TREASURY & RESOURCES DEPARTMENT

AMENDMENTS TO INCOME TAX LEGISLATION
RELATING TO PENSION SCHEMES – ESTABLISHMENT
OF NEW CATEGORY OF SCHEME

The Chief Minister
Policy Council
Sir Charles Frossard House
La Charroterie
St Peter Port

10th January 2012

Dear Sir

1. Executive Summary

1.1. This Report contains proposals to amend the Income Tax (Guernsey) Law, 1975, as amended ("the Law") in respect of pension schemes, in order to protect and enhance Guernsey's status as a major provider of services in the international pensions field, and in particular in respect of transfers from UK pension schemes (Qualifying Recognised Overseas Pension Schemes ("QROPS") business).

1.2. The proposals stem from the need to accommodate significant changes proposed to UK legislation recently in respect of QROPS business, which if adopted in their present form, would have an effective date of 6 April 2012. There are currently no transitional provisions incorporated into the proposed changes to UK legislation which would assist administrators in Guernsey of QROPS to adapt to these proposed changes and so if the appropriate changes to the Law are not made, or are not made before 6 April 2012, there could be significant ramifications for this particular sector of Guernsey's financial services industry.

2. Background

2.1. QROPS business flows from changes made to UK legislation in 2006 which, in summary, allowed more flexibility with regard to the transfer of pension funds overseas when a scheme member left the UK than had previously been available. It is understood that these changes were necessitated by the need for the UK to facilitate freedom of movement of capital within the European Union, although the changes did not specifically restrict transfers to EU Member States only.

2.2. Guernsey was well placed to offer facilities for such business, partly because of the expertise in international pensions which already existed in the island, but also because of the structure of the income tax legislation, including its system of taxation of personal income, and very quickly Guernsey became a major base for QROPS.

2.3. In 2008, it became evident that the UK tax authorities had concerns regarding the operation of QROPS in some jurisdictions, specifically with the apparent ability of some schemes to offer 100% commutation of pension benefits, so that the whole fund could be accessed by the member in one lump sum. This practice is contrary to what HMRC regards as the purpose of QROPS, namely to provide an income in retirement and support pension savings.

2.4. Although there was no evidence that Guernsey schemes were involved in what the UK authorities viewed as abuse of the QROPS rules, the Director of Income Tax ("the Director") felt it was important to understand HMRC's concerns, and he met with them in order to discuss matters. As a result, certain aspects of Guernsey's tax regime, as it applied to non-resident members of Guernsey approved pension schemes, were amended, in particular to align the rules on benefits in respect of non-resident members with those applicable to resident members. This put it beyond doubt that a Guernsey approved scheme could not pay out 100% of the fund as a lump sum, except where full commutation is permitted on the grounds of triviality (i.e. where the value of a member's aggregate pension does not exceed, currently, £30,000).

2.5. On that basis, Guernsey's QROPS industry has continued to flourish, to the extent that there are approximately 200 people fully employed in the industry, with significant pension funds under management.

2.6. Under the Law, QROPS may be offered as occupational schemes approved under section 150, or as personal pension schemes approved under section 157A. In practice QROPS are usually offered as trust-based personal pension schemes, which also meet the conditions of section 157A.

2.7. It should be emphasised that the placing of a QROPS in Guernsey does not, of itself, create a tax advantage, nor does it facilitate tax avoidance in respect of UK tax.

2.8. This is perhaps best illustrated by an example. If a UK resident retires to Spain, and his pension fund remained in the UK, the operation of the UK/Spain Double Tax Arrangement would give Spain sole rights to tax that pension. Similarly, if the funds are transferred to a QROPS in Guernsey, it would also remain subject to Spanish taxing rules, because Guernsey's system of taxation of personal income, bases liability to Guernsey tax on residence in Guernsey. In this example the individual is resident in Spain,

not Guernsey, and (as a consequence of sections 40(p) and 40(ee) of the Law) there is no liability to tax in Guernsey. Thus, the effect on UK tax revenues is the same, whether the fund is established in the UK or transferred to a QROPS in Guernsey or, indeed, Spain; the key factor is the place of residence of the individual at the time that individual receives pension benefits.

3. Recent Developments (including effect of loss of QROPS status)

3.1. On 6 December 2011, HMRC published draft Regulations for a limited consultation period, which imposed additional conditions on QROPS. Whilst most of the proposals presented no major difficulties for Guernsey based providers, one aspect created a significant threat to such schemes, to the extent that they will find it difficult to operate after 6 April 2012 in the present framework. This is a proposed new condition 4 within UK legislation entitled "The Pension Schemes (Categories of Country and Requirements for Overseas Pension Schemes and Recognised Overseas Pension Schemes) Regulations, 2006" (which set out the criteria for qualification as a QROPS).

