TAXATION OF FOREIGN PENSIONS IN IRELAND – WALKING THE TRICKY TIGHTROPE

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INTRODUCTION

As more and more individuals come home to Ireland or relocate to Ireland, the taxation of assets brought with them takes on importance once Irish tax residence is established. What tends to be of most concern is the myriad of pension products that individuals accumulate while living and working outside of Ireland. The tax treatment of overseas pensions, and in particular, the taxation of lump sum payments from foreign pensions is an increasingly complex affair in the Emerald Isle.

This article will examine the tax treatment of overseas pension income and overseas pension lump sum payments, together with the current Irish Revenue position on such lump sum payments.

TAXATION OF FOREIGN PENSION INCOME

Irish Domestic Legislation

The good news is that the taxation of foreign pension income (*i.e.*, regular, ongoing payments) is relatively straightforward for Irish resident taxpayers. Foreign pension income is chargeable to Irish income tax under Schedule D Case III by virtue of Section 18(2) Taxes Consolidation Act ("T.C.A.") 1997. There are some rules particular to non-Irish domiciled taxpayers which are discussed later in this article.

Ireland has 3 charges on income - Income tax, Universal Social Charge ("U.S.C.") and Pay Related Social Insurance ("P.R.S.I."). The Irish income tax system has been labelled as progressive, in that the tax rates progressively increase as income increases.

Pension income is liable to income tax and U.S.C. However, P.R.S.I. is normally not levied on pension income. An Irish tax resident individual is entitled to a personal tax credit of €1,650 per tax year, and the first €35,300 of income is subject to income tax at 20%, the standard rate band. Taxpayers jointly assessed with a spouse can avail of a higher standard rate band, the precise amount of which is determined by the extent of the income of the spouse. Both the taxpayer and spouse must be tax resident in Ireland to avail of joint assessment.

The U.S.C. charge graduates from 0.5% to 8%. The 8% rate currently applies to pension income exceeding €70,044. Social welfare income, including both Irish and foreign social welfare pension income, is exempt from U.S.C. and this can be relevant in optimizing the tax position for a non-domiciled taxpayer remitting income to Ireland.

Individuals are also entitled to an age tax credit once the taxpayer reaches the age

of 65 and a married couple may be entitled to a joint credit of €490. Certain foreign pension income may also qualify for a further tax credit of up to €1,650.

Once an individual becomes Irish tax resident and is in receipt of foreign pension income within the charge to tax in Ireland, the individual will need to

- register for income tax,
- include details of the pension income on a self-assessment tax return filed with the Irish Revenue on an annual basis, and
- pay tax to Irish Revenue.

The annual Irish tax return is due for filing by October 31 each year, and tax payments are due on the same date. The deadline is generally extended to mid-November where returns and payments are made electronically.

International Considerations

In general, most tax treaties with Ireland will allocate the taxing rights of foreign pension income by reference to where the recipient of the pension is resident at the time the pension payment is received. Therefore, typically, foreign pension income is only taxable in Ireland if the individual is Irish tax resident under both Irish domestic legislation and the tax treaty in question. There can however be anomalies in some treaties.

For example, the Ireland-U.S. Income Tax Treaty allows the U.S. to continue to tax pension income of U.S. citizens who are tax resident in Ireland as there is a specific provision applying to anyone that is Irish tax resident and a U.S. citizen. It is known as the "saving clause" because the U.S. saves the right to tax its citizens as if the treaty had not come into effect. Depending on the treaty, limited exceptions to the saving clause may exist. The U.S. effectively included a clause in the Ireland-U.S. Income Tax Treaty to ensure that the U.S. can continue to tax its citizens even if they become tax resident in Ireland. Therefore, for individuals that have retained US citizenship and are Irish tax resident, both Ireland and the U.S. have taxing rights on U.S. pension income. This should be read in conjunction with the Irish taxation of U.S. Social Security pensions which is dealt with later in this article.

The Ireland-U.S. Income Tax Treaty permits a credit for double taxation and this generally operates by allowing a credit in the U.S., allowing Irish tax paid on U.S. pension income to be set off against the U.S. tax liability on the same income. Typically, the Irish tax rate exceeds the U.S. tax rate, so there should be no additional tax on U.S. pension income when filing U.S. tax returns when the income is also chargeable to tax in Ireland in the same taxable period. While there may be no U.S. tax cost, from a compliance perspective, the requirement to file returns in both jurisdictions can be a burden.

