Pension transfers by those in ill health and inheritance tax calculations

Synopsis: Pension transfers and ill health. Quantifying the transfer of value for IHT purposes for those who die within two years of the transfer. How life expectancy at the date of transfer considerably affects the calculation of the loss to the estate.

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Where a person knowing they are in serious ill health, makes a pension transfer and dies within two years, this may result in HMRC taking the view that the individual made a lifetime chargeable transfer for inheritance tax (IHT) purposes when they made the transfer. This will involve quantifying the value of the rights in the pension plan that are given away. To undertake this, it is necessary to value the rights of the death benefits at the date of transfer and deduct the value of any pension rights that are retained by the pension scheme member.

This is a guide to how the transfer value may be calculated. However, the actual value will need to be negotiated between HMRC and the personal representatives of the estate. In this respect, the position on valuing the rights that the individual was entitled to can differ according to the age at which the individual dies and the options then available under the pension plan they belonged to.

(i) Death at age 55 or more and where the deceased is a member of a scheme offering flexible benefits

Where the individual making the transfer is aged 55 or more, and the transfer is to a defined contribution pension plan that permits flexi access drawdown, HMRC have confirmed that, in calculating the value of any retained rights to the member, it is possible to deduct the tax-free cash entitlement and the residual pension fund net of income tax.

However, if the value of the non-PCLS (Pension Commencement Lump Sum) part of a pension fund taken as a guaranteed ten-year annuity generated a higher value than the value of the residual fund net of income tax, then the guaranteed annuity valuation would effectively be the market value of the non-PCLS part of the retained rights.

Which of the two values would be higher in any particular case will, of course, depend on the facts and the annuity capable of being generated by the residual fund. It is certainly open to the personal representatives to put forward the guaranteed annuity valuation approach if they believe that value was greater than the retained rights net of income tax.

Example – Oliver

- Oliver is aged 61.
- He has a pension transfer CETV (Cash Equivalent Transfer Value) of £1 million.

- He has cancer with life expectancy of one year.
- He transfers to a plan offering flexi-access retirement and death benefits.
- He dies eight months later.
- Oliver has other taxable income in the year he dies of £100,000.

Value of pension rights before transfer				
Fund value			£1,000,000	
Take account of assumed investment growth of 5% p.a. and discount of 15%* (1.05/1.15)				
over one year life expectancy				**£913,043**
Value of pension rights after transfer				
PCLS			£250,000	
Fund after PCLS		£750,000		
Less: tax on remaining fund		£336,243**		
			£413,757	
Total value of remaining fund =				**£663,757**
Transfer of value = Value before less value after transfer				**£249,286**

*15% discount reflects the return on the investment required by a notional purchaser and the uncertainty of the sum that is expected to be paid and the date of payment.

**£25,140 @ 40% plus £724,860 @ 45%.

In Oliver's case the value of £413,757 is higher than the present value of a ten-year guaranteed annuity.

So, Oliver would be treated as making a transfer of value of £249,286 for IHT proposes when he made the pension transfer. This would probably fall within his nil rate band when he made the transfer and so not give rise to any lifetime IHT. But it would use £249,286 (or £243,286 after two annual exemptions) of his nil rate band as he died within seven years of the transfer.

If he was married or in a civil partnership it would mean that this would impact the percentage of the transferable nil rate band that would pass to his widow/civil partner.

The deemed transfer of value would reduce if it could be shown that Oliver’s life expectancy at the date of transfer was five years although he in fact died within two years of the transfer.

Consider the following example…

Value of pension rights before transfer				
Fund value			£1,000,000	
Take account of assumed investment growth of 5% p.a. and discount of 15%* (1.05/1.15)				
over five year life expectancy				**£634,537**
Value of pension rights after transfer				
PCLS			£250,000	
Fund after PCLS		£750,000		
Less: tax on remaining fund		£336,243**		
			£413,757	
Total value of remaining fund =				**£663,757**
Transfer of value = Value before less value after transfer				**(£29,220)**

*15% discount reflects the return on the investment required by a notional purchaser and the uncertainty of the sum that is expected to be paid and the date of payment.

**£25,140 @ 40% plus £724,860 @ 45%.

This produces a negative transfer of value. This is due to the fact that the individual’s life expectancy was five years. In practice, we understand that HMRC will treat this as a nil transfer of value.

In such circumstances, none of Oliver’s nil rate band is used before his death and so, if his spouse/civil partner survives him, a 100% transferable nil rate band is available.

(ii) Death under age 55

Where someone under 55 makes a transfer, so that they would not have been able to take a PCLS and withdraw the remainder of the fund, the question would be what options were open to them to access their pension at that time? If they could have converted their whole pension into a 10-year guaranteed annuity, then a valuation of their retained rights on that basis would be reasonable.

However, if they were unable to access any of their pension fund until they reached age 55, then the market value of those retained rights would have to reflect that fact. The valuation of the retained rights would have to allow for the delay until the funds could be accessed and the likelihood of the individual surviving until age 55.

In valuing those rights, it is important to note that it is not the life expectancy that is relevant, but the insurability of the member. These are rights which only have value if the member survives to age 55 so, much like the valuation issues with discounted gift schemes, the open market purchaser is at risk of getting nothing if the member dies before the age when benefits can be taken, i.e. 55. Those rights therefore only have any substantive value if the member's life is insurable at the transfer date.

Given that HMRC would only look to pursue a claim in cases where the member was in ill-health when the transfer took place, it is highly unlikely that the member's life would be insurable when the transfer occurred, so the open market value of the retained lifetime rights is likely to be nominal at best.

The fact that the rights are non-assignable in the real world does not affect the position. The open market purchaser hypothesis is required by section 160 IHTA and various legal decisions by the courts have confirmed that the fact that property cannot, in fact, be sold does not prevent the assumption of a sale for valuation purposes.

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