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GUIDANCE ON CONTRIBUTIONS TO U.S. PENSION PLANS ISSUED BY U.K. TAX AUTHORITY

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Her Majesty's Revenue & Customs (HMRC) has issued guidance¹ regarding the U.K. tax treatment, under the United States-United Kingdom tax treaty, of contributions to U.S. pension plans. A change in pension law in the U.K. has resulted in potentially more generous treatment. (For related coverage, see [Flash International Executive Alert 2004-111](#), 9 June 2004.)

The guidance HMRC has issued explains the situation and how relief should be claimed for the tax year 2006/07.

Background

The U.K.'s tax treaty with the U.S.², in conjunction with the associated Exchange of Notes dated 24 July 2001³, deals with the issue of pensions in a rather more detailed way than most of the U.K.'s tax treaties. In particular, it sets out the types of plans established in one state to which contributions will automatically be eligible for tax relief in the other state. In the U.K., contributions to U.S. 401(k) plans (amongst others) are eligible for tax relief (subject to limitations) in designated circumstances.

On 6 April 2006, extensive changes to pensions legislation⁴ in the U.K. came into effect.

As treaty relief in the U.K. for contributions to U.S. plans is given on the same basis as contributions to U.K. tax-recognized pension plans, the way in which relief is calculated under the treaty has had to be amended as a consequence of the 6 April 2006 changes.

KPMG Observation

U.S. international executives working in the U.K. should take note of the following two matters:

1. For an employee who is resident but not ordinarily resident in the U.K., it is necessary to apportion that employee's earnings between those for U.K. duties and those for non-U.K. duties. The whole of the U.K. duties earnings is taxable; however, the income relating to non-U.K. duties is taxed on the remittance basis -- i.e., taxed only if remitted to the United Kingdom.

Prior to 6 April 2006, it was necessary to deduct the employee's eligible pension plan contributions before apportioning the income. However, following the changes mentioned above, the apportionment is made first, and then the employee's pension plan contributions are deducted from U.K. taxable income.

KPMG Observation (cont'd)

2. Under the new U.K. tax rules, contributions to appropriate pension plans are, broadly speaking, eligible for tax relief by reference to the lower of the “annual allowance”⁵ for the tax year (£215,000 in 2006/07) and U.K. taxable earnings for the year. This is potentially significantly higher than the limits that have hitherto applied. It could be that there will be tax charges when benefits under the plan crystallize (under the “lifetime allowance” rules), so care has to be taken when considering the amount to be contributed. However, ignoring that factor, U.K. tax relief could prove far more generous than previously. That said, this is likely to be of limited value to many members of U.S. plans since contributions which can be made to these are restricted by U.S. rules.⁶

Footnotes:

1 See: <http://www.hmrc.gov.uk/pensionschemes/uk-usa-tax.pdf>.

2 See: http://www.hmrc.gov.uk/pdfs/ukusa_dtconvention.pdf.

3 See: <http://www.ustreas.gov/offices/tax-policy/library/uknotes.pdf>. (For prior coverage of the treaty, see the following issues of *Flash International Executive Alert*: [2003-071](#) (3 April 2003) and [2001-108](#) (25 July 2001).)

4 The main body of the legislation is set out in Finance Act 2004. The legislation is complex and the interpretation of various aspects of it is still evolving. (For related coverage, see [Flash International Executive Alert 2006-090](#), 5 May 2006.)

5 The “annual allowance” relates to the aggregate of employer and employee contributions.

6 In certain specific circumstances, a U.K.-based U.S. international executive might find it advantageous from a tax perspective to make contributions to a non-U.S. pension plan under which contributions are eligible for tax relief under the U.K.’s basic legislation.

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