability if they do not have access to the funds due to the fact that they are locked in.

Furthermore, in addition to the issues highlighted above the payment of the tax needs to be taken in the context of the legislation and rules that allow the transfer out (of the country of origin). A quick review of relevant UK scheme rules and HMRC legislation raise some key issues, which need to be considered, the main points of these are:

- Many UK Trustees will not allow the transfer of a pension where they deem that the conditions of the transfer will be non-beneficial to the transferee. To ensure that this is the case often the New Zealand schemes (the QROPS) receiving the UK pension transfer values must warrant that there are no conditions under which all or part of the scheme could be forfeited. Such a warranty would not be able to be given in the instance that the transfer of the scheme created a tax liability that was to be taken directly from the scheme. This is the difference between the direct taxation of the inward transfer value and the taxation of the payments from the scheme in retirement. Therefore, the very imposition of the tax could effectively disallow the taxpayers pension transfer subsequently disadvantaging them in the future (as when the income was paid out in the future they would effectively be paying their full marginal tax rate)
- The tax on the scheme, if taken directly, may be construed as the member having taken a benefit, as the scheme is established for the member. Such a payment may then be deemed to be an unauthorized payment under HMRC QROPS regulations. If the payment was deemed to be unauthorized then the HMRC could choose to levy a further 40-55% penalty on the payment. This would represent tax on the tax which are sure was not the intended effect of the legislation. We would therefore ask that the Inland Revenue engages with HMRC on this issue if the Inland Revenue intends to take the funds directly out of the transferred amount.
- Furthermore, if the Inland Revenue took a charge over the scheme, under UK legislation this would represent assignment and therefore be deemed an unauthorized payment and therefore subject to the same regulations as described above. Again we implore that the Inland Revenue takes account of all foreign legislation when setting New Zealand legislation.

Based on the restrictions above it would seem that the only practicable why of enforcing the payment under the proposed legislation would be for the individual tax payer to declare the income in their tax return in the years that they receive the income (rather than in the year of the transfer). We believe that such a payment would be fairer as it would:

- Match the cash inflows from pension payments with the tax payment outflows for the individual
- Use the correct marginal tax rate at retirement (rather than at the time of transfer which could be significantly different) which we believe is more ideologically correct

However, we also understand that this would be a significant more complicated to manage from the Inland Revenue and the individual's perspective, as it would require an assessment of:

- What was the relevant transfer value and how was it recorded
- How is the time value of money accrued for the Inland Revenue (or is this simply ignored for the sake of simplicity)
- How are the original funds earmarked so as they do not include any future non-transfer contributions?
- What happens in the instance that the fund value falls? Will the tax liability still accrue on the original transfer amount or the amount at the time of payment?
- What happens if the funds growth (will the subsequent growth be taxed?)
- Does the liability cease if the individual ceases to be resident in New Zealand in the future and transfers their pension fund out of New Zealand? Would there be a tax on any transfer out of the fund and how would that tax be measured and monitored (particularly if the Inland Revenue cannot take a charge over the scheme – as might be the case for UK pension transfers as previously discussed)? The Inland Revenue will need to understand whether an earmarking order can be applied that does not allow the transfer of the funds until taxation on any such transfer is paid. This would obviously be beneficial for the New Zealand scheme managers as it would retain funds under management in most instances.

The calculation methodology of the proposed tax regime

The issues in respect of the calculation methodology are:

- The use of the current marginal tax rate
- The calculation of the inclusion rate

The use of the current marginal tax rate

The Issues Paper uses the individuals current marginal tax rate to tax the "deemed" growth on the funds while the individual has been tax resident in New Zealand. The issue with this is that this assumes that the individuals current marginal tax rate has been their existing marginal tax rate in the past and will continue to be their marginal tax rate into the future.

In many instances, an individuals marginal tax rate will be lower in retirement than while they are working. The benefits that accrue from many overseas pensions are 'locked in' and therefore cannot be accessed until retirement. It would therefore seem fair that the benefits are taxed in retirement at the individuals marginal tax rate in retirement – as previously discussed. Otherwise in the majority of instances individuals would be paying over the odds in terms of their marginal tax rate.

We believe that this further supports the argument that the only thing determined at the point of the transfer is the inclusion rate and the marginal tax rate is determined when the benefits are released (either through payment or transfer out of the scheme to an overseas scheme).

The inclusion rate reaching 100%

We have a methodological exception to having a 100% inclusion rate, as this implies that the funds initially had no value and therefore the growth in the funds has been infinite. This can obviously never be the case as seed capital is required in any fund.

Furthermore, the implication that growth is a static 5% a year is achievable is obviously a dangerous assumption given recent financial market performance. Below we have attempted to map the performance of a benchmark FTSE100 portfolio to the implied growth curve implied by the Issues Paper inclusion rate. As is clearly demonstrated in all instances (barring the most recent performance) there is a significant difference between the implied rate and the actual growth rate – and in the majority of those instances the growth factors have significantly advantaged the Inland Revenue. While we applaud a simplified method (which this represents) – simplification at the expense of reality is a dangerous game.

