INTERGENERATIONAL PENSION PLANNING

A summary of the tax benefits of personal pensions and their potential use as an estate planning vehicle.

THOMAS COUGHLAN

Tom has spent over 15 years in technical roles. He has wide experience including the provision of technical support to financial advisers covering life, pensions and investment compliance. He currently specialises in pension planning.

The Freedom & Choice reforms, as well as making money purchase pensions more accessible, significantly improved the tax position and death benefit options. For those that can make use of it, this combination of changes transformed personal pensions that offer beneficiary flexi-access drawdown into a simple and effective inheritance tax (IHT) planning vehicle.

Traditional IHT planning is usually centred on investment bonds, life policies, trust deeds, gifts between parties and often requires the involvement of solicitors. When it comes to tax planning, however, there is rarely a single solution to the problem of how to legitimately reduce your tax bill. Irrespective of how deeply ingrained a particular approach is, or for how long it has been the traditional practice, all that matters is how – whilst staying on the right side of the rules – a tax bill can be minimised. And often, the simplest approach for a particular individual will be the most appealing. So, is a personal pension a viable alternative to the formal world of traditional IHT planning?

The answer for most will be no; the primary purpose of a pension is to save for retirement and, in many cases, the fund will only be sufficient (or may eventually prove insufficient) to provide adequately for the member's own needs. However, those who already have sufficient retirement provision and have spare income or capital might want to consider whether a personal pension can help them reduce their IHT bill.

IMPORTANT NOTE

Please note there are three main occasions when pension activity can result in an IHT charge. In outline they are:

CONTRIBUTIONS	TRANSFERS	IRREVOCABLE TRUST FOR DEATH BENEFITS

...whilst the member is in serious ill-health. As these only apply when a member is aware of a terminal illness, they are not considered further in this article. For more details see our recent TechTalk article on this subject.

For those who can afford to use a personal pension for IHT planning, it stacks up quite nicely against a more traditional solution. Here's why:

Firstly, contributions to pensions can be paid without IHT consequences, provided the member is not in serious ill health at the time. This takes funds outside of the member's IHT estate without any transfer of value. They must have earnings to justify personal contributions and available annual and lifetime allowances to avoid the tax charges associated with exceeding those allowances. Up to £40,000 can be removed from the estate each year using this approach although this will be lower for those who are restricted by the tapered annual allowance and/or money purchase annual allowance. Contributions already being paid to other schemes for actual retirement provision perhaps, including any paid by an employer and accrual within a defined benefits scheme, will also reduce the maximum that can be paid each year.

Secondly, there is no IHT charged on the investment growth that funds benefit from once they been paid to a pension scheme. Even though the funds are often held within a trust or equivalent structure there are no ongoing IHT charges and nor does the fund form part of any beneficiary's estate. A personal trust/bond solution would either include the trust fund in the beneficiary's estate (e.g. a bare trust) or raise periodic IHT charges (e.g. a discretionary trust) though these are often nil or very low amounts.

Thirdly, the distribution of funds to a beneficiary does not trigger an IHT charge. As a potential IHT planning vehicle, personal pensions would fall down if the distribution of funds to the beneficiary triggered a significant IHT charge. But the payment of a lump sum death benefit to a beneficiary within the pensions lifetime allowance should have no IHT consequences, other than the lump sum is then included within their IHT estate.

Even this drawback can be avoided by the beneficiary utilising drawdown rather than receiving a lump sum death benefit. This option gives complete control over when funds are received and exactly how much is taken over the course of the tax year, allowing only necessary amounts to be withdrawn and the undrawn capital remaining outside their estate in an IHT-efficient environment.

And finally, there is no IHT charge when funds are moved into beneficiary drawdown and no lifetime allowance charge if the member's available lifetime allowance was not exceeded.

INCOME TAX

Outside of the potential lifetime allowance charge, the only tax charge to consider is an income tax charge on withdrawals from beneficiary drawdown or a lump sum death benefit. This also changed on 6th April 2015. If the member (or previous beneficiary) died before reaching age 75, death benefits are paid tax-free provided that they are paid out of drawdown established within two years of death. For deaths on or after age 75 the beneficiary's marginal rate of income tax applies. Once again though, that the amount and timing of payments from drawdown is at the beneficiary's discretion gives plenty of scope for tax planning around the personal allowance and basic rate tax band helping to keep the tax bill to a minimum.

Contributions to pensions can be paid without IHT consequences, provided the member is not in serious ill health at the time.