EXEMPTIONS UNDER IRISH DOMESTIC LEGISLATION

As already noted, pension payments to Irish residents from a foreign pension source are taxable under Schedule D Case III, as *per se*ction 18 T.C.A. 1997. However, section 200 T.C.A. 1997 provides that certain foreign pensions are exempt from Irish tax. Several conditions must be satisfied before the exemption applies:

- It must be a pension, benefit or allowance which is

- ○ given in respect of past services in an office or employment; or
- ○ payable under the provisions of the law of a foreign country in which the pension arises which correspond to certain Irish legislation which governs Ireland's pensions, benefits and allowances for the purposes of our Social Welfare legislation.

- The country in which the pension, benefit or allowance arises has a tax which is chargeable and payable under the law of that country, and which corresponds to income tax in Ireland.
- If that pension, benefit or allowance were received by a person who is resident in the country in which it arises in and not resident elsewhere, it would not be regarded as income for income tax purposes in that country.

This can be a very useful exemption where Irish individuals who have been living abroad for several years return to Ireland to retire. It is key to determine if the foreign pension would have been exempt from income tax in the foreign jurisdiction had it been received by the person as a resident of that foreign country. In practice, this exemption has been seen to operate in Ireland on pension payments from Australia and Switzerland, where payments have been received by Irish residents.

For the purposes of section 200 T.C.A. 1997, the term "tax" in relation to any country means the tax that is chargeable and payable under the law of that country and which corresponds to income tax in Ireland. It is necessary for the country in which the benefit arises to have a tax meeting the foregoing criterion. Countries that do not have an income tax system like Ireland would not satisfy the conditions for the exemption to apply. The United Arab Emirates is an example.

Some Australian pension funds are structured so Australian residents are not subject to tax in Australia once the pension fund starts to pay out. This is because contributions are not relieved from tax with relief applied on payments from the pension instead. On this basis, some Australian pension income may be exempt from Irish tax under section 200 T.C.A. 1997 once an individual becomes Irish tax resident.

It is important to note that some foreign pension payments are not taxable in a foreign jurisdiction for individuals who are considered to be nonresident, however, the payments would be taxable if the individual were resident in that country at the time of receipt. The exemption would not apply in these circumstances as the person cannot be subject to income tax in the foreign jurisdiction were they resident there.

It is important to distinguish between the different types of pensions, benefits and allowances that can be paid by a social security regime in a relevant jurisdiction. For example, Irish residents in receipt of a U.S. Social Security pension will be subject to tax in Ireland as these payments are specifically excluded from the exemption. The reason for excluding U.S. Social Security pensions from the exemption is that the U.S. allows for an exemption from tax in the U.S., on the basis that the U.S. Social Security pension would be subject to tax in Ireland. In effect, the taxing rights have been transferred from the U.S. to Ireland in this regard.

Prior to April 6, 1998, U.S. Social Security pensions that were paid to nonresident aliens were subject to a 25.5% withholding tax in line with the U.S. rules. This gave rise to issues as withholding tax in many cases that resulted in a higher effective rate of tax than would normally have applied if the pensions were only taxable in

Ireland. Accordingly, from April 6, 1998, an Irish resident recipient of a U.S. Social Security pension is chargeable to tax on such pensions for income tax purposes, with no income tax charge in the U.S.

It is also important to distinguish between the different types of pensions that can be paid by a social security system. There may be other types of pensions paid to Irish residents which are not covered by article 18 of the Ireland-U.S. Income Tax Treaty. Those other types of pensions could potentially benefit from this exemption. Examples of such pensions could be items such as disability payments, war-related pensions, and other gratuity payments.

As you can see, understanding the type of payment that is received by an individual is important to determine the tax treatment. A payment from a private pension may be taxable in Ireland (and the U.S.) while a benefit, state pension or allowance may be exempt under Irish domestic legislation. Alternatively, the source country may retain taxing rights over the payment or relinquish such rights.

TAXATION OF FOREIGN PENSION INCOME AND THE INTERACTION WITH REMITTANCE BASIS TAXATION IN IRELAND

As noted, foreign pensions are a taxable source of income in Ireland. In general, the taxation of such pensions is determined by reference to the individual's tax residence position in Ireland. However, in Ireland an individual's domicile is relevant for determining the extent of that person's exposure to Irish taxation. In this context, individuals living in Ireland can be classified broadly into two categories for determining taxation status: non-Irish domiciled and Irish domiciled.