Years since migration to NZ	Percentage of transfer that is income (inclusion rate)	Implied fund growth (from base)	FTSE 100 growth (taking mid-point)
0 – 2	0%	0%	16%
3 - 5	15%	18%	8%
6 – 8	30%	42%	9%
9 – 12	45%	82%	16%
13 – 16	60%	150%	2%
17 – 20	75%	300%	229%
21 – 24	90%	900%	No further data was available
25+	100%	Infinite (as assumes no opening value)	No further data was available

We went further and calculated based on a 5% growth rate and simple arithmetic averaging of the returns in any given year you would end up with as inclusion rates. Our simple analysis shown in the "Calculated inclusion rate" column in the table below is significantly lower than the figures calculated

in the issues paper. We are uncertain why this should be the case.

We have gone a step further and backwards calculated the implied inclusion rate based on the FTSE100 data. These figures are lower again still. From these results we have developed a suggested inclusion rate based on common sense, analysis and the calculated inclusion rate (based on the Issues Paper methodology – to an extent).

Years since migration to NZ	Inland Revenue proposed inclusion rate	Calculated inclusion rate	FTSE implied inclusion rate	Our suggested inclusion rate
0 – 2	0%	0%	0%	0%
3 - 5	15%	18%	7%	15%
6 – 8	30%	29%	8%	30%
9 – 12	45%	40%	14%	40%
13 – 16	60%	51%	2%	50%
17 – 20	75%	60%	70%	60%
21 – 24	90%	67%		65%
25+	100%	70% (assuming 25 year maximum)		70%

We would hope that the Inland Revenue gives pause to consider what the inclusion rate should be based on all the factors as described above rather than the theoretically nice (but non-realistic) methodology developed.

Getting industry onboard with the proposed changes

The Issues Paper recognises that in order for the legislation to be effective then the pension transfer industry players need to be actively involved. There is a significant opportunity to create a simple tax structure that incentivises people to transfer their pensions to New Zealand as quickly as possible. Industry players would welcome this as it allows the following:

- A significantly larger number of pension transfers which is excellent for Financial Advisors that are specialist in pension transfers – thereby increasing their fee base
- QROPS schemes in New Zealand who would be the recipient of large fund inflows to New Zealand
- Tax practitioners – who can apply simple rules for their clients going forward

Therefore, there is a reason for people to get behind the legislation going forward. And as highlighted in sections throughout this paper the Inland Revenue will need to seek the cooperation on many industry participants in order to develop a robust and efficient taxation system around pension transfers.

However, as mentioned previously the retrospective nature of the legislation is going to irk the industry and spurn them as the first set of calls to clients will be around retrospective legislation and potentially put a large amount of heat on all industry participants.

We do not believe that anyone in industry will support a retrospective legislation that creates a tax liability for clients in the past. We further believe that in order to get 'industry onboard' and get the forthcoming tax changes out into the public domain and achieve the objective of getting funds under management in New Zealand that the following should occur:

- The retrospective inclusion rate should be set at 0% for ALL pension transfers that have occurred in the past – this will eliminate all the current confusion with the previous tax regimes and rates and whether UK transfers qualified etc
- No reporting of past transfers should be required, these funds are now in New Zealand, contributing to the tax base of New Zealand and that should be sufficient

- The legislation should be passed as soon as possible, 31 March 2013 at the latest
- In the interim the Inland Revenue should state that new legislation is forthcoming outlining the principles of the legislation and state that the new legislation will include a 0% inclusion rate window until 31 March 2013. This will light a significant burner under the pension transfer industry to get out and advertise and get a significant sum of funds under management into the country. The reason for the six month window is that this is how long it will take to get the majority of pension transfers complete (a typical transfer takes somewhere between 6 weeks and 3 months – although some can take up to a year)

We trust that the suggestions made in this paper will be taken seriously as a significant amount of work, time and thought have gone into the issues that arise due to the proposed legislation.

Please feel free to contact us to discuss any of the issues.

Kind regards

Simon Swallow

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APPENDIX A: Benefit Crystallisation Event – Summary

BCE No.	Event
1	When funds are designated to provide a drawdown pension
2	Commencement of a scheme pension
3	When a scheme pension, already in payment, increases above a permitted level
4	Commencement of a lifetime annuity
5	When a member of a defined benefit scheme reaches age 75 with uncrystallised benefits remaining in the scheme
5A	When a member reaches age 75 with a drawdown pension fund*
5B	When the member reaches age 75 with uncrystallised money purchase funds, and does not take benefits at that time.
6	Payment of certain lump sums, including a pension commencement lump sum or serious ill health lump sum
7	Payment of a lump sum death benefit**
8	A transfer to a Qualifying Recognised Overseas Pension Scheme
9	Payment of certain lump sums (as prescribed by SI 2009 No. 1171)