IHT for pensions schemes: special rules

Synopsis: The three common sets of circumstances in which a special inheritance tax (IHT) charge can arise in relation to a member's interest in a registered pension scheme because of action taken by a pension scheme member during their lifetime.

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It is usually the case that death benefits paid from pensions are free from IHT. There are circumstances where IHT can apply when the deceased's estate has a right to death benefits, where there is a general power of appointment and also in relation to guaranteed annuity payments continuing to be paid to the Estate on death.

This paper considers three common sets of circumstances in which a special IHT charge can arise in relation to a member's interest in a registered pension scheme because of action taken by a pension scheme member during their lifetime. These concern…

- the payment of contributions;
- the transfer of death benefits by, say, declaring a trust "lifetime transfers of death benefits"; and
- the transfer of pension scheme rights to a different pension plan "pension transfers."

Contributions

Normally, when a person makes a pension contribution, the prime intention will be to enhance their retirement provision. Therefore, even though death benefits are subject to a discretionary trust, the actuarial likelihood of the member dying before retirement is remote and so no transfer of value is likely to arise when the contribution is paid. And even if there is a measurable loss, s.10 IHTA 1984 can provide relief. This section states that there will be no transfer of value in cases where there was no intention by the transferor to confer a gratuitous benefit, i.e. when the contribution was paid.

However, the situation changes if, when the contribution was paid, the member knew they were in serious ill health. In such cases, the protection of s.10 IHTA 1984 – "no intention to confer a gratuitous benefit" – would not be available and so a measurable transfer of value could arise under s.3(1) IHTA 1984. In these circumstances, HMRC adopts a "two-year test".

This means that, in general, it will only consider such cases as possibly giving rise to a transfer of value if the member dies within two years of making the contribution. In other words, if the member survives for two years, HMRC will assume (unless there is clear evidence to the contrary) that the member was in normal health at the time of the contribution so there is no transfer of value.

To capture this information, Box 22 of IHT 409 (the pension supplement to the IHT account on death) requests details of contributions paid in the two years before death.

This is obviously more likely to be relevant in cases of larger contributions, as any transfer of value arising on smaller contributions may well be covered by the IHT annual exemption, etc.

Example 1
Grant, aged 61, knowing he is in serious ill health, decides to pay a substantial contribution of £25,000 to his personal pension plan which is subject to a master trust and personal discretionary trust. He dies four months later.

Because Grant was in serious ill health when he made the contribution a transfer of value will take place. Grant will not be helped by the s.10 exemption ("no intention to confer a gratuitous benefit") as he knew he was in serious ill health when he paid the contribution. A part of this contribution will therefore give rise to a loss to his estate that can be actuarially determined. This will be a chargeable lifetime transfer.

Example 2
Frances, aged 57, who believes she is in excellent health, pays a contribution of £40,000 to a personal pension plan effected subject to trust. Two and a half years later and out of the blue she has a heart attack and dies. Even if she was actually in poor health when she made the contribution, the s.10 exemption should apply because, at the time she made the contribution, she had no reason to believe that she was likely to die before drawing retirement benefits.

In any event, as she survived the contribution by two years, HMRC are unlikely to investigate the case and no entry is needed on form IHT 409.

Example 3
Rob is aged 68. He pays a contribution of £40,000 to his personal pension plan under which death benefits are held subject to a discretionary trust. At the time of the contribution he has lung cancer but doesn't realise this until some four months later. He dies 15 months after making the contribution. The payment of the contribution could give rise to a chargeable lifetime transfer.

Because Rob died within two years of the contribution it is reportable on form IHT 409. However, because he was unaware of his illness when he made the contribution, his personal representative may be able to claim that any transfer was covered by the s.10 exemption ("no intention to confer a gratuitous benefit").

Even if an individual does die within two years of making a contribution, knowing they are in serious ill health at the time of the contribution, the question arises as to whether s.12 IHTA 1984 would help them.

Section 12 provides that a disposition is not a transfer of value if it is allowable in computing the transferor's profits or gains for the purposes of income tax. Payments of contributions to a registered pension scheme may be allowable for

income tax purposes, but the allowance is in the form of a deduction or set off against the "relevant UK earnings" of the person making the contribution.

