



Personal Pension Capital – Death and Taxes

BRIEFING

For many of our clients, their pension “pot”, however held, now represents a significant part of their capital base. As such, we would take it very much into account when advising on wills and estate planning.

We are all tending to live longer and the costs of providing for the latter years remain uncertain – this includes fun as well as housing and healthcare! In many cases, of course, pension savings are not going to be the only source of funds in old age and should be seen as part of the overall picture. But as a society it is widely agreed that we are under pensioned – even if we are in a better position than most of our European fellow citizens.

Pensions and Inheritance Tax Mitigation: The Current Official View

The steady erosion of annuity amounts over recent years is well documented. And the now accepted practices described below of income draw-down and, at the age of 75, the ‘alternatively secured pension’ have become standard practice.

Governments generally abhor the thought that the Income Tax reliefs given upfront to provide for a pension might be used (or abused) for purposes of Inheritance Tax (IHT) mitigation.

Pension capital unspent on death may therefore (at worst) attract a total combined income and

inheritance tax charge of 82% (70% plus 40% of 30% = 82%), even where passing outside the individual’s chargeable estate through a trust to chosen members of the family.

Outline of the Current Regime

There are two key features:

- The ‘*annual allowance*’ determines the maximum Income Tax relieved amount which can be contributed each year. In fact, it is the lower of the individual’s ‘relevant UK earnings’ and the annual allowance which can be contributed. If the contributions exceed the annual allowance for any year, a penalty of 40% of the excess is charged.
- The ‘*standard lifetime allowance*’ is the total of pension savings at any one time which can benefit from the tax-relieved regime, subject to transitional provisions which operated at 6 April 2006 (known as A-Day).

The increasing amounts for the first five years of the new regime were and are:



<i>Tax year</i>	<i>Annual Allowance</i>	<i>Standard Lifetime allowance</i>
2006/07	£215,000	£1.5m
2007/08	£225,000	£1.6m
2008/09	£235,000	£1.65m
2009/10	£245,000	£1.75m
2010/11	£255,000	£1.8m

The annual allowance and the standard lifetime allowance are to be frozen for five years following 2010/11 (ie.: up to and including tax year 2015/16).

The details of those transitional provisions is beyond the scope of this Briefing, but, whether under 'primary protection' or 'enhanced protection', a taxpayer could have secured an additional measure of tax efficiency in cases where their pension savings at A-Day exceeded the then standard lifetime allowance of £1.5m. Either of those elements of protection required an election to be made by 6 April 2009.

Income Tax Relief for Contributions

Any pension contribution will be made net of the basic rate tax of 20%. So a cash payment to the pension fund of £8,000 will be treated as a gross contribution of £10,000, with the trustees recovering the £2,000 from the Government. For higher rate taxpayers the incentive to contribute has been even more generous.

Tax relief is given only where the individual is aged under 75. The annual allowance does not apply in the tax year in which the individual takes all the benefits under the scheme. So it is possible in that final year to make a very substantial contribution exceeding the annual allowance, both achieving Income Tax relief (even if only at 20%) and maximising the benefit of the 25% tax-free lump sum, described below, assuming that the total funds did not exceed the then lifetime allowance.

The 2009 Restrictions

For contributions made before 22 April 2009, even in the current tax year, the full 40% Income Tax relief is available. For the future, however, such relief will be severely restricted.

A new top rate of Income Tax of 50% has been proposed from 2010/11 for taxable incomes in excess of £150,000. It is proposed that from 2011/12, 40% tax relief on pension contributions will be available only for those whose taxable income does not exceed £150,000, with tapering relief for incomes between £150,000 and £180,000.

For the balance of tax years 2009/10 and 2010/11, so-called 'anti-forestalling' provisions have been introduced by this year's Finance Act, for 'high-income individuals'. 40% relief will automatically be given on £20,000 of gross contributions.

To get relief on more than that, either (a) it must be shown that the excess is within a pattern of 'normal, regular ongoing pension savings' which



implies a commitment before 22 April 2009 to make contributions quarterly or more frequently and at a rate that does not increase; or (b) alternatively, those whose mean of 'infrequent money contributions' for tax years 2006/07, 2007/08, 2008/09 exceeded £20,000 may contribute that mean, up to a limit of £30,000.

This restriction is particularly harsh, especially on those whose incomes are variable and who are used to making one-off contributions at the end of each tax year.

