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Pensions death and IHT planning

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Learning Objectives

- To understand the Budget changes that impact pensions
- To understand the proposed pension and IHT changes
- To understand the considerations when advising clients on decumulation with pensions

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1

The basics

Overview

- From 6 April 2027 most pension funds will fall into the estate for inheritance tax (IHT) purposes.
- The scheme will have to pay the proportional share of the IHT charge, if applicable
- Scheme pensions, ongoing annuity income and funds paid as charity lump sum death benefits will be exempt.
- The new rules will apply to all overseas pension schemes as well as UK.
- The spousal exemption will still apply in the normal way and so any funds that pass to a spouse or civil partner will remain free of IHT on first death.
- RNRB could be impacted.

The consultation

- A Technical consultation on how this is implemented
- Not, if it should be implemented
- Mainly with regards to the interaction of pension schemes and personal representatives as well as the timing of charges.
- Closed on 22nd Jan, most recent update is that they aren’t ready to respond.

Some unknowns

- If there will be any look through with regards to underlying assets
- It is a little unclear with regards to the changes to death in service
- What happens with regards to illiquid assets such as property or frozen funds
- What happens if you can't value an asset, such as failed direct investments, unlisted shares etc etc.

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2

How does it work?

Example – Take out the TFC?

- Joe, a widower aged 75, has an estate of £2m and a SIPP worth £800,000.
- His estate will benefit from the transfer of his late wife's nil rate band (NRB) as well as his own.
- The beneficiaries of his SIPP are likely to pay at least 40% tax (probably nearer 45%, especially if the PCLS is not taken) on any lump sum they receive.

	Take the PCLS	**Leave SIPP untouched**
Estate	£2,200,000	£2,000,000
Pension fund	£600,000	£800,000
NRBs allocated to estate	£510,714	£464,286
IHT on estate	-£675,714	-£614,286
NRBs allocated to pension	£139,286	£185,714
IHT on pension	-£184,286	-£245,714
Income tax on pension 40%	-£166,286	-£221,714
Net of tax inheritance	**£1,773,714**	**£1,718,286**
PCLS advantage	**£55,428**	

Example – Pension or ISA?

- Joan has an estate of £1 million which includes £100,000 in an ISA from which she draws the underlying net investment return of 5% a year (£5,000) as tax free income.
- She also has a Pension which produces the same return from the same underlying investments.
- As Joan is a marginal **higher** rate taxpayer, she could choose to allocate £166,667 of her Pension to drawdown, draw out 5% of that sum (£8,333) a year, pay the £3,333 income tax due and again have £5,000 a year income.
- Beneficiaries are **basic** rate taxpayers.

If she dies after 10 years (aged over 75) with a single NRB

	Use ISA	**Use pension**
Estate ex ISA	£900,000	£900,000
ISA	£100,000	£162,889
Pension fund	<u>£271,483</u>	<u>£166,667</u>
Total	**£1,271,482**	**1,229,556**
NRB allocated to estate	£255,607	£280,946
NRB allocated to pension	£69,393	£44,054
IHT on estate	-£297,757	-£312,777
IHT on pension	<u>-£80,836</u>	<u>-£49,045</u>
Total IHT	<u>-£378,593</u>	<u>-£361,822</u>
Income tax on pension **20%**	<u>-£38,129</u>	<u>-£23,524</u>
Net of tax inheritance	**<u>£854,760</u>**	**<u>£844,209</u>**

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IHT on estate	-£297,757	-£312,777
IHT on pension	-£80,836	-£49,045
Total IHT	-£378,593	-£361,822
Income tax on pension **40%**	-£76,259	-£47,049
Net of tax inheritance	**£816,631**	**£820,685**

Pensions Example: Paid to Bypass Trust pre-75

Bob has an estate of £500,000 and a pension of £300,000. He isn't married and wants his pension paid to a Bypass Trust and the rest of the estate to his nephews.

- He has a full Nil Rate Band available.

- The IHT charge is calculated on the £800,000
  - £325,000 is within the NRD
  - The IHT charge is therefore £190,000

- The pension will have to pay a proportional amount of the charge
  - (£190,000/800,000)x300,000 = £71,250

*Therefore **£228,750** would be paid to the trust because there is no additional charge.*

The levels and bases of taxation, and reliefs from taxation, can change at any time. The value of any tax relief depends on individual circumstances.

Pensions Example: Paid to Bypass Trust post 75

Leading on from the previous example, but Bob is now over 75

- The IHT calculation remains the same, but the residual funds are subject to a 45% tax charge before payment to the Trust
- The charge is £102,937.50
- The trust will receive a payment of £125,812.50
- There will be a tax credit available of £102,937.50 when income is paid to the beneficiaries.

The levels and bases of taxation, and reliefs from taxation, can change at any time. The value of any tax relief depends on individual circumstances.

Pensions Example: Paid to spouse

- If Bob were married to June and the funds were left directly to her, the spousal exemption would apply.

- This means no IHT is payable

- If he dies before age 75 then June would receive the whole £300,000 and could draw it as a lump sum, or income tax free.

- If he dies after age 75 then June would receive the whole £300,000. If she takes it as income, it will be taxed at her marginal rate when drawn. If taken as a lump sum, it will suffer an immediate charge at her marginal rate.

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3

Planning considerations

Taking action, or not?

- If you determine there is a strong reason your client should take action ahead of any legislative changes, for example, if they are concerned about the potential impact of delaying any gift, there are several options you may wish to consider to help mitigate your client's IHT liability.

  - Take their PCLS out of their pension.

  - Use their pension to make gifts out of normal expenditure.

  - Purchase a Whole of Life Policy to create a legacy for your clients' beneficiaries.

Client is 75 or over, Not yet accessed their PCLS

- Discuss whether it is suitable for them to take their PCLS.
  - Come April 2027, this could help avoid the potential double taxation of IHT and Income Tax on any residual funds accessed by their beneficiaries.

- In all circumstances, you should consider and discuss the following with your client:
  - Impact on sustainability of their funds by making withdrawal now.
  - The impact of acting now, given the changes are not coming in until April 2027.
  - You should also discuss whether a gift inter-vivos or term assurance policy would be appropriate.

Using Gifts out of Normal Expenditure

- There are three rules for a gift to qualify as ‘Gift out of Normal Expenditure’.
  - The gifts must be from your income.
  - They must be paid on a regular basis and become part of your ‘normal expenditure’.
  - Making these gifts shouldn’t impact your current standard of living.
- The tax deferred withdrawals from both Investment and International Investment Bonds don’t count towards this exemption but could be used as part of your client’s annual exemption (currently £3,000).
- Increase in income payments to gift need to be factor in sustainability and taxation
- Consider direct gifts or funding a trust.
- Your client should keep a record of any gifts as these can only be claimed retrospectively upon death.

Purchase a WoL to create a legacy

- Until April 2027, clients don’t have an increased IHT liability
  - Determining the potential future liability would be difficult.
  - Therefore, this sort of planning should be considered to create a legacy at this stage

- You should discuss:
  - The legacy your client wishes to leave their beneficiaries.
  - How the premiums will be paid and ensure these are sustainable for your client.
  - The appropriate trust and whether multiple trusts need to be considered.
  - Any legacy planning should not increase your client’s IHT liability.

Learning Outcomes

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Thank you