Swallow Financial Planning

IHT & PENSIONS

Recent changes to the rules for pensions have radically changed the approach of advisers with regard to pension savings. The following notes are designed to give our current views as to the options available to clients.

SECTION **PAGE**

1. CONTRIBUTIONS

1.1 Personal Contributions

Contributions to a pension scheme are not normally treated as transfer of value for IHT purposes. They can, however, be considered as a lifetime transfer if the health of the member at the time the contribution is made is very poor and/or if the member dies within 2 years of making, say, a very substantial contribution. Care, therefore, needs to be taken to ensure that if a very substantial contribution is made then documentation is available to prove the contributor is in good health at the time the investment is made.

1.2 Contributions Made For Other People

Gifts from one party to another in order to facilitate a pension contribution are potentially exempt transfers (PETs). So, for instance, a parent can give their offspring and/or grandchildren a gift of a pension contribution. In the case of minors, or those without earned income, the maximum would be £3,600 gross (£2,808 net) but for children who are over 18 the gift could be up to 100% of their earned income.

It is even possible for the parent to make a direct contribution on behalf of their beneficiary. This is best explained by example.

George and Frances Osborne have a son named Fred who is a bit wayward. Fred earns good money but is always getting into financial scrapes. George is concerned that if he and Frances give Fred substantial gifts now the cash will simply go to supporting Fred's wayward ways.

Swallow Financial Planning (SFP) establish a pension plan for Fred. We have to check his circumstances and ensure a pension plan is suitable and Fred has to agree to sign the paperwork etc. Having got the paperwork Osborne (senior) writes a cheque out for the net of tax investment into the pension fund. So if the net investment was £20,000 the figures would look as follows:

Parent makes PET (or gift out of income) of:	£20,000
Which is saving IHT (after 7 yrs) of:	(£8,000)
So is a net loss to their estate of:	£12,000
The pension contribution of	£20,000
This is uplifted by HMRC to a gross contribution of:	£25,000
Adult child then claims HRT relief of 20%	£5,000
So total benefit is	£30,000

So everyone wins! George and Frances get £20,000 out of their estate thus saving 40% IHT. The cash creates an investment of £25,000 for their wayward son which he cannot access until age 55. Son on the other hand gets a lump sum of £5,000 so sees an immediate benefit and if his income is in the 60% or 45% bracket he is even better off.

2. DEATH BEFORE AGE 75

Subject to our comments in section (4):

2.1 Are You In Retirement?

The death benefit taxation rules are not generally affected by whether you have taken (crystallised) your benefits or not.

2.2 Defined Benefit Schemes

The legislation allows for dependant's pensions to be paid tax free. However, the scheme rules may not.

2.3 Defined Contribution Schemes

The value of the pension fund can be paid out as a lump sum tax free (including payment to a spousal bypass trust) ***or*** the fund can continue and a tax free draw down can be taken by the chosen beneficiary.

2.4 Death In Service

Benefits can be paid out as a lump sum free from tax including payment into a discretionary trust.

3. DEATH BENEFITS AFTER AGE 75

Subject to our comments in section (4) below:

3.1 Defined Benefit Schemes

Will inevitably be in payment and benefits will be paid subject to tax and the scheme rules.

3.2 Defined Contribution Schemes

Firstly there is still a lifetime allowance test at age 75 regardless of whether you have taken benefits or not. The pension or pension fund would typically be left to the surviving spouse and thereafterwards can be passed to children / grandchildren ***inheritance tax free***. The new recipient can then take his or her income from the pension fund subject to their highest rates of tax.

As an alternative a lump sum can be paid subject to 45% tax (or tax free if left to a charity).