Permissible Investments

Many individuals now have their own self-administered scheme (SAS) as opposed to holding direct a variety of pension funds with one or more insurance companies. SAS is a collective term for which are principally known as self-invested pension plans (SIPPs) and small self-administered schemes (SSASs). There are technical differences between the two categories, although for all practical purposes they can be treated as the same except that:

- a) A SIPP is a scheme under which a member can direct the investment of the funds. Under a SSAS the investment of the funds remains under the control of the trustees who will be appointed by the employing company.
- b) A SSAS is one with fewer than 20 members, typically members of the same family or perhaps employees of the same close company, while there is no limit on number of members for a SIPP.

- c) A SSAS can lend back to the company on certain terms, which a SIPP cannot do.
- d) In terms of investment, a SIPP can hold as many unquoted shares as it likes, whereas a SSAS has a restriction of 5% on the proportion of shares in a company connected with a member of the scheme. This 5% limit becomes 20% in the case where the SSAS has four or more subsidiaries.

For convenience we refer below to a SIPP (though this will include a SSAS where appropriate).

Investments will typically be made in conventional insurance funds and in self-administered assets such as unquoted shares, commercial property and buildings occupied by and loans to sponsoring employers. There are certain defined 'prohibited assets', being specified residential property and tangible moveable property, e.g. fine wines, classic cars, art, antiques and also any property costing more than £6,000. The prohibition extends to property owned by a company shares in which are held by the scheme, if the individual is a 'controlling director', that is he owns more than 20% of the voting share capital or with his associates more than 50%. If the scheme does hold prohibited assets, punitive tax charges result.

A SIPP or a SSAS can be used to acquire property which is then occupied for the purposes of the business. The question is how the acquisition is financed. Before A-Day a SIPP could borrow up to 75% of the acquisition cost. Now no more than 50% of net assets can be borrowed. That is, a fund of £1 million could



borrow £500,000 and so buy property worth up to £1.5 million. By contrast, before A-Day, property could have been acquired for £4 million (£1 million equity plus £3 million borrowed). This limitation can be overcome by having a share in the property acquired by either the individual or even a third party on appropriate terms.

Retirement benefits

In the past, whether under the retirement annuity/personal pension route or under the occupational pension alternative, an individual would retire at say age 65 and start drawing his or her pension on the basis of an annuity purchase, ideally guaranteed for a period of say 5 years to protect against death within the period. Within the annuity would be built in provision for a surviving spouse or other financial dependant(s).

Then there was introduced under personal pensions the idea of income draw-down, while the individual was below the age of 75, which deferred the time at which an annuity would have to be purchased.

And now, under the current regime, we have an equivalent system, with *unsecured pension income* (USP) before age 75 but also, beyond age 75, with the *alternatively secured pension* (or ASP).

Both USP and ASP offer some response to the classic downside of annuities that in an historical context annuity rates are currently low and effectively eat up the whole of the individual's lifetime pension savings.

Current thinking, encouraged by the legislation, is that the individual takes the risk by having present and future pension income entitlement geared to the performance of the assets in the fund. Capital and levels of income withdrawal can be reviewed regularly. The individual will hope that the underlying assets will perform well, so ensuring a reasonable level of pension going forward. Further, more and more people are indulging in a phased flexible retirement, perhaps putting off the time at which they need to start making serious inroads into the fund, with the benefit of (largely) tax-free growth meanwhile and the fact that the individual will be that much older before he or she starts to draw an income.

a) Options up to age 75 – 25% withdrawal of capital and unsecured pension income

The option to draw 25% of the fund applies between age 50 (rising to 55 in 2010/11) and 75. Tax-free cash can be drawn irrespective of an annuity. However a withdrawal will reduce to that extent the amount available IHT-free in the event of death before age 75. It is possible to draw tax-free cash from part of the fund which allows the other part to remain IHT-free on death. The part on which has been drawn is liable to 35% scheme taxation on death before age 75.

Income drawn before the age of 75 will be unsecured (as USP). The maximum which can be drawn is 120% of present single life annuity rates (fixed by the Government's actuarial department (GAD) tables with reference to the current long term gilt yield) with no prescribed minimum. The higher the age (below 75) at which an individual



starts to draw USP, the higher the maximum allowed by the GAD single life annuity. The income drawn is reviewed every five years.