NOMINATIONS & SUCCESSION

Another key benefit for personal pensions is that funds can be retained within the pension environment indefinitely and passed down through the generations by utilising beneficiary drawdown. This was not possible before 6th April 2015 as drawdown for death benefits could only be established for dependants. This generally meant only a spouse, minor child or some other 'financial dependant' could receive drawdown and so there wasn't much scope for drawdown to continue for a long period of time: at some point the funds would have been paid out in the form of a lump sum as there were no dependants remaining.

This changed on 6th April 2015 when the Freedom & Choice reforms came in, so beneficiary drawdown can now be set up for anyone who was either dependant or was nominated as a beneficiary. A further change was the introduction of the new concept of a 'successor', who could be nominated by the current beneficiary to receive drawdown after their death. This meant that the death benefits could be passed from one beneficiary on to another – still within beneficiary drawdown – and remain outside of their estates but accessible at any time without IHT consequences.

The income tax treatment of beneficiaries is as explained above. A successor is treated in the same way as any other beneficiary, but the tax they pay is determined by whether the previous beneficiary died below age 75 or not.

To enable full use of these rules, it's important that clients keep their nomination forms up to date. This is because of some remaining rules that restrict who can receive beneficiary drawdown.

There is no IHT charged on the investment growth that funds benefit from once they been paid to a pension scheme.

Where the member has made a nomination and has dependants, the scheme can set up beneficiary drawdown for anyone in either of those categories. However, if there are no nominated beneficiaries, but there are dependants, the scheme can only set up drawdown for a dependant. The reverse also applies, so that if there is a nominated beneficiary but no dependants, the scheme can only set up beneficiary drawdown for a nominated beneficiary. And to conclude this unnecessarily complicated set of rules, if there are no nominated beneficiaries and no dependants, the scheme can nominate any individual to receive drawdown.

These restrictions do not apply to lump sum payments, so the trustees have discretionary powers to pay these to anyone.

For these reasons it is important to keep nominations up to date, amend them when significant lifestyle changes occur and regularly review them at key points, such as when age 75 is reached. At this point, the change in the taxation of death benefits may mean an alternative beneficiary is more appropriate.

EXAMPLE

Liz dies aged 68 with £500,000 remaining in her pension fund and has nominated her husband Brian to receive 100% of her benefits.

Brian asks to receive this as beneficiary drawdown. He can receive tax-free withdrawals from the fund for the rest of his life taking as much or as little as he needs each year.

When Brian dies any remaining funds can be passed on to a beneficiary he has nominated. If he were to die over the age of 75 subsequent death benefits would be taxable in the beneficiaries' hands. Brian may choose to nominate his children to receive funds. However, if they are already wealthy in their own right he may skip a generation and pass the funds down to his grandchildren who may pay income tax at a lower rate.

If Brian had sufficient retirement income of his own, Liz could have instead nominated her children or grandchildren to receive all or part of the funds. They could then have received the funds free of tax for the rest of their lives. By using beneficiary drawdown the funds remain outside of anyone's estate and invested within the tax-efficient pension environment throughout.

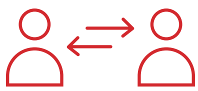
PROS AND CONS

The drawbacks of a personal pension being used in this way have to be considered. In addition to those already mentioned, the amount that can be paid in each year is limited by the annual allowance – as low as £4,000 if the tapered annual allowance or money purchase annual allowance applies. This prevents large sums being accumulated at once, but those who have the full annual allowance available could potentially contribute £40,000 each year, which would accumulate into a significant sum quite quickly. Another drawback relates to an investment shortfall: should the existing retirement funds take a hit – perhaps because of a pension debit following divorce or poor fund performance – then any additional funds earmarked for IHT planning might have to be used to make up the shortfall. Finally, the non-binding nomination approach, which leaves the final decision over the recipient of death benefits to the scheme trustees, may not sit well with everyone.

The pros for money purchase pensions are simplicity, flexibility, low costs and the significant tax benefits covered above.

USE OF TRUSTS

Passing funds on via the pension fund will often offer the simplest and most tax-efficient option. However, the cost of this is a lack of control and this may not be a suitable option particularly where family situations are more complex.



Where clients would like more control over how and when their chosen beneficiaries receive benefits a trust such as a bypass trust can be used. To be IHT-efficient this will still rely on the scheme making the initial payment at their discretion but once the funds are in trust the trustees have full control. The price paid for this is that funds move from a tax-efficient environment to one taxed under the discretionary trust regime. In addition, if the member dies over age 75, 45% income tax is deducted when the death benefits are paid into the trust. This can act as a significant drag on the fund performance over the long term. It also adds potential IHT periodic and exit charges as well as the administrative complexities of having to deal with a trust. In addition, to achieve the required control in complex situations, this may need to involve bespoke trusts and the appointment of professional trustees which will further increase the costs.