4. POSSIBLE ISSUES PREVENTING ADVANTAGEOUS TAX TREATMENT OF BENEFITS

4.1 HMRC Stated Reasons To Attack The IHT Exemption

We have not seen a single attack on a deceased client's pension fund passing outside their estate however the following are areas which have been raised as possible issues:

- If a contribution is made when the contributor is in ill health HMRC could attack this as tax planning, not pension savings;

- If the plan is put into trust and/or significant changes are made to the beneficiaries which are beneficial from an IHT perspective when the contributor is in ill health, HMRC may attack the arrangement;

- If the contributor defers retirement for any reason and dies within 2 years of taking the action then HMRC may attack the arrangement unless it is crystal clear from the documentation that the reasons for deferring said retirement were nothing to do with estate planning.

4.2 The Lifetime Allowance

Your lifetime allowance (LTA) can be anything from infinite to £1,030,000 for 2018/19 tax year.

The inheritance tax treatment of death benefits has no effect on the HMRC tax treatment of the lifetime allowance. Therefore, if your death benefits exceed the lifetime allowance applicable to you, your beneficiaries will pay 55% tax on the benefits.

4.2.1 Death In Service

We are increasingly seeing clients with large death benefits written under pensions legislation. People forget that these benefits are subject to the lifetime allowance of £1,030,000 for 2018/19.

The simple expedient of replacing these group schemes with a “relevant life” arrangement can avoid this tax trap.

4.2.2 Pension Benefits

Again if your benefits when crystallised on death exceed your relevant lifetime allowance the LTA tax will have to be paid before proceeds are distributed.

4.3 Scheme Rules

Although it seems unlikely scheme rules will not have been changed to accommodate the new tax regimes, it has to be pointed out that scheme rules override many tax rules and so could prevent the new freedoms being available to you.

5. GETTING YOUR BENEFITS TO THE RIGHT BENEFICIARIES

If you have a large estate then planning the death benefits from your pension plan should be part of a global IHT strategy where you take specialist legal and taxation advice.

5.1 Nomination Forms And Global Trust Schemes

Most pension funds are set up under a global trust. This means that in the event of the death of a contributor the trustees of said trust have absolute discretion as to where the funds go. This means that where the trustees have such discretion death benefits will not normally fall into part of a deceased person’s estate and the scheme administrators/trustees have up to 2 years to arrange the death benefits to be paid to beneficiaries.

A nomination form is nothing more than a request to trustees that they consider your wishes post your death. The trustees are not obliged to follow your wishes, but in reality nearly always do.

We have been using a much wider wording in recent nominations to try and give clients the maximum flexibility, for instance:

If she is alive my preference would be to let my wife continue to draw upon my pension for her lifetime however if Frances has pre-deceased me then I would like my children and / or grandchildren to benefit. My financial advisers, Swallow Financial Planning, will be able to provide you with details of any beneficiaries and current addresses and I would appreciate it if you would listen to their advice as to which beneficiary should receive any income / funds remaining.

5.2 Creating Your Own Discretionary Trust

The alternative to using the nomination form would be to create your own discretionary trust (sometimes called a spousal bypass trust) for one or several of all your pension funds. This can be an expensive exercise (typically £400 for a simple trust).

This would only really be an option up to age 75 since after 75 lump sum benefits are taxed at 45%.

The tax treatment of a trust is worse than simply passing the pension benefit to a chosen beneficiary since once the pension fund is in the trust ongoing investment is subject to discretionary trust taxation. Any capital growth within the trust over and above the trust annual exemption (£5,650 for 2018/19) will be taxed at 28%. Any income over £1,000 will be taxed at 45%.

Depending on the amount of money in the trust, there may be inheritance tax charges, periodic charges every 10 years and an exit charge if the beneficiaries take the money out.

If you simply nominate the pension income the growth remains tax free within a pension fund and the income is tax free.

Nonetheless, a trust may well be appropriate if you have specific requirements, the surviving spouse may be in a nursing home and you want to prevent local authority attack, there may be a minor or special needs individual or a complicated IHT position all of which can be planned for with your legal and taxation advisers.

6. OTHER IHT NOTES

We have a number of other notes relating to IHT issues. These can be found on our website under Library.