No income need be drawn (though it can be) under the age of 75.

b) Options at age 75 – Alternatively secured pensions

At age 75 one moves to the secured ASP regime where at least the minimum of 50% of the single life annuity rate for a 75 year old must be drawn, with a maximum of 90%. Because the maximum and minimum amounts are based on age 75, these will not change as the individual gets older and so there remains a danger of the fund running out before death, if the maximum is taken (especially as the measure is single life rather than joint lives); in the industry this is called 'morbidity drag'. The issue of what policy should best be adopted in relation to both the tax-free lump sum and to income drawing is considered below. The income drawn is reviewed every year.

Death benefits

a) Death before retirement - before payment of tax-free cash

The full value of the fund can be paid free of all taxes (income tax and IHT) to the nominated beneficiaries. Alternatively, the trustees can retain the pension fund to pay income to a surviving spouse/civil partner and any children or other financial dependants under the age of 18 (or under

21 and still in full-time education or otherwise dependant on account of a disability).

b) Death during retirement - after drawing tax-free cash but before age 75

Pensions can be paid to a surviving spouse or to financial dependants, in the case of each subject to their own draw-down limits. If the whole or any part of the funded excess of draw-down limits is paid to surviving members of the family, there will be a Scheme Tax charge of 35%.

By defining retirement in terms of the drawing of tax-free cash, the clear difference between options (a) and (b) is the ability to withdraw the whole fund free of IHT. If an individual, knowing that he was in ill-health and unlikely to attain age 75, postpones the drawing of tax-free cash to allow this, the legislation incorporates the old HMRC concession that this is permissible given that the beneficiaries are members of the family.

c) Death after age 75

At this point the ASP will be in place and the surviving spouse's/civil partner's pension and/or dependants' pension must be paid first. Once that income requirement is satisfied, typically on death of the recipient, any capital remaining can be paid IHT-free to charity or transferred to pension funds of members of the scheme, subject however to Income Tax and IHT.

For Income Tax purposes this would be an unauthorised payment with charges totaling 70% plus IHT on the balance, amounting to a maximum



possible tax charge of 82%. This then leads to the question as to what is the best policy to adopt, certainly once age 75 has been attained.

d) ASP funds on death after age 75

Any funds paid as a *'transfer lump sum death benefit'* (ie where the funds remain within the scheme for the benefit of other scheme members) or refunded to an employer or used to provide benefits for someone who is not a spouse, civil partner or person who is financially dependant will be subject to an IHT charge on the death of the original scheme member as if the funds formed part of the scheme member's own taxable estate on death.

Any funds paid to charity on the death of the scheme member will be exempt from IHT, as will funds expended for the scheme member's spouse, civil partner or a person who is financially dependant on the scheme member.

Any left-over funds, once use by the spouse, civil partner or financial dependant (the beneficiary) has come to an end, will be chargeable to IHT on the earlier of the cessation of those benefits and the death of the beneficiary. These remaining funds will be treated as if they were an addition to the original scheme member's estate. However, any left-over funds which are paid to charity will be exempt from IHT.

Conclusion: So What Should One Do?

- a) The matter of pension provision must be very much an individual decision, depending on

overall financial circumstances, aims, aspirations, family circumstances etc. Within the strict context of pensions, however, it must be right so far as possible to defer drawing of pension benefits in the interests of investment and tax efficiency as long as possible: the larger the fund and the higher the age at which an income is drawn, the greater that income. And in the unfortunate event of death under age 75 there are clear IHT advantages of having the lump sum pass under a trust to the family before benefits have been drawn.

- b) At age 75 ASP is clearly preferable to annuity purchase.
- c) But there is another issue: should income be maximised or minimised in retirement, subject to government thresholds? Certainly, even after a combined tax charge of 82% (viz Income Tax at a total of 70% and IHT at 40% on the balance), illustrations show that significant funds could be left to the next generation (other things being equal)
- d) Assuming that the individual has sufficient outside funds to provide an income, that might be an argument for drawing the minimum income post-age 75 so as to maximise tax-free growth in the fund (apart from the non-payable tax credit on dividends), with a view to maximising the amount for the next generation. That might seem attractive, other things being equal, assuming that the thought of an 82% tax charge is not completely horrifying.



- e) An alternative suggestion would have income maximised in retirement, noting that the initial maximum based on 90% of the equivalent annuity is based on single rather than joint lives and so in the case of a married couple or civil partners allows a rather greater amount to be taken, at least in the early years. Certainly such an approach could be justified, especially where there has been good capital appreciation in the fund, even if the income which can be drawn is not strictly required for living expenditure.

A final word

This is no more than a very brief introduction to a very complex subject. However, it is an important one and we should be delighted to discuss with you further any of the points raised by this Briefing

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