An individual who is resident in Ireland but who is not Irish domiciled is liable to Irish tax on all income and gains arising in Ireland. However, for most types of income and gains, there is no Irish tax on foreign income and gains provided that the income/gains are not remitted into Ireland. This is known as remittance basis taxation.

Foreign source pension income is subject to tax under Schedule D Case III. This can have either favorable or unfavorable consequences. The favorable consequence is that the pension income could benefit from the remittance basis of taxation. The unfavorable consequence is that treaty benefits in the source country may be lost if the income is not taxed in Ireland because it remains offshore. Some income tax treaties contain provisions that are designed to curb double nontaxation by permitting an override of benefits in one country or the other. The purpose of those provisions is to ensure that the pension income is either taxed in Ireland if remitted or the source country if the income is not remitted.

If an individual remits pension income to Ireland where a clause like this exists with the source country treaty, Ireland will tax this income in the year of remittance. One planning point that should be considered is to confirm the tax rate that applies in each country. If the rate of tax is lower in the source country it may be beneficial to leave this pension income to be taxed in the source country and not remit it to Ireland. Alternatively, if the Irish tax rate is lower, the pension should be remitted.

LUMP SUM DRAWDOWNS FROM A FOREIGN PENSION IN IRELAND

Background

To appreciate the taxation of lump sum drawdowns in Ireland it is important to understand the historical position regarding the Irish taxation of lump sum drawdowns.

Prior to December 7, 2005, Ireland did not have any domestic legislation which taxed lump sum drawdowns from pension funds. This meant that lump sums of 25% of the value of a pension fund could be taken tax-free regardless of the value of the pension fund. In Finance Act 2006 the Irish Revenue introduced section 790AA T.C.A. 1997 which put an end to this treatment. Section 790AA T.C.A. 1997 is the section which governs the taxation of lump sum payments in excess of a tax-free amount. This meant that the tax-free amount was capped at a value of €200,000 and any excess over and above €200,000 would be taxed at 20% up to a total drawdown of €500,000. Any balance over and above €500,000 would be taxed at marginal rates.

"For the purposes of lump sum drawdowns from foreign pension schemes, the only category that is relevant to consider is a qualifying overseas pension plan."

For the purposes of the legislation, "a lump sum" is a reference to a sum that is paid to an individual under the rules of a "relevant pension arrangement." A "relevant pension arrangement" means any one or more of the following:

- A retirement benefit scheme within the meaning of Irish legislation which has been approved by the Irish Revenue Commissioners
- An annuity contract or trust scheme or part of a trust scheme approved by the Irish Revenue Commissioners
- A P.R.S.A. contract, within the meaning of Irish legislation
- A qualifying overseas pension plan
- A public service pension scheme within the meaning of Irish legislation
- An Irish statutory scheme

For the purposes of lump sum drawdowns from foreign pension schemes, the only category that is relevant to consider is a qualifying overseas pension plan.

An "overseas pension plan" is defined in Irish legislation to mean a contract, an arrangement, a series of agreements, a trust deed, or other arrangements – but not a state social security scheme – which is established in, or entered into under the law of the United Kingdom or a Member State of the European Communities, other than Ireland itself.

For the purposes of the Irish legislation, a "qualifying overseas pension plan" means an overseas pension plan (i) which is established in good faith for the sole purpose of providing benefits of a kind similar to those referred to in Irish legislation, (ii) in respect of which tax relief is available under the law of the Member State of the European Communities in which the plan is established (or the United Kingdom) in respect of any contributions paid under the plan, and (iii) in relation to which the relevant migrant member of the plan complies with the requirement in Irish legislation in order for it to qualify as a qualifying overseas pension plan.

The above requirements mean the administrator of the pension plan must have the overseas pension plan "blessed" by the Irish Revenue Commissioners for it to fall within the definition set out in section 790AA T.C.A. 1997. As a result, most foreign pensions schemes are considered nonqualifying overseas pension plans because they haven't been blessed by the Irish Revenue Commissioners. Therefore, lump sums from such pension schemes are not taxable in Ireland as we have no domestic legislation to tax lump sums.

