TECHNICAL SALES BRIEFING

IHT "BITESIZE" SERIES - PART SEVEN
PENSION SCHEMES AND INHERITANCE TAX CONSIDERATIONS

KEY POINTS

This Technical Sales Briefing:

› Is the seventh in a series covering many aspects of UK Inheritance Tax (IHT). The full content is available on our uTech site

› Deals with the interaction between pension schemes, their legislation and IHT.

PENSION SCHEMES AND INHERITANCE TAX CONSIDERATIONS

CONTRIBUTIONS, DEATH BENEFITS AND TRANSFERS

A registered pension scheme will not normally attract IHT on contributions made by either the member or their employer, or payments of death benefits paid at the discretion of the scheme trustees. It should, of course, be noted that any death benefit payment made on the member's death to a beneficiary would then form part of his or her taxable estate and would therefore increase the IHT liability on his or her subsequent death.

CONTRIBUTIONS

Contributions made by the pension scheme member for their own benefit are generally not regarded as transfers of value.

However, HMRC may argue that contributions represented a transfer of value where they were made when the member was in ill health, or unlikely to survive to take some or all of the pension benefits, and the death benefits are paid outside the member's estate (e.g. at the scheme's discretion).

HMRC guidance suggests that contributions made by the member more than two years prior to death can be assumed to have been made when the member was in good health. Therefore contributions made within two years of death are more likely to attract HMRC attention and these should be recorded on IHT schedule 409.

Large and/or unusual contributions are also likely to be viewed with some suspicion, perhaps more so than a continued direct debit payment of long established monthly contributions.

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EXAMPLE 1

Connie earned £100,000 p.a. and had been paying £400 p.m. net (£500 p.m. gross or £6,000 p.a.) into her personal pension for a number of years. She was diagnosed with a terminal illness and her life expectancy was therefore considered very short.

She decided to make a significant single premium pension contribution, despite the fact she had no intention, or expectation, of drawing the pension benefits in her lifetime.

She made a contribution of £75,200 net (£94,000 gross) using her remaining pension annual allowance for the year as well as carry forward of previous unused annual allowance. This brought her contributions for the tax year up to £100,000 and 100% of pensionable earnings so the contribution benefitted in full from tax relief.

On her death a few months later her Personal Representatives should include details of the pension contribution on IHT schedule 409.

Connie had named her daughter as beneficiary of her pension fund and the scheme exercised its discretion in payment of the death benefits to her.

HMRC may well argue that the £75,200 was a chargeable transfer for IHT purposes, on the basis that her contribution was not intended for her own benefit but to reduce her taxable estate and to benefit her daughter.

THIRD PARTY PENSION CONTRIBUTIONS

HMRC guidance confirms that where third party contributions are paid:

- The payments would constitute "transfers of value" for IHT purposes
- The "transfers of value" would be the "net" payments
- The "transfers of value" could fall within the transferor's £3,000 annual exemption (if available) and/or could fall within the transferor's normal expenditure out of income exemption. This would assume that the normal three conditions are all satisfied
- To the extent that any of the "transfers of value" could not be covered by the transferor's exemptions, then the payments would be potentially exempt transfers (PETs).

The treatment of a third party contribution is important to consider. For example, a grandparent may have many grandchildren and may wish to make payments towards stakeholder pensions for all of them.

PAYMENT OF DEATH BENEFITS THAT FORM PART OF THE MEMBER'S DEATH ESTATE

Where the deceased member's estate has legal right to the death benefit the value of the payment should be aggregated with the rest of the member's estate.

Examples may include:

- Retirement annuity/S226 contracts & Section 32 buy-out contracts where benefits payable on death have not been assigned into trust[1]
- Some contract-based personal pensions[2]
- Where the member has a general power to dispose of death benefits
- Payments continuing after the member's death (such as guaranteed annuities).

[1]Section 32 buy-out contracts, like Retirement Annuity contracts are contracts effected between an insurance company and the policyholder/member. Death benefits are typically payable to the member's estate and are not held under trust.

[2]Not all personal pensions are written under trust but are contract based.

Where contracts are not written under trust they may be assigned into trust.

ASSIGNMENT OF DEATH BENEFITS INTO TRUST

It is common to assign pension policies that are not written under trust into trust, such that death benefits are paid at the trustees' discretion rather than to the member's estate.

The assignment of the death benefits is a transfer of value, as the death benefits that would otherwise have been paid to the estate as a right will now be paid at the discretion of the trustees. Further, in all likelihood the trust will include a range of potential beneficiaries rather than be limited to the deceased member's estate.

