AJBell Investcentre

ADVISER GUIDE

Pensions and IHT

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IMPORTANT

This information is based on current understanding of pension tax rules. This is provided for information only; we do not provide advice.

Tax rules may change in the future and the tax treatment depends on personal circumstances. This guide and case studies are provided for professional advisers’ use only.

Background

Although we are often told pensions are free from Inheritance Tax (IHT), there are circumstances where private pensions can have IHT implications. This adviser guide explores the IHT issues surrounding pensions..

Forms

Where a client had pension provision other than the state pension, form IHT 409 must be completed. The form asks for details about the pension schemes, including lump sum benefits paid out. It also asks for information about actions within two years of death – any transfers made, any changes made to pension benefits, and any contributions paid to the scheme.

Pensions
Schedule IHT409

When to use this form

Fill in this form if the deceased received, or had made provision for, a pension or benefit from an employer or under a personal pension policy other than the State Pension.

If the deceased had more than one pension or benefit for any one section of this form, you will need to complete a separate form for each pension and benefit.

Help

Please read the guidance notes for form IHT409 in the IHT400, 'Notes' before filling in this form. For more information, help or another copy of this form:

- go to **www.gov.uk/inheritance-tax**
- phone our helpline on **0300 123 1072** – if calling from outside the UK, phone **+44 300 123 1072**

Name of deceased

Date of death DD MM YYYY

Inheritance Tax reference number (if known)

Your rights and obligations

'Your Charter' explains what you can expect from us and what we expect from you. For more information go to **www.gov.uk/hmrc/your-charter**

Death benefits

On death, the key consideration as to whether IHT is payable is whether the estate was entitled to, or guaranteed to receive, benefits due to be paid out in respect of a deceased member.

Where death benefits are paid according to a binding nomination – where a beneficiary is named in an instruction that the pension scheme trustees must follow – then IHT will be payable. The trustees do not have discretion over the distribution.

There are also instances where the pension arrangement pays the death benefit direct to the member's estate, for example section 32 buyout plans and retirement annuity contracts.

The exemption granted to spouses or civil partners who receive assets in the event of a client's death is generally available in respect of death benefits. If the beneficiary in the binding nomination was the member's spouse or civil partner, or a death payment was made to the estate and the will directed this to a spouse or civil partner, the spousal exemption to IHT can be available.

Lifetime transfers

IHT can also arise from circumstances deemed to be 'lifetime transfers'.

These lifetime transfers are known as 'dispositions' and examples include:

1. transfers between pension schemes;
2. contributions made to pensions; and
3. writing death benefits into trust (for example section 32 death benefits) that might have ordinarily been paid to the client's estate.

If a lifetime transfer is carried out when a member is in ill health and they subsequently die within two years, that previous 'disposition' can have a significant value when it comes to calculating what, if any, IHT is due.

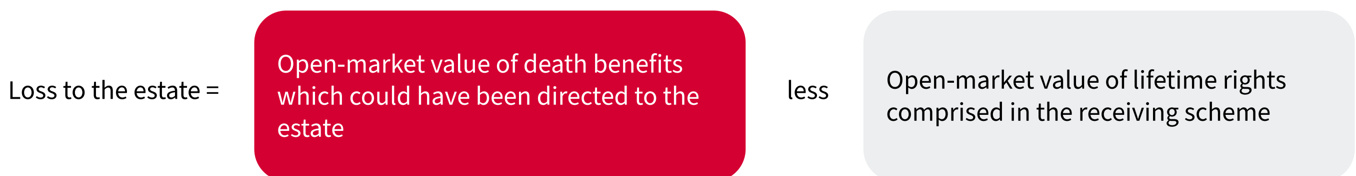
Loss to the estate

HMRC takes the view that at the point of transfer, the member has the theoretical opportunity to redirect the death benefits under the new plan to the estate. For example, using an expression of wish included as part of a new pension plan application form.

One of the most common questions we get asked is – what is the likely IHT bill?

IHT would be payable on what HMRC values as the loss to the estate. This is usually calculated on a case-by-case basis by HMRC actuaries.

In general, the loss to the estate will be the difference between the amount that could be directed to the estate as death benefits and what the client could have accessed at the point of transfer from the new pension. It is not the whole pension transfer value or CETV.



