

This note is dangerously simplified and is not advice in any circumstances.

Abbreviations: Inheritance Tax Act 1984 (ITA 1984); Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003); and Finance Act 2004 (FA 2004).

general rule

There is no general IHT exemption for pension schemes but a number of significant ones, which means that, in most "normal" cases, no IHT is payable on the death of a member of a registered pension scheme. Age 75 however is a tax watershed.

basics of IHT

A "chargeable transfer" is a transfer of value, which is made by an individual but is not an exempt transfer: ITA 1984 s2. Amongst the exempt transfers in part II of the ITA 1984 are transfers between spouses and civil partners (s18), annual exemption of £3,000 for all gifts (s19), small gifts not over £250 a year to any one person (s20), normal expenditure out of income (s21) and gifts to registered charities and sports clubs (s23). If the transfer is made on or within seven years before the death, the rates of IHT are nil of the value of the estate up to £325,000 (the threshold) and 40% from that amount (s7 and sch 1). The 40% rate is reduced progressively if the transfer was made more than three years before the date of death: to 80% of the rate in the fourth year, 60% in the fifth, 40% in the sixth and 20% in the seventh. The rate is reduced to 36% if at least 10% of the net estate is left to charity (sch 1A para 2(5)(6)), and the nil rate band threshold is increased by a "residential enhancement" of £175,000 to £500,000 if the deceased leaves his or her home to descendants etc and the estate is less than £2,000,000 (s8D et seq).

IHT and pensions

Amongst the specific reliefs from IHT in respect of pension schemes are that contributions by members are not transfers of value (ITA 1984, s10), contributions by employers are not chargeable transfers (ib, s12), property held for the purposes of a registered pension scheme is not relevant property, so it will not be subject to the tax payable every ten years on a discretionary trust or on distribution of capital, such as the payment or lump sums on retirement (ib, s58(1)(d)), and property applied to pay a lump sum on the death of a member is not relevant property if it is paid within two years from the day on which the death was first known by the trustees or ought reasonably to have been known by them (ib, s58(2A), and see also see FA 2004 s206(1B)(c)).

IHT does apply, on the other hand, if a member has a "general power" to dispose of property as he thinks fit, which includes power to direct pension scheme trustees how to dispose of it, when he is treated as beneficially entitled to it (ITA 1984, s5(2) and s151(4)). In its manual, IHTM17052, HMRC clarified its view about the treatment of the exercise of options on the death of a member and writes: "A member may make a binding nomination in connection with who should receive any flexi-access

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drawdown fund, but if the scheme provider can chose which type of death benefit to pay and the member cannot also make a binding nomination of any lump sum death benefit, the death benefits will not treated as part of the member's estate on death."

Contributions paid within two years of the member's death while he was in ill-health and unlikely to survive to take some or all of his benefits, and so increasing the death benefits payable outside his estate, would be treated as transfers of value and subject to IHT (IHTM17043 and17072).

age 75

Four main consequences of attaining age 75 are that (1) no tax relief is available on contribution to the scheme (FA 2004, s188), (2) the pension fund is tested against the lifetime allowance (FA 2004, s216), (3) the payment of a serious ill-health lump sum becomes liable to income tax (ITEPA 2003, s636A), and (4) either (i) a special lump sum death benefit charge of 45% on the payment of death benefits to a non-qualifying person (not an individual or if an individual is a trustee etc, FA 2004 s206) or (ii) income tax if paid to a qualifying person (ITEPA 2003, s636A(4ZA) and s636AA).

spousal bypass

Most pension schemes provide for lump sum death benefits to be held in discretionary trusts, so they do not form part of the member's estate for IHT purposes. In pension as in family discretionary trust practice, it is common for the settlor to sign a letter of other expression of wishes, to which the trustees may have regard in the exercise of their discretions. In pensions these are usually a simple form, in which the member nominates one or more beneficiaries, but often nominates only his or her spouse. Thus the spouse often receives the lump sum, which would have been exempt in any event, but now has an increased estate on which IHT will be levied on his or her death.

A spousal bypass trust puts the lump sum into a discretionary trust, of which the pension scheme member's spouse is a member of the discretionary class. The trust may also give the trustees power to lend money to the spouse, so there would be two ways of passing money to him or her, but the attraction of a loan, instead of a discretionary appointment of income or capital, is that it should be a debt on the surviving spouse's estate.

There are some disadvantages. The trust is liable to a tax charge of up to 6% on each ten-year anniversary (ITA 1894 s64) or on exit (ib, s65). The trustees are non-qualifying persons, so liable to the 45% special lump sum death benefit charge mentioned above if the member dies having reached age 75. The trust fund does not have the exemptions from tax and capital gain enjoyed by a registered pension scheme under FA 2004 s186 and s187.

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