Provided the individual is in good health, the transfer of value made by the trust declaration would be negligible. Indeed, HMRC would not normally enquire into the individual's state of health provided that he survives the trust declaration by two years. This is because, when the member transfers the rights to death benefits into trust, it is the **present value of those death benefits** that is leaving the member's estate. If the member is in good health, and may be expected to survive to take most or all of the pension benefits in their lifetime, the present value of any residuary death benefits would negligible.

If, on the other hand, the member is not likely to survive to take most or all of the benefits in their own lifetime, the value of the death benefits would be regarded as significant (relative to the value of the fund).

So, by extension, assignment of death benefits into trust where the member is in ill health may give rise to a transfer of value that is not negligible. For this reason an assignment of death benefits within two years prior to the member's death should be reported on IHT schedule 409.

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It is important to note that the assignment would be a lifetime transfer and would not aggregate with and form part of the estate at death.

The right to assign a pension is limited in that any sums which become payable on retirement (either as an annuity or as a lump sum in part commutation) must be payable direct to the member.

Many personal pension schemes are established under trust and death benefits are paid at the discretion of the scheme, as such the death benefits would ordinarily be paid free of IHT. There are, however, other circumstances where a charge to IHT may arise.

OMISSION TO EXERCISE A RIGHT (IHTA 1984 S3(3)

It was thought that HMRC held the view that a policyholder who does not exercise an option to take an annuity once they become entitled to do so (normally at age 55) makes a continuing 'omission to exercise a right' within the meaning of section 3(3) Inheritance Tax Act 1984. The result would be that, if the right was not subsequently exercised in the policyholder's lifetime, a charge to inheritance tax would arise immediately before death based on the aggregate of the lump sum which the policyholder could have taken by way of cash commutation and the open market value of the annuity which could have been obtained had the option been exercised at that time.

However, HMRC subsequently stated that they would only have considered raising a claim in such cases where there was clear evidence that the policyholder's intention in failing to take up retirement benefits was to **increase the estate of somebody else** rather than benefit him or herself.

DEATHS POST 5 APRIL 2011

IHTA 1984 s12 (2ZA) now prevents the omission of a right under IHTA 1984 s3(3) from applying to; registered pension schemes, QNUPS & s615 schemes in respect of deaths since 6 April 2011.

It is important to note however that s3(3) may still be relevant in respect of deaths that occurred pre 6 April 2011.

The Fryer and Staveley cases were both well documented and involved a claim by HMRC under s3(3).

S3(3) continues to apply to pension schemes other than those above, mainly employer-financed retirement benefit schemes (EFRBS).

THE MEMBER HAS A GENERAL POWER TO DISPOSE OF DEATH BENEFITS

Where the pension scheme member can nominate who will receive a lump sum death benefit, and where the pension scheme provider is bound to comply with that nomination, the payment falls within the member's estate. This is because the member has a general power that enables them to dispose of the property (IHTA84/s5(2) and IHTA84/s151(4)).

It is unusual for a scheme to offer such a binding nomination. Where such a binding nomination is available the scheme provider may restrict its application so that it can only be in favour of a surviving spouse/civil partner where the spouse/civil partner exemption would apply.

The terms "nomination" and "expression of wishes" have often been used interchangeably in the past and the term "nomination" is now extensively used since the introduction of the "nominees' pension" under The Taxation of Pensions Act 2014. It is important to note that only a binding nomination would be caught under s5(2) and s151(4).

Where a scheme makes a lump sum payment to the estate, but at the scheme's discretion, the lump sum is not to be regarded as part of the estate. Such a situation may arise where it is not clear to the scheme provider who a lump sum benefit should be paid to or where the situation is contentious and payment to the Personal Representatives appears to the scheme to be the best solution.

Pension death benefits may be paid as a lump sum or to provide a beneficiary's pension (dependent or nominee's pension and subsequently as a successor's pension). For the death benefits to be regarded as part of the estate at death, the member's binding nomination must apply to all benefits however they are paid. For example, where a member can make a binding nomination in respect of a lump sum death benefit, but the scheme has the discretionary power to provide a dependent/nominee's pension that is not subject to a binding nomination. Here the benefits are not regarded as part of the member's estate.

From a financial planning perspective it is important that clients understand that most schemes will not allow a binding nomination. From an IHT perspective, a non-binding nomination may be preferable but it may then come as a surprise to the member that the scheme may not necessarily pay benefits to the person they have nominated. The schemes' discretion on payment of death benefits is an important factor in preventing IHT applying to the lump sum death benefit, a compromise of control vs IHT efficiency.

PAYMENTS CONTINUING AFTER THE MEMBER'S DEATH

The deceased may have had an annuity in payment during their lifetime where the payments were guaranteed for a certain length of time. If the guaranteed payments made after the death are paid to the estate, or at the direction of the deceased, the value of those continuing payments is an asset of the estate. Conversely if the continuing payments are made at the discretion of the pension or annuity provider, their value is not treated as part of the estate.