HMRC takes the view that relief under s.12 is therefore not available in this scenario – the payment of the contribution is not allowable in computing the contributor's profits for income tax purposes. Rather the contribution is, or may be, a deduction from "relevant UK earnings" and these are calculated after computing the person's profits for income tax purposes.

Lifetime transfers of death benefits

Where a member of a pension scheme transfers their death benefits to a trust, they may be considered to have made a transfer of value under IHTA 1984, s.3(1).

In most cases, any transfer of value will have a nominal value because the member will be in good health and it is likely that they will survive to draw their retirement benefits, at which time the death benefits will lapse.

In this respect (and assuming there is no evidence to the contrary), provided the member survived the transfer by two years, HMRC will assume that the member was in normal health at the time of the transfer and no further investigation will be necessary. On the other hand, if a member makes such a transfer and does die within two years, Box 17 in IHT 409 will need to be completed.

This provision could apply to a situation where an individual places a retirement annuity policy in trust or (depending on the circumstances) declares a personal trust of the death benefits of a personal pension plan. In both of these cases, if the member is in ill health, careful thought should be given before declaring the trust.

For example, if the rules of a personal pension plan permit a member to declare a trust of the actual death benefits under their plan (so that any death benefits must be paid to those personal trustees), extreme caution should be exercised if the member knows that they are then in serious ill health.

In such circumstances, if possible, it may be better to establish a pilot trust to which the Scheme Administrators may exercise their discretion to make an appointment of lump sum death benefits. This would not give rise to the "two-year ill-health" consequences.

Pension transfers

From time to time a number of people will consider the transfer of their pension rights from one pension scheme to another – perhaps with a view to increasing investment choice, improving investment performance and / or reducing administration costs. The recent advent of the pension freedoms, in particular, has encouraged many people to transfer final salary scheme pensions to money purchase pension schemes.

However, a note of caution needs to be sounded on making a pension transfer from an IHT standpoint.

Where the pension scheme member knows they are in serious ill health, the transfer may give rise to IHT problems. This may mean that, by making the transfer, the member goes from a position of freedom from IHT (on current pension funds) to one of liability to IHT (on new pension funds).

The reason for this somewhat startling consequence is because HMRC takes the view that, when a person makes a transfer they, in effect, surrender the rights under the existing pension plan and so brings to an end any existing trusts that apply to those death benefits. Because the member can then control which new pension provider the funds are transferred to, they can, by implication, determine what new trusts the death benefits are subject to.

Those trusts could be trusts under which the member's personal representatives are beneficiaries and under which the member can appoint benefits. By exercising their right to transfer, the individual is therefore bringing the death benefits under the first scheme back into their taxable estate.

In turn, this means that unless the member directs that death benefits under the new plan are to be paid to their own estate, there will be a transfer of value for IHT purposes when the transfer of pension rights occurs. The reality of the situation is that the new pension plan will include trusts of the death benefits which will exclude the member as a beneficiary and so, according to the HMRC rationale, a transfer of value will occur under s.3(1) IHTA 1984.

In practice, however, HMRC will only treat this as a transfer of value which has more than a nominal value if the member is in serious ill health when making the transfer. As with the position on contributions, it seems that HMRC will, in general, assume that the member was in good health at the time of the transfer unless they die within two years of the transfer, in which circumstances HMRC will require boxes 17 to 21 of the IHT 409 death return to be completed.

Even if the member did die within two years and a return is made under IHT 409, if the member did not know they were suffering from a life-threatening illness when they made the transfer, there is an argument to say that the s.10 exemption (no intention to confer a gratuitous benefit) should apply.

As will be appreciated, the transfer of pension benefits for people in this position could have serious IHT consequences. The moral therefore is very clear – if an individual is in serious ill health and is concerned about IHT, a transfer of pension rights to a new plan should only be undertaken with extreme caution.

Note that the case of Mrs Staveley deceased in relation to a transfer of value has been through the Courts and was found not to give rise to an IHT liability. However, this judgement should be treated with caution as there were very specific circumstances which gave rise to the outcome. There has been no further cases or guidance issued by HMRC in this regard since the August 2020 Supreme Court ruling.

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