The red box takes the transfer value, increases it by investment growth, and then discounts it to present value using a discount rate. This is the value that could have been directed to the estate on the new pension scheme application.

The grey box is the value of the pension benefits that could have been drawn from the new scheme following the transfer. Following pension freedoms, this could be an uncrystallised funds pension lump sum (UFPLS) net of Income Tax.

The difference between the two amounts is the deemed loss to the estate on which IHT is claimed.

The sooner the member dies after the transfer, the bigger the value of the red box, and therefore the bigger the loss to the estate.

Case study – Jason

Jason was terminally ill and had been given less than a year to live.

He transferred a retirement annuity contract worth £500,000 on 1 May 2019 to a SIPP but unfortunately died within 12 months of the transfer.

His executors report the transfer on the IHT409 form (see above), but what might the IHT liability be?

In Jason's case, the value of the death benefit (red box) will be close to the transfer value as his prognosis was very poor at transfer date. If we assume a 3.5% growth rate and a 7.5% discount rate that gives us:

£500,000 x 3.5% discounted by 7.5% = around £480,000

The grey box could be the net value of a £500,000 UFPLS paid as a retirement benefit.

After a tax-free amount of £125,000 (25% of £500,000) is paid out, this leaves the remaining £375,000 subject to Income Tax. Assuming no other income, this leaves a net amount of about £222,000. Adding this to the tax-free amount of £125,000 gives a net lump sum of £337,000.

The loss to the estate could be:
£480,000 – £337,000 = £143,000.

Although these are only reported upon the death of the client, the lifetime transfer is an event, act or gift that occurred in the client's lifetime. This is an important distinction as it means no spousal exemption is available against any claim for IHT by HMRC.

Although a spouse might be the ultimate beneficiary of any benefits payable after the client's death, the IHT here is claimed in respect of lifetime acts.

The property transferred (the pension rights as part of the lifetime transfer) does not comprise the spouse's estate and, at the time of transfer, there was a loss to the client's estate, rather than a transfer to their spouse.

If the loss is below the nil rate band (NRB), IHT may not ultimately be payable in relation to the transfer itself. However, the amount of the NRB used will not be available for the rest of the client's estate, which could alter the estate's position. Any NRB used would also not be available for any spouse or civil partner on the second death.

Drawdown-to-drawdown transfers

HMRC has indicated that if drawdown income continued at least at the same level after a transfer as was payable before, then it is unlikely to make a claim.

Supreme Court Judgement – HMRC v Parry and others – 'The Staveley case'

Mrs Staveley was a member of a section 32 plan. Following an acrimonious divorce, she wanted to ensure that her ex-husband could not benefit in the event of her death. Under the rules in force before A-Day (6 April 2006), surplus funds from the section 32 might be returned to her former company, Morayford Ltd, that was still in the hands of her ex-husband.

When Mrs Staveley received a terminal diagnosis of cancer in 2006, she transferred the section 32 plan to a personal pension. She used an expression of wish form to nominate her two sons as beneficiaries of any death benefits under the personal pension. She died just six weeks later.

Her sons were also the beneficiaries under her will.

HMRC argued Mrs Staveley's decision to transfer her pension and nominate her children – rather than leave it in the existing scheme and allow her ex-husband to benefit, or take an income from her pension after the transfer – conferred a gratuitous benefit on them. A gratuitous benefit is deemed to occur when a particular action is taken in relation to funds with the intention of reducing the Inheritance Tax applied on those funds.

The case had previously been heard by three different lower courts, and was finally heard by the Supreme Court.

IHTA 1984 definitions

HMRC argued that Mrs Staveley made two transfers in connection with her pensions:

1. a transfer under IHTA84/S3(1) on the transfer from the section 32 policy to the personal pension; and
2. a disposition under IHTA84/S3(3) on the omission to exercise her right to draw the pension benefits from the personal pension.

The definitions in the IHT Act 1984 that HMRC was looking to rely on were:

Section 3(1) – an act

Transfer of value = a disposition by a transferor that leads to their estate value being immediately less than it was prior to the transfer.