Current Irish Revenue Position

The foregoing historical background sets the scene in relation to the history of this topic. However, the Irish Revenue's position has changed over the years in relation to this matter.

The Revenue's current interpretation is that income from foreign securities and possessions is charged under Schedule D Case III, which is correct. However, they state that it includes the profits or gains arising from any kind of property the person possesses, including pension lump sum payments. The Revenue's current position is that the commutation of such lump sums is subject to income tax under Schedule D Case III as they are considered to be "foreign possessions." Accordingly, if a payment (even a lump sum) is paid from a foreign pension fund, the Revenue considers it to be income arising from possessions outside the State. As pension payments to Irish residents from a foreign source are normally taxable under Case III of Schedule D, the receipt of a lump sum from a foreign pension is a taxable source of income liable to Income Tax and U.S.C.

This stance is a fundamental change in Revenue practice. Of greater import, the Revenue have not formally notified practitioners of this change, nor have any of the appropriate manuals been updated to reflect this change. Irish practitioners are currently challenging the Revenue's position on the matter.

Current Irish Practitioner's View

Income tax in Ireland can be imposed only if there is a domestic charging provision. The Revenue are attempting to impose an income tax charge under Schedule D Case III. Income tax is chargeable on income and not capital. Schedule D applies to income only. As there is no income arising, a charge under section 18(2) T.C.A. 1997 cannot arise. Under section 18(2) T.C.A. 1997, the foreign possession is the foreign pension plan. Therefore, from a technical perspective, it is difficult to see how the Irish Revenue can legitimately view lump sum drawdowns as taxable income under Schedule D Case III. Lump sum payments are capital, not income. The ultimate conclusion is that a charge under Schedule D Case III cannot arise.

Looking at first principles, if a pension fund has been accumulated while an individual was neither Irish tax resident nor ordinary tax resident in Ireland, the taxation of any lump sum drawdowns from this pension fund is outside the scope of Irish taxation. This is because it is a well-accepted principle that capital accumulated before an individual becomes resident in Ireland is outside the scope of Irish tax.

The lump sum cannot be classed as employment related income because the employment related to the funding of this pension was carried out wholly outside of Ireland. Moreover, it was accumulated from contributions out of foreign income in respect of which no Irish tax relief was provided.

As discussed above, the foreign lump sum drawdown is not taxable under section 790AA T.C.A. 1997 because this section relates only to "relevant pension arrangements." As the pension arrangement is not within the definition of a qualifying overseas plan, the drawdown is not taxable under this section.

Another section which should be considered is section 781 T.C.A. 1997 which deals with the taxation position for individuals who decide to commute their entire pension in one lump sum. This section applies to an approved pension scheme and specifically does not apply where the employment was carried on outside Ireland.

Finally, there is an old Revenue Precedent, Precedent 28, dated July 30, 1987, which states that the tax-free lump sum in commutation of foreign pensions is not taxable in Ireland should an individual come to live in Ireland following retirement. Because this precedent is more than 5 years old, the Revenue are no longer willing to confirm the application of this precedent to lump sum drawdowns of foreign pensions by Irish residents. Nonetheless, precedent 28 is widely relied upon by practitioners.

CONCLUSION

As is evident from this article, the taxation of pensions in Ireland is complex. The trend we are seeing is that each foreign pension plan becomes more complex than the next. Individuals are returning from places such as the U.K. and the U.S. with pensions such as 401(k) plans, 529 plans, and 527 plans, all of which have a firm and certain purpose in relation to the source country in which they originated. Difficult tax issues arise when individuals move from one jurisdiction to the next, bringing along their entitlement to pension payments. On a global basis, it seems unfair to penalize an individual merely because of a change in the country of residence.

A wider implication of this stance by the Revenue is the principle that capital accumulated by an individual prior to becoming an Irish tax resident is within the scope of Irish taxation. Submissions have been made to the Irish Revenue requesting it to identify the domestic charging provisions that are applicable in Irish that authorize the imposition of an income tax charge in respect of overseas lump sum payments. At least one case has been appealed to the Tax Appeal Commission in Ireland.

We wait to see the outcome of the lobbying and the appeal to the Tax Appeal Commission on behalf of taxpayers to see how the taxation of foreign lump sums will evolve. It is likely that we will have a firm view on the position sooner rather than later.

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