NEW PENSION RULES

IHT Savings

The latest amendments to the Taxation of Pensions Bill firmly position flexible pensions as the estate planning vehicle of choice. Tax relief on contributions without the seven year wait for them to be outside the estate and tax-free investment returns were already good reasons for pension funding.

Combine these with the new rules where a flexible pension, such as a Self Invested Personal Pension (SIPP), allows pension wealth to cascade down the generations within the pension wrapper and it creates a truly tax-efficient wealth management and inheritance plan.

Set out below are details on the recent amendments and our top 10 advice points for clients interested in passing on their accumulated pension wealth.

1. **Wealth Transfer vehicle**

Remaining pension wealth within the pension fund and passing it down to future generations is an extremely tax-efficient estate planning solution. It combines IHT free inheritance with tax-free investment returns and, potentially for some beneficiaries, tax-free withdrawals.

The new rules will allow defined contribution scheme members to nominate an individual to inherit the remaining pension fund as a 'nominee's flexi-access drawdown account'. This can be anyone at any age and is no longer restricted to your 'dependants'. Adult children who have long since flown the nest can now benefit and don't have to wait until 55 to access it.

If the original member dies after age 75, any withdrawals will be taxed at the beneficiary's marginal rate but if death occurs before age 75, the nominated beneficiary has a pot of money they can access at any time completely tax-free. In either case, the funds are outside the beneficiary's estate for IHT while they remain within the drawdown account and will continue to enjoy tax-free growth.

This could see a u-turn in strategy for those clients whose primary concern is maximising what can be passed on. The previous wisdom of stripping out funds and gifting the surplus income to minimise the impact of the 55% tax charge has given way to retaining funds within the pension as a more tax efficient solution.

2. And it goes on and on ….

The ability to pass on and on pension wealth doesn't stop there. The nominated beneficiary can nominate their own successor who will take over the drawdown fund following their death – unlike the current rules where lump sum death benefits are the only option for non-dependants.

This will allow accumulated pension wealth to cascade down the generations, whilst continuing to enjoy the tax freedoms that the pension wrapper will provide.

This relies on the existing pension arrangement being able to offer the nominees' and successors' drawdown accounts. Some schemes may only be geared up to offer a lump sum death benefit which would lose the protection of the pension wrapper for IHT and any income tax payable would be shoehorned into a single tax year.

3. Tax rate determined by age at last death

Each time a pension fund is inherited by a nominee or successor, the tax rate will be reset by the age at death of the last drawdown account holder.

For example Joe, a widower, dies aged 82 and nominated his son, John, to receive his flex-access drawdown fund. As Joe died after age 75, John is taxable at his marginal rate on any income withdrawals. John sadly dies age 70 and leaves the remaining fund to his daughter Jenny. Jenny can take withdrawals from her successor's drawdown account tax-free as John died before 75.

On death before 75, it is worth considering skipping a generation with at least some of the pot to ensure a tax-free inheritance for the kids. With a 94%* chance that at least one of a 65 year old couple will live to at least 80, routing all the wealth via the surviving spouse means it is likely any subsequent inheritance to the kids will be taxable.

4. Crystallised or uncrystallised – what's the difference?

Previously, those concerned with passing on their pension wealth to future generations would delay crystallising benefits to avoid a potential 55% tax charge should they die before age 75. This is no longer the case as both crystallised and uncrystallised benefits will have the same death benefit options and tax charges.

- Source: Office of National Statistics 2010-2012 Life Tables

5. **Testing against the Lifetime Allowance**

There is no test where death benefits are paid after age 75 as these funds have already been tested. However, a new benefit crystallisation event is to be created to test uncrystallised funds which are taken as a dependant's or nominee's flexi-access drawdown against the deceased's Lifetime Allowance (LTA) prior to age 75.

This test doesn't apply where benefits are taken as an annuity or scheme pension, but this would mean the income becomes taxable and can only be paid to a dependent.

6. **Two year unauthorised payment charge has gone**

Currently there is a two year window to pay lump sum death benefits from uncrystallised funds without the payment triggering unauthorised payment tax charges of up to 70%. These tax charges will be removed from April 2015.

7. **The new 2 year rule**

As one two year rule goes another one crops up in its place. Death benefits will only be tax-free for deaths before age 75 if they distribute or the nominee flexi-access account is set up within two years of death.

Failure to designate the funds for drawdown within this two year window will see benefits taxable as income. Where funds are taxed as income they are not also tested against the lifetime allowance. This could mean those with funds in excess of the LTA may want to weigh up the merits of delaying to see if the tax charge for exceeding the LTA is greater than the potential income tax charge payable by the nominated beneficiary.

8. **Reviewing nominations**

The new death benefit rules have changed the dynamics for those looking to pass on any remaining pension fund on death. This means revisiting existing death benefit nominations to ensure they continue to meet your needs and objectives. It is also worth discussing whether your existing scheme will even allow your preferred solution.

Under the new rules, the scheme administrator cannot nominate someone for nominee's drawdown if there is an existing dependant or an existing nomination in place.

A nomination doesn't have to be all or nothing. It is possible to nominate a number of different beneficiaries and to perhaps skip a generation with some of the fund.

9. **Bypass Trust – when you still might want one**

It is worth remembering that each time a pension fund is inherited it is the new owner that has control over the eventual destination of those funds. Not only can they nominate who benefits on their death but, under the new flexibility, they could withdraw the whole fund themselves leaving nothing left to pass on.

This may be an issue where there are children from previous marriages or concerns about a beneficiary's ability to manage their own financial affairs, either through a lack of capacity or their own reckless spending habits.

Where control is an issue, there are two potential solutions:

- Nominate a split share of the pension fund, for example, 50% to the spouse with the remaining 50% split equally among the children. This gives all parties their own fund which they can manage themselves and when it's gone, it's gone.
- Pay a lump sum death benefit to a Trust which will put the control into the hands of the member's chosen trustees. The trustees can determine when and how much to distribute to beneficiaries. Choosing this option means only a lump sum can be paid to the trustees – there is no option for them to be a drawdown holder.

10. **Should I take my tax-free cash?**

The changes will see many behavioural changes on how benefits are taken. Currently, some pension savers delay taking their tax-free cash until 75 to escape the 55% tax charge on crystallised funds. But what now with the 55% tax charge gone and equal treatment between uncrystallised and crystallised funds?

There is no longer any reason to delay taking tax-free cash if it can be gifted and outside the estate after seven years, but if the tax-free cash remains in the estate and suffers IHT at 40%, it may be better to leave the cash within the pension fund if the beneficiary is able to draw on it at basic rate or less.

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