3.2. In effect, condition 4 would require that, for QROPS status to be maintained, an overseas pension scheme must, in addition to meeting the existing Regulation Requirements and Tax Recognition Requirements set out in the current version of the Regulations, be able to provide any exemption from tax in respect of benefits paid from the scheme to both resident and non-resident members of the scheme. At present, Guernsey residents are given relief on contributions and taxed on benefits paid out to them, whilst non-resident members are not given Guernsey tax relief on contributions (because, ordinarily, there would have been no income assessable to Guernsey tax from which the contributions are paid – the individual being non-resident at the time of the contribution) and benefits paid are exempt from Guernsey tax, as described at 2.8 above. Thus, unless Guernsey's system of taxation of personal income is changed so that Guernsey residents and non-residents alike are either taxed or exempt from taxation in Guernsey, on benefits that they receive from a Guernsey established QROPS, the pension scheme would lose its status as a QROPS for UK tax purposes with effect from 6 April 2012.

3.3. According to HMRC Draft Guidance published on 20 December 2011, a scheme which was eligible to be a QROPS when it originally notified HMRC but no longer has that status will be removed from the published list of QROPS and will cease to be a QROPS. Transfers to such schemes made after the date on which the scheme ceased to be a QROPS will not be recognised transfers for UK tax purposes. Unrecognised transfers give rise to an unauthorised payments charge and a surcharge on the member, and to a scheme sanction charge on the scheme administrator. Because Guernsey's system of personal taxation fails to meet condition 4, this would mean that

most existing Guernsey based QROPS, which had non resident members, established as retirement annuity trust schemes under section 157A of the Law would lose their QROPS status, thus threatening the whole future of this sector of Guernsey's financial services industry.

4. Proposals

4.1. There are three approaches open to Guernsey:

(1) Take no action.

This would mean that after 6 April 2012, Guernsey based QROPS would effectively be unable to operate, and this particular sector of industry would, in all probability, dissipate over a relatively short timescale.

(2) Extend taxation of pension benefits to non-residents.

At present, a non-resident will only be taxable on pension benefits if they were resident in Guernsey at the time of making contributions, or had performed service in Guernsey which led to the payment of such benefits.

By extending taxation to all non-residents, whilst this would ensure compliance with condition 4, it is clear that it would also have an adverse impact on the competitiveness of Guernsey's QROPS business, particularly if other jurisdictions are able to offer exemption.

It should be noted that as Guernsey does not have an extensive network of Double Tax Arrangements at present, the extent to which any Guernsey tax paid could be relieved in the jurisdiction of residence of the member is uncertain. Any Guernsey tax paid, therefore, becomes a potential cost to that member and therefore a disincentive to place their pensions savings in a Guernsey QROPS.

(3) Extend exemption of pension benefits to Guernsey residents.

At present, Guernsey resident members receive relief from contributions to pension schemes; the income of the scheme itself is exempt but any pension benefits paid are taxable as they arise.

To ensure compliance with condition 4 without a major loss of tax revenue, a new, and separate, pension regime could be put in place under which no relief would be given for contributions, and pension benefits would be exempt on receipt. This regime would operate in parallel to the existing regime within sections 150 and 157A of the Law, which would continue on the same basis as at present. Clearly

this new regime will create a potential loss to States revenues (because the investment growth element of any pension fund on retirement would be paid out tax-free) but the States will, to an extent, receive revenues earlier than they would otherwise have done in the form of withdrawal of relief from income which is used to fund contributions, so that contributions are then paid out of taxed income. If this option were adopted, therefore, it would be necessary to reduce potential tax leakage caused by the new regime by imposing the following rules:

(a) No tax relief would be available for contributions to the proposed new pension schemes made by either members or their employers. There would be no limit on the amount of such contributions, however. Any contributions made by an employer would be taxable as a benefit in the hands of the employee.

(b) Income of the scheme and all benefits would be exempt from liability to income tax in Guernsey.

(c) Schemes must be established and properly administered, in Guernsey, under either contract or trust, by a person who is licensed to do so and, if under trust it must have either two individual trustees , or one if there is a corporate trustee in place and all administration including main decision-making should be carried on in Guernsey.

(d) Benefits should not ordinarily be paid before age 55, except in case of ill health, but may commence at any age thereafter.

(e) Any benefits paid by way of lump sum should not exceed 30% of the fund value at maturity.

(f) Schemes which currently have approval under sections 150 and 157A of the Law may, with the approval of the Director, elect into the new regime, but if they do so any funds held by the scheme which are derived from contributions that have benefited from tax relief in Guernsey (including investment income arising on such contributions) would be subject to a tax charge at the individual standard rate of 20%. This charge would be paid by the trustees or other person having administration of the transferring scheme out of the relevant funds.

(g) Transfers into schemes approved under the new regime would be possible only from schemes approved or recognised under the Law (subject to a tax charge at the individual standard rate-see (f) above - if a transfer is from a scheme approved under section 150 or 157A) or from pension schemes in the UK.

