ADVISER FACTSHEET

JAMES HAY PARTNERSHIP

Tech Talk

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Pension IHT pitfalls when dealing with members in ill health

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For professional advisers only

Income Tax

With the outcome of the case of *Revenue and Customs Comrs v Parry and others (personal representatives of Staveley, dec'd) (2017) UKUT 0004 (TCC)*, it is a good time to consider the inheritance tax (IHT) pension pitfalls that can arise when dealing with members who are in ill health. In most circumstances on a member's death, pension benefits should pass to beneficiaries free of any IHT. However, there are three circumstances where action taken by the member, whilst in ill health, can generate a charge to IHT. These are;

- payments of contributions,
- transfer of death benefits, and
- transfer of pension scheme rights to a different pension scheme.

Before looking at each of these circumstances in detail it is important to consider when HMRC regard an individual as having been in ill health. Generally it is where the member was aware they were in ill health at the time of making the payment or transfer and they subsequently died within two years of doing so. The outcome of this is payments and transfers made will be treated as transfers of value under IHTA 1984 s3(1). The supplementary form IHT 409 covering pensions specifically covers such actions and is required to be completed in addition to the form IHT400 – Inheritance Tax Account.

Payments of contributions

The main aim of a pension contribution is to provide an income in retirement. As there is no intention by the member to confer any gratuitous benefit to a third party the exemption contained in IHTA 1984 s10 means that it will not be considered a transfer of value under IHTA 1984 s3(1). In addition, though death benefits are normally subject to a discretionary trust as the actuarial likelihood of a member in normal health dying before retirement is low, the transfer of value as a result of the contributions made are regarded as of little or no value.

However, where HMRC deem the member to be in ill health at the time the contributions are made, and the member dies within two years, the relief provided by s10 is lost. HMRC in such circumstances is therefore likely to treat any large or unusual contributions made within two years of the member's death as chargeable transfers and the value of the loss to the member's estate will be actuarially determined.

A terminally ill person may be tempted to try and make additional contributions to their pension in the belief that they will be able to pass wealth on to their beneficiaries in an IHT effective manner. The stance taken by HMRC ensures that this will not be the case.

Transfer of death benefits

When a member transfers the rights to death benefits in respect of their pension fund to a by-pass trust it is a transfer of value for IHT purposes under IHTA 1984 s3(1). That said, providing the member is in good health at the time, the actual rights to the death benefits are deemed to be of negligible value as it is assumed the member will live to take their pension fund. However, if the individual is in ill health at the time of transfer and dies within two years of the transfer then the death benefits will be deemed to have significant value. The transfer will be treated as a chargeable transfer and the loss to the member's estate will be actuarially calculated.

With the introduction of pension freedoms in 2015 and the changes in the taxation of death benefits, the demand for by-pass trusts has reduced significantly as they are no longer tax effective. However, they do still allow control over who receives benefits and when. For this reason, a by-pass trust may still be desirable. Where an individual who is considered as being in ill health wants a by-pass trust, they can still proceed providing they opt for a pilot trust, set up with a minimal amount and reliant on a non binding nomination asking the pension scheme trustees/administrators to consider paying the death benefits to the trust.

Transfer of pension scheme rights to a different pension scheme

HMRC has long taken the view that when a member transfers from one pension scheme to another the member surrenders their right under the existing scheme in return for rights in the new one. The member therefore brings to an end any existing trust that applied to the death benefits of the original pension scheme. As the member can control which new pension provider they use they can therefore determine what new trusts the death benefits are subject to. In theory, the member could, under the new pension arrangement, direct the death benefits to their own estate. In all likelihood, however, the new arrangement will exclude the member's estate as a beneficiary and as such there is a potential loss to the member's estate. So HMRC would treat the transfer of the pension rights as a transfer of value under IHTA 1984 s3(1).

As covered earlier, if the member is in poor health and dies within two years of the transfer, the rights to the death benefits have significant value and will be treated as a chargeable transfer to IHT. This can appear to be particularly harsh when transfers have been made for reasons such as to obtain access to pension freedoms or a more competitively priced product. It is not uncommon for a member when diagnosed with a terminal illness to wish to bring various pensions together to make matters easier to administer on their death. The idea that what appears to be a benign action could generate an IHT charge seems unjust when no IHT benefit was created.

The good news is that HMRC have now been challenged on this very point.

Mrs Staveley was divorced in 2000. The split between her and her husband had been acrimonious. She transferred her pension from an Executive Pension Plan that had been established by her husband's company to a section 32 plan. As the scheme had been overfunded under the terms of the s32 plan on Mrs Staveley's death, any overfunded benefits could be returned to her husband's company. Mrs Staveley wished to ensure that this could not happen.

To this end she transferred from the section 32 plan to a personal pension in November 2006 but she was suffering from cancer at the time. Unfortunately she died in December 2006. HMRC claimed IHT on the basis that there had been a transfer of value under IHTA 1984 s3(1) and in addition that she omitted to exercise a right, as in not taking any retirement benefits, so protecting the value of her pension fund.

Since 6 April 2011 the omission to exercise a right provision has not been applicable to registered pension schemes. Though the Upper Tier Tax Tribunal came out in favour of Mrs Staveley's executors in this regard there is little point covering the matter since such a challenge can no longer arise.

As regards HMRC's claim that there had been a transfer of value, Mrs Staveley's executors argued that no transfer of value arose under section 3(1) as the exemption under s10 would apply as there was no intention to confer a gratuitous benefit. Mrs Staveley's only aim was to ensure that her husband

could not benefit from her pension. The First Tier Tribunal had agreed with her executors and said in their judgement:

"If HMRC was right, a transfer from one PPP to another PPP for commercial reasons (perhaps to get a better rate of return) without any change in beneficiaries, would be caught. We do not think that this was intended by Parliament."

HMRC appealed against this decision but the Upper Tier Tax Tribunal agreed with the earlier ruling of the First Tier Tribunal and said:

"In our judgement, therefore the First Tier Tribunal was entitled on the evidence to find, as it did that the disposition by transfer of funds from the s32 policy to the AXA PPP was not intended to confer a gratuitous benefit on any person. The First Tier Tribunal did not, contrary to HMRC's submission, shut its eyes to the desired destination of the death benefits; to the contrary, it clearly took that factor into account."

Conclusion

When advising anyone who is in ill health, advisers have to be aware of the IHT risks in relation to payment of contributions, transfer of death benefits and transfer of pension scheme rights to a different pension scheme. The outcome of the Late Mrs Staveley's case is that we have some reprieve in relation to pension scheme transfers providing the transfer is for reasons such as to gain access to a wider fund range, obtain lower charges or be able to access pension freedoms and most importantly, the transfer was not associated to IHT planning.

For many observers this result is overdue. Countless individuals over the years have been unfairly penalised where they have transferred pension arrangements based on the fact they were knowingly in ill health at the time and died within two years, though IHT planning was not the driving force behind the transfer.

HMRC will provide further guidance in due course.

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