

## UI/ASP death benefits and IHT - part one

The options on death for unsecured income are basically the same as drawdown before A-Day; the tests applied to determine whether an IHT charge should apply are also very similar. Nonetheless, advice and record keeping remain vitally important.

The prospect of an IHT charge on ASP funds (be it on the death of the member or their financial dependants) is unlikely, we believe, to put wealthy, annuity-averse clients off ASP. However, care must be taken to avoid the risk of a double tax charge.

Including:

The options on death

IHT

### The options

#### Unsecured income (UI)

If a policyholder dies while receiving UI (prior to age 75) there are two options available: a lump sum subject to 35% tax; or dependant's benefits, which can take a variety of forms: a dependant's unsecured income, annuity purchase or, if the dependant is over 75, ASP.

#### Alternatively secured pension (ASP)

If a policyholder dies in ASP then any residual fund must, in the first instance, be used to provide dependants' benefits. These can take a variety of forms such as a dependant's annuity, ASP or unsecured income (if under age 75).

Where there are no dependants, the fund may:

- » be used to augment the fund of another scheme member; or
- » where an appropriate nomination has been made by the policyholder, paid to a registered charity.

### IHT

#### Unsecured income

According to [BN26 – Inheritance tax and pensions simplification](#) issued by the HMRC on 22 March 2006, the present IHT rules will continue to apply to registered pension schemes in much the same way they do currently.

The HMRC state that "an IHT charge can arise in a scheme member's lifetime under section 3(3) Inheritance Tax Act 1984 if they do not exercise their right to take pension benefits. The charge applies at the latest time when the

right could be exercised i.e. immediately before death." This is likely to arise in such circumstances where a policyholder opted for unsecured income when their life expectancy was seriously impaired and this resulted in an enhanced death benefit being paid to their beneficiaries. In this case the two year rule would be applicable such that, provided they survived two years after entering UI, no IHT would be payable. Moreover even when IHT would be due, by concession

it is not charged where the beneficiary is a spouse, civil partner or financial dependant of the policyholder. HMRC have also amended their view regarding changes in circumstances following the initial decision to defer benefits. It is now clear that provided a policyholder does not amend their level of income following new information regarding their state of health and they survive two years from the original decision then again no IHT would be due.



## IHT continued

### Alternatively secured income

HMRC have now made it clear that the generous tax relief on pensions is only provided on the basis that the funds are used to secure an income in retirement by age 75 – and this means an annuity or scheme pension for the majority.

When the government first introduced the concept of ASP (in the December 2003 proposals) it was as a result of principled religious objections to annuitisation. In the guidance issued just 15 days before A-Day, the government stated its intention to try and restrict ASP to those with principled religious objections by applying IHT charges to remaining ASP funds on the death of the policyholder/surviving dependents. Our current understanding of the way in which IHT will apply to a Suffolk Life SIPP is as follows.

- » Any funds remaining within the scheme for the benefit of other members who are not a spouse, civil partner or person who is financially dependent will be subject to an IHT charge on the death of the original policyholder. The funds will be treated as

if they are part of the deceased's estate and valued immediately before death

- » If the remaining funds are paid to charity or used to provide benefits for the policy holder's spouse, civil partner or financial dependant, no IHT will be payable.
- » When a dependent beneficiary dies or becomes non dependent, such as on reaching age 23 or leaving full time education, any remaining funds will revert to the scheme and be treated as if they were an addition to the original policyholder's estate and may be subject to IHT. If, however, the remaining funds were paid to a registered charity then the funds would not be subject to IHT.

One instance in which the IHT charge would fall on the dependant's estate and not the original policyholder is as follows:

- » A policyholder dies before age 75 and the financially dependent beneficiary, who is under age 75, chooses to

continue to take an income from the fund. The dependent then converts to ASP on reaching age 75. On their death the IHT charge, if applicable, would fall onto the beneficiary's estate and not the original policyholder's estate as it would in other cases. HMRC have already indicated that they intend to monitor such cases although this will not remove the responsibility for delivering an account.

There is at least one circumstance in which a double charge may apply as follows:

- » A policyholder dies while taking ASP, the residual fund is then used to provide a dependant's unsecured income. If the dependant dies before age 75 the residual fund will initially form part of the original policyholder's estate and be charged to IHT. The remaining funds will then be subject to the 35% tax charge applicable to lump sum death benefits under unsecured income, prior to being paid.

### Our view

We cannot see that these new guidelines and the subsequent changes to be included in the Finance Act will deter many people who are annuity averse from ASP, even with the prospect of paying IHT. Many people would prefer to pass on something to later generations. The potential 40% tax charge (payable by the scheme), in most cases, is partially offset by the tax relief on contributions and the tax-free growth within the SIPP.

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

For wealthier clients it could even be seen as saving on behalf of future generations. However, care must be taken to avoid the risk of a double tax charge.

What represents uncharted territory is HMRC's requirements on scheme administrators and legal personal representatives in the event of death in ASP and this is what we will be looking at shortly in part two.