The value of the outstanding guaranteed payments is calculated actuarially based open the open market value of the continuing payments at the date of death.

PENSION TRANSFERS

Perhaps the most topical aspect of IHT in respect of pensions is the treatment of pension transfers. The Staveley case was an important and much reported case where the IHT implications of a pension transfer were considered.

When a member transfers their pension benefits from one scheme to another, the member surrenders their rights under the first scheme in return for rights under the second.

The pension funds themselves do not fall back into the member's estate during the transfer process, however, the member does have the right to determine the terms of payment of death benefits in the receiving scheme. This right has a value because the member could* direct the payment to their own estate. If payment is not directed to their estate then there may be a loss to the estate.

*NB (it could be argued that the power to direct the future payment of death benefits is a hypothetical power where the receiving scheme refuses to accept a binding nomination from the member and the scheme rules insist on the scheme having discretion over payment of death benefits).

The value of the transfer of death benefits depends on the member's health at the time of the pension transfer. If a person is in normal health at the date of the transfer then the loss to the estate is nominal. If they are in ill-health at the date of the transfer then the loss may be significant.

Details of any transfers made within the two years before the death should be reported on IHT schedule 409.

It is important to note that the transfer would be a lifetime transfer; it is not relevant therefore where pension death benefits are ultimately paid. The spouse/civil partner exemption would not apply in respect of a lifetime transfer of value in respect of death benefits via a pension transfer.

The application of IHT to pension transfers has caused a great deal of confusion and concern not least as regards the actual valuation of the transfer of value. Some confusion relates to the misapprehension that the transfer of value is essentially the pension transfer value but, as the "loss to the estate" principle applies and the pension funds themselves do not fall back into the member's estate, this cannot be the basis of valuation.

EXAMPLE 2

Joe transfers his pension fund from Scheme A to Scheme B. The transfer value is £1,000,000 and Joe is in serious ill health when he effects the transfer.

WHAT IS THE "LOSS TO THE ESTATE" ON THE TRANSFER?

HMRC's methodology for calculating the loss to the estate is determining the difference between the "before" and "after" values:

Before value:

› The open market value of the death benefits that the member could have directed to be paid to their estate following the transfer

After value:

› The open market value of the pension rights available to the member after the transfer into the second scheme has been completed

If the "**after**" value is **lower** than the "**before**" value **there will be a loss to the estate** – the difference will be included in the estate for IHT purposes.

If the "**after**" value is **greater** than the "**before**" value **there will be no loss to the estate** – nothing will be included in the estate for IHT purposes as a result of the transfer.

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Scheme A – Before value

£1,000,000 transfer value

"Open market value" of £1,000,000 of potential death benefits in respect of the member who is assumed to be in serious ill health with a limited life expectancy is, hypothetically, calculated to be **£900,000**.

Scheme B – After value

£1,000,000 transfer value received. (Associated costs and charges assumed to be taken from other resources)

BENEFIT	VALUE
PCLS	£250,000
10 year guaranteed annuity (£750,000 x assumed 9% annuity rate)	£67,500 p.a.
Net annual annuity (assuming purchaser is 40% taxpayer)	£40,500 p.a.
Annuity factor for 10 year annuity, payable monthly in arrears, at 3.6% p.a. net (6% p.a. gross of 40% income tax)	8.411
Net annuity x annuity factor	£340,645.50
Reduced by 10% discount for non-assignability	£306,580
Less purchaser's costs (approx. £1,000)	£305,580
TOTAL	**£555,580** (£250,000 + £305,580)

The difference between the "before" and "after" values is £900,000 - £555,580 = £344,420.

Based upon these assumptions the chargeable transfer would be **£344,420**!

What impact has The Taxation of Pensions Act 2014 and "pension flexibility" had on the above valuation method?

We understand that HMRC would expect the "after" value to be calculated based upon the options available under the receiving scheme **and** which options would generate the greater open market value. This is likely to be a combination of PCLS and withdrawal of the whole fund.

Any calculation method that would legitimately increase the "after" value would reduce the chargeable transfer.

If the member was under age 55, the "after" value would apparently depend on what benefits they had the right to receive, rather than merely a right to request (for example an ill health commutation which they might have the right to request, but no automatic right to receive).

FURTHER UPDATES IN THIS SERIES AND OUR UTECH SITE

This was the last in our "IHT Bitesize" series – we hope to bring you more Technical Sales Briefings soon.

Note the content in this briefing is taken from our comprehensive Inheritance Tax Manual which is available in the Technical Briefings section of our uTech site (utmostwealth.com/utech). uTech has several other technical briefings exploring the more niche and complex areas of UK IHT. These include several guides to the Residence Nil Rate Band and a detailed briefing exploring Domicile, Remittance Basis and Excluded Property.

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