4.2. The Department believes that if it is wished to protect Guernsey's wider pension industry, including its contribution to the Bailiwick's economy and employment, the only viable option is the new, discrete regime set out at (3) above, and therefore proposes that the States agrees to adopt such a regime.

5. Principles of Good Governance

In preparing this Report, the Department has been mindful of the States Resolution to adopt the six core principles of good governance defined by the UK Independent Commission on Good Governance in Public Services (Billet IV of 2011). The Department believes that all of the proposals in this Report comply with those principles.

6. Legislation

6.1 Following Royal Assent to the Income Tax (Zero 10) (Guernsey) Law 2007, the Income Tax Law was amended to introduce section 208C, which permits the States to amend the Income Tax Law by Ordinance. This is the process which will be used to effect the amendments proposed in this Report.

6.2 The Law Officers have been consulted about these proposals.

7. Resource Implications

7.1. Although, under the proposals, pension benefits paid out would not be taxed, no tax relief will be given on contributions made to the scheme; this means that any loss of revenues to the States is limited to the tax which would otherwise have accrued on the investment growth of the fund when it is paid out as pension benefits.

7.2. In addition, these schemes are unlikely to be attractive to a large proportion of Guernsey resident taxpayers, as the lack of tax relief on contributions (especially for a contributing employer), the tax charge on transfer from existing schemes and the requirement for most of the funds to be paid out by way of income over a long period rather than one lump sum, will be deterring factors.

7.3. Although it is not possible to provide an accurate estimate of the potential loss of tax revenues, because this will depend on taxpayer behaviour, the Department is satisfied that, for the reasons set out at 7.2 above, the risk is significantly reduced.

8. Recommendations

The Department recommends the States to direct that legislation is enacted in order to amend the Law to provide for approval of a new type of pension arrangement with the following features:

(1) Tax relief will not be available to the member on contributions made to the scheme by that individual or, if the individual is an employee, by their employer in respect of earnings to which benefits under the scheme relate.

(2) All income of, and benefits paid from, the scheme would be specifically exempt from income tax and paid gross as being in respect of pension savings.

(3) The scheme must be established and administered in Guernsey under either contract or trust by a person who is licensed to do so by the Guernsey Financial Services Commission under the relevant legislation, and, if under trust, there should be at least two individual trustees, although a corporate trustee may act alone. All administration of, including main decision making in relation to, such schemes should be carried on in Guernsey.

(4) A separate approval regime will apply to the new pension scheme, similar in structure and administration to that currently applicable for section 150 and 157A schemes. Applying for, and being granted, approval, by the Director, under the new regime will confirm that the applicant scheme is identified as being of a type that can qualify for exemption from tax in respect of income of, and benefits paid from, that scheme

(5) Benefits may commence at any age after 55, although they may commence earlier in the case of ill health of the member. Given that benefits will not be taxed on receipt, there would be no need to impose the requirement that benefits must be drawn by the age of 75, as is currently required under the Law for pensions generally.

(6) The scheme's rules must provide that at least 70% of a member's tax-relieved scheme funds will be designated by the scheme manager for the purpose of providing the member with an income for life. Therefore, any lump sum paid by way of commutation of any annuity or pension should not exceed 30% of the fund value at maturity.

(7) Any schemes currently having approval under other sections of the Law may, with the approval of the Director, elect to be approved under the new regime.

(8) A consequence of any scheme making the election referred to in (7) above would be that the trustees, or other person having administration of the transferring scheme are required to deduct and pay to the Director income tax at the individual standard rate in respect of any funds which are transferred following such election and which are derived from contributions that have benefited from tax relief in Guernsey (including investment income arising on such contributions).

(9) Transfers into such schemes could be made only from other Guernsey approved or recognised schemes (in which case a tax charge at the individual standard rate should apply to any funds so transferred if a transfer is from a scheme approved under section 150 or 157A as referred to in (8) above) or from funds which have been, or are derived from contributions that have been, subject to UK tax relief.

Yours faithfully

C N K PARKINSON
Minister

Deputy J Honeybill (Deputy Minister)
Deputy R Domaille
Deputy A Langlois
Deputy S Langlois

ANNEX

Proposed revisions to income tax legislation

This Annex sets out information which:

1. contains information justifying the need for legislation;

2. confirms how funding will be provided to carry out functions required by the new legislation;

3. explains the risks and benefits associated with enacting/not enacting the legislation;

4. provides an estimated drafting time required to draw up the legislation.

1. The need for legislation

The proposals contained in the Report will provide support to Guernsey's financial services sector.

2. Funding

It is not anticipated that additional funding will be required.

3. Risk and benefits

If the legislation to implement the proposals is not enacted, it is likely that the ability of this particular aspect of Guernsey's financial services sector to expand or continue in existence might be inhibited .

4. Drafting time

Required drafting time for legislation is estimated to be one week.