For financial advisers only

DB to DC case study – potential inheritance tax liability

How to consider a potential inheritance tax (IHT) liability for a client in ill health who is transferring their pension benefits to a new scheme.

The FCA rules on defined benefit (DB) transfers continue to require advisers to start from the assumption that transferring will be unsuitable. However, the FCA also states this doesn't prevent an adviser from recommending a transfer where this can be demonstrated to be suitable to the client.

This communication is for advisers only. It mustn't be distributed to, or relied on by, customers or any other persons.

The details in this case study are based on our understanding of current taxation law and HMRC practice, which may change.

Meet Susan: a case study

Are you concerned that if you transfer a client's pension benefits from a DB to a defined contribution (DC) scheme an IHT charge may apply in future?

Susan:

- Was 58 years old, divorced, and had two grown-up children.
- Was a deferred member of her employer's DB scheme.
- Following a serious health scare that left her unable to work full time, she decided to review the retirement and death benefits potentially payable from her DB scheme.

Her regulated adviser undertook a comprehensive review of:

- Her personal circumstances.
- The role her existing DB scheme and the receiving DC scheme would play in meeting her immediate and longer term income needs.
- The death benefits available under both schemes.
- And, considered all possible alternative ways of achieving her objectives.

After the review, Susan decided to follow her regulated adviser's recommendation to transfer her cash equivalent transfer value (CETV) of £600,000 to a DC scheme.

Sadly, Susan died within seven months of making the transfer.

AEGON

Pensions and IHT

Pension death benefits aren't normally treated as part of an individual's estate on death for IHT purposes when the scheme administrator or trustee has absolute discretion over who receives the benefits. However, IHT can apply to pension death benefits in certain circumstances, many of which are misunderstood by clients.

One such circumstance relates to pension transfers where the client dies within two years of making a transfer (DB to DC, and possibly even between DC schemes depending on the specific circumstances) and HMRC finds out that the client was aware of their ill health when they made the transfer.

Disclosure to HMRC

In Susan's case, the completion of the IHT forms on death (specifically the IHT400 and IHT409 for pensions) by her legal personal representatives supplied information to HMRC on the pension transfer that was made within two years of her death. HMRC then looked into the circumstances of her health when the transfer was made. They then sought to levy an IHT charge having found evidence that she was aware of her ill health at that point.

Discretionary disposal?

With Susan in ill health at the point of transfer, her adviser had set out in the transfer recommendation the risk of IHT applying if she were to die within two years of the transfer.

This outlined HMRC's view that, despite the transfer being made between schemes operating discretionary disposal of benefits on death, Susan would have been able to transfer her benefits to a scheme that would have paid benefits to her estate on her death. Because she failed to do this, it meant that there would be a possible loss to the estate if she died within two years of the transfer.

Spouse's IHT exemption?

The transfer recommendation recognised Susan's divorced status, though for completeness covered the IHT position in the event that she died shortly after remarrying.

This explained that the normal inter-spouse IHT exemption wouldn't apply in these circumstances. This is because the pension transfer was being made between the trustees of registered pension schemes, rather than transferring from Susan's estate to a new spouse or registered civil partner – even if death benefits are ultimately paid to such a person.

Loss to Susan's estate

Having accepted HMRC's position, Susan's beneficiaries presumed that the loss to the estate would be calculated as 40% of the CETV initially received. However, Susan's adviser explained that HMRC generally determines the loss by taking a before value and subtracting an after value to arrive at an appropriate amount.

The before value is the value of benefits at the precise point of transfer (essentially the CETV). This is increased by growth and discounted by the client's expectation of life at that point (a small adjustment would apply if the expectation of life was short).