Section 3(3) – an omission to act

Where an estate is diminished and another's increased as a result of the failure to exercise a right.

Mrs Staveley's representatives argued her sole motivation was to make sure Morayford Ltd (and her ex-husband) could not benefit in any way from her pension fund or any excess, and so the exemption to these rules available in section 10 of the same act applied.

Section 10

A disposition is **not a transfer of value** provided it was not intended, or not made in a transaction intended, to confer any gratuitous benefit on any person.

'Disposition' includes an omission to act and 'transaction' includes a series of transactions and any associated operations.

HMRC said the exemption could not apply, because Mrs Staveley also intended for her sons to benefit and signed the expression of wishes to that purpose. However, in its ruling the Supreme Court reiterated a previous tribunal's point that the sons were due to benefit from the original section 32 contract due to the terms in Mrs Staveley's will and in her mind there was no change in beneficiaries.

HMRC also argued that Mrs Staveley's failure to take benefits increased the value of her sons' estate and diminished hers and, together with the transfer itself, Mrs Staveley had entered into a scheme (or transaction) that was designed to confer a gratuitous benefit on her sons.

The onus is on the taxpayers to prove the motive of the client in such cases.

Supreme Court ruling

The Supreme Court considered the case as three separate issues.

1. Was the transfer alone subject to an exemption under s10(1) IHT1984?

   The judges were unanimous that the transfer was solely motivated to prevent any excess benefits within the section 32 returning to her ex-husband's company, and therefore was subject to an exemption under section 10 of IHTA 1984. It's important to note that, although the transfer may have resulted in a better position for the beneficiaries, it is all about intention to confer gratuitous benefit. If she had written death benefits into trust whilst seriously ill, this assignment would have also been a lifetime transfer.

2. Was the transfer, together with the omission to take pension benefits from the new scheme, associated operations of a wider transaction intended to confer a gratuitous benefit?

   Amajority of the judges felt that although the transfer, the nomination of the sons under the new scheme and the failure to take benefits might have improved the position for her sons, they were not part of a contrived scheme intended to do so.

3. Whether the omission to act was a disposition under s(3) IHT1984.

   The court found unanimously that the failure to take benefits from the new scheme after the transfer was a transfer of value for IHT. The rules here no longer apply in respect of pensions and transfers since 2011 but, unfortunately for Mrs Staveley's beneficiaries, as she died in 2006, this was still an issue.

Our comments

Although many of the headlines professed the court ruling was good news, we do not believe it means all pension transfers are now safe from IHT implications.

There were circumstances that were specific to this particular case. When transferring, Mrs Staveley was solely motivated by the desire to stop her husband having a claim on the funds. Whilst the new provider had full discretion over distribution of death benefits, and therefore it was possible they could pay these to her ex-husband, it was always going to be very unlikely as he wasn't financially dependent.

In the detail of the judgement, HMRC was criticised by the judges for its wholly artificial analysis of the calculation of the transfer of value in the cases of pension transfers in ill health. This is interesting as HMRC has published guidance in the IHT manual which, at face value, reads as if it feels the ruling supports its thinking.

As we have said previously, there is still a danger cases could be caught, particularly where the primary motivation for a transfer is enhanced or more flexible death benefits that become payable to a wider class of beneficiaries and the client is in ill health.

Other practical issues

Although the IHT409 form collects information on transfers within two years of death, cases transferred in ill health outside of this transfer window could, in theory, be challenged.

Thanks to section 200 of IHTA 1984, beneficiaries may also find some providers withhold some funds until they receive appropriate confirmation that any IHT matters are settled with HMRC.

This is because the legislation allows HMRC to call on the trustees or scheme administrators to settle an unpaid IHT bill in relation to a lifetime transfer.

Even where a client is in poor health, a transfer may still be the right decision despite the IHT threat.

However, we can agree that the calculation is at best complicated and can still create significant uncertainty when considering with clients the merits of a transfer. In fact, the Supreme Court appeal ruling did criticise what it called HMRC's "return to zero" approach and "wholly artificial analysis".

Consistency is an issue too. Anecdotal evidence from advisers suggests that even where they helped executors to fully disclose details of recent transfers upon the client's death, to their surprise, no claim or action was taken by HMRC.

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