

Bulletin 3
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IHT and the new pensions tax regime

The tax treatment of death benefits is always one of the key considerations when advising a client concerning their pension arrangements. HMRC's current attitude towards Inheritance Tax (IHT) and pensions was set out in a Tax Bulletin issued in 1992, and this was supplemented by a further note issued in June 1999 to take account of the introduction of income withdrawal benefits.

The new pension tax regime, and its new benefit options, effective from 6 April 2006, has resulted in HMRC considering the IHT treatment of death benefits under the new regime, and issuing a discussion paper concerning this. This Talking Point bulletin will consider the potential changes to the way in which HMRC may apply the IHT rules to death benefits.

Inheritance tax - some basics

IHT is charged on transfers of value, arising either on death or by virtue of lifetime dispositions which reduce the value of a person's estate. The normal meaning of dispositions is extended by section 3 (3) of the Inheritance Tax Act 1984 (IHTA 1984) to include cases where a person deliberately omits to

exercise a right, with the consequences that their estate is diminished and that of another person (or the value of property in trust) is increased. In such a case, the person in question is treated as making a disposition at the time, or the latest time at which they could have exercised the right, unless it is shown that the omission was not deliberate

There is also a general exemption under section 10 of the Inheritance Tax Act 1984 for any disposition that is not intended to confer a gratuitous benefit on another person and is made in a transaction either at arm's length or on arm's length terms.

HMRC discussion paper

The discussion paper is called 'Inheritance Tax and Pension Simplification'. The paper makes the following proposals:

Where a member dies after starting to draw a scheme pension or lifetime annuity

HMRC felt there could potentially be an IHT charge under section 3 (3) where a member died within 7 years of committing to a pension, if he/she had not taken this pension at the earliest opportunity or had taken a pension with less than the strongest available guarantees. However, in practice HMRC felt any transfer of value which might be

seen as arising from such actions would almost certainly be covered, as now, by the exemption in section 10 IHTA 1984.

Member aged 75 or over who dies while taking ASP

In HMRC's view the use of alternatively secured pension (ASP) will, in most cases, have the effect of increasing the assets held for the benefit of the member's spouse or dependants or of other participants in the member's scheme. HMRC indicates "**in these circumstances, we think that it will in general be very hard for the deceased member's**

personal representatives to show that the member's choices to continue in ASP were eligible for the exemption in section 10".

HMRC goes on to indicate that in general it would expect that the member's IHT estate immediately before death to include a chargeable transfer determined in accordance with section 3 (3). This will be calculated by reference to the best annuity return achievable at the latest time at which the member could have exercised his right to annuitise his benefits.



HMRC discussion paper (cont.)

Since the member will be aged at least 75 at that time, and has the right to take a guaranteed 10 year annuity, the value of the chargeable transfer is likely to approach the value of the member's residual fund.

Another question to address in these circumstances is who pays the IHT – the pension scheme, which has the cash, or the estate?

Member taking an unsecured pension and dying before age 75

This is currently possible under income withdrawal and so it is possible to compare the current practice with the new proposals. In the discussion paper HMRC recognises that this is nevertheless a difficult area covering a wide range of possible circumstances approach the value of the

At one extreme HMRC indicates that there will be members with modest pension funds who will often want to defer taking a pension, especially if they have some continuing income from employment, for the sake of getting a higher pension later, when their need for income may be greater.

In such circumstances HMRC would expect their decision to qualify for the exemption in section 10 if they were ultimately to die before annuitising their benefits.

However, even in the above circumstances potential problems could arise should the individual's circumstances change. It indicates, for example, that if a member initially deferred taking their pension when in good health but subsequently comes to believe that their life expectancy may be significantly reduced, then this could result in a charge to IHT. In other words, a member who had initially decided to defer taking a pension in order to maximise their future income may nevertheless be chargeable under section 3 (3) if they do not review that decision in the light of changing information about their health.

HMRC goes on to indicate that there may be cases where members defer committing to a regular pension wholly or partly for estate planning reasons. HMRC recognises the difficulty of ascertaining the exact reasons why an individual has decided to take an unsecured pension rather than an annuity. However, in circumstances where the taking of the income from the

unsecured pension was clearly to enhance the available death benefit, there would be a charge to inheritance tax in exactly the same way as for an individual who dies while taking ASP (see above).

In view of the difficulty of determining whether a deceased member's particular circumstances will result in a chargeable transfer, HMRC has indicated that **“the onus on this issue lies firmly with the deceased member's estate. In the circumstances we are concerned with, there will be a charge under the rule in section 3 (3) unless the estate's representatives can show that the deceased member's choice not to commit to a regular pension is exempt by virtue of section 10”**.

To show that it is exempt under section 10, the member's executors must satisfy two tests. The first is that it was not intended to confer a gratuitous benefit on any person and the second that it was **“such as might be expected to be made in a transaction at arm's length between persons not connected with each other”**.

The implications

If HMRC decides to proceed largely as set out in the discussion paper, this raises a number of issues:

» There is the potential for a double tax charge where a member, taking an unsecured pension by means of income withdrawals, dies while

taking such benefits prior to age 75. This could result in an IHT charge as well as the 35% standalone income tax charge on the lump sum death benefit.

» No mention is made in the discussion paper of any exemption from the IHT charge where death benefits are paid to a spouse or dependant. It is to be hoped that the inter-spouse

exemption will continue to apply.

» Under the current IHT and pension rules, HMRC had indicated that it would not seek to pursue an IHT charge where the benefit was paid to a dependant. However, will this continue to be the case in respect of the new rules?





The implications (cont.)

- » Where a member dies while taking an unsecured pension, HMRC are proposing that the onus will be placed on the member's executors to prove an IHT charge under section 3 (3) should not apply. This is very tough and may be extremely difficult to prove especially where the presumption is that the deferment of full benefits was in order to enhance the estate of others.

Great care will need to be taken where advice is given to a member. For example, if the advice fully indicates that the member's intention is to maximise death benefits, then a section 3 (3) charge is likely to apply if the member dies while taking unsecured pension. The documenting of advice where a member takes an unsecured pension will need to be very precise. For example, if the member's intention is to take an unsecured pension as he/she has no immediate need for income, this should be set out as the prime reason. It should also be remembered that advice will need to be given to the member on an ongoing basis concerning the potential IHT position. Any change in the member's state of health is likely to affect the advice given.
- » Although the new IHT provisions will not take effect until after 6 April 2006, they need to be taken into account when advising clients now, as in most cases it will be these provisions that will determine the IHT treatment of the client's benefits on death.

Postscript

- In the pre-budget report the Chancellor indicated that the changes to be made to the IHT regime will be included in the Finance Bill 2006 and that further information on the rules to apply will be set out in 2006.
- It is a great pity that the further information on the IHT rules has been delayed. Although these will only take effect after 6 April 2006, it will affect the advice given to clients now as the majority will die after A-Day.
- Without this information it is extremely difficult to advise clients concerning their pension arrangements.

This bulletin is based on our current interpretation of the changes under Pensions Simplification.