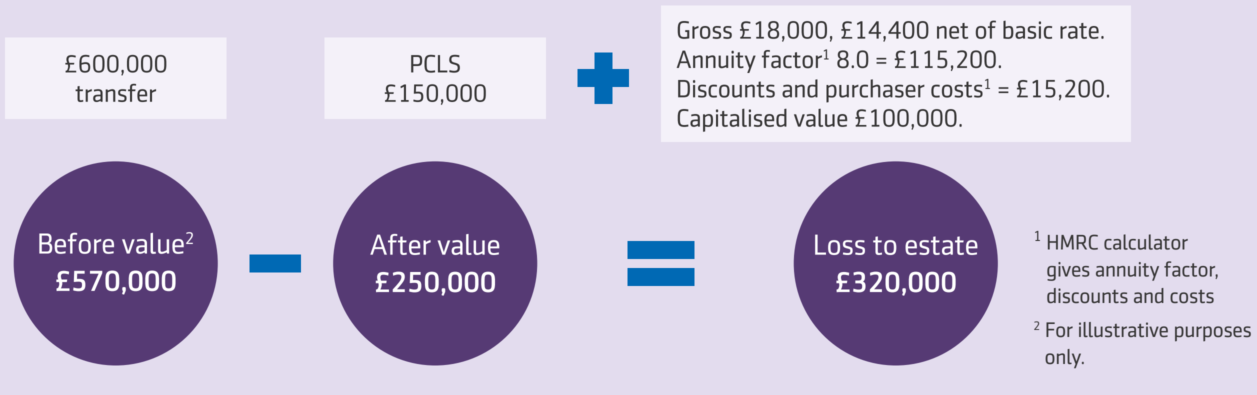
The after value is the total of the pension commencement lump sum (PCLS), plus the capitalised value of a 10-year guaranteed annuity. This is calculated in line with an HMRC calculator that allows for income tax to be deducted and is also discounted by various costs.

It could be argued that an uncrystallised funds pension lump sum, net of income tax, is a more relevant amount to be used as the after value where flexible access of benefits is offered under the receiving scheme.

In Susan's case, the calculated loss to her estate by HMRC was £320,000 (see the diagram on the next page) rather than the full CETV. This amount was added to all other assets in her estate and IHT applied only to the amount in excess of her nil rate band, which was paid by her estate.

This is a simplified example and each case is looked at on its own merits, although some general principles normally apply. A negotiation with HMRC, based on the facts of the particular case, may be necessary.

Susan, in ill health, transfers £600,000 and dies within seven months of the transfer



[1] HMRC calculator gives annuity factor, discounts and costs

[2] For illustrative purposes only.

Summary

The risk of an IHT charge applying on death following a pension transfer must be considered as part of every advice process and formally recorded in any transfer recommendation. Often an ill-health event will focus a client's mind on what death benefits are available under their existing schemes. It will also encourage them to think about transferring to a DC scheme to improve the options available and widen the class of potential beneficiaries. The knowledge that a possible IHT charge may apply on death within two years may not in itself stop a transfer proceeding. In Susan's case, the transfer was demonstrated to be in her best interests even with the risk of IHT applying on her death. All parties must be made aware of the possible HMRC challenge and base their decisions in full possession of all relevant information.

Aegon Retirement Choices SIPP, Aegon SIPP and One Retirement

Any financial review and personal recommendation to transfer benefits from DB to DC will include your assessment of the suitability of the receiving scheme, the investment choices, benefits, and options that are available.

The Aegon Retirement Choices (ARC) SIPP, Aegon SIPP and One Retirement offer the full income and death benefit flexibilities. They give your clients more control over their pension savings and also a wide investment choice that can be tailored to meet their individual risk appetites.

You should be comfortable with the investment choices that you make for your client as they may lose features, protections, guarantees or other benefits when they transfer. Please also remember that a transfer to the ARC SIPP, Aegon SIPP or One Retirement is moving to an investment-based product where the client's capital is at risk and the final value of their pension pot may be less than has been paid in.

For more information on DB to DC transfers, have a look at our Consolidation toolkit, which aims to help with the suitability assessment and important areas to consider before deciding if a transfer is suitable.

If you have any questions, please speak to your usual Aegon contact.