ATT Welcome, November 2015

Welcomes

01 November 2015

Tax-free income for life, but with a catch

The great thing about tax is that it is constantly changing so there is never a shortage of topics to develop into training seminars.

I chose to develop training that crosses the boundaries of the different professions I work with, specifically private client departments in solicitors' firms and personal tax departments for small to medium-sized accountancy firms.

Many professional firms have asked me to explain how their clients can benefit from the significant changes to the taxation of pension death benefits and how these have a bearing on the advice they can give. Specifically, they ask how a client's dependents can qualify for tax-free income for life from a pension scheme.

Tax-free income for life is now a reality. The catch is that your client needs to die before age 75! In addition, the Taxation of Pensions Act 2014 that sets out the tax-free income option for life applies only to money purchase pension schemes. Your client's pension scheme needs to have adopted the new rules, known as flexi-access, and the death benefits need to be paid out within two years of death. There are also a few complications that exceeding the lifetime allowance creates, but for most clients it is as simple as that.

From my experience, it is only the modern types of individual personal pension plan and SIPPs that have automatically adopted the new flexi-access pension rules. Many of the older pension plans, group personal pensions and group money purchase schemes have not adopted the new rules.

Discussing a client's options after a death is not a regulated activity so you can explain to them that, if their pension has adopted the new rules, they have a choice of a tax-free lump sum on death before 75 or a tax-free income for life for their nominee, dependant or successor. Remember – the payments must be made within two years of death, otherwise the tax-free status changes fundamentally.

It is interesting that, if the recipient of the tax-free income for life also dies before age 75, this sum can continue to be paid to their successor for their life. However, this is academic if the new rules have not been adopted.

To be able to advise clients on their options in the event of death, you need to ask a few more questions about the value and type of your client's pension scheme. You may need to ask the product provider. You can do this if you get a signed letter of authority or ask your financial adviser regulated by the FCA to help you.

If the pension scheme has not adopted the new rules the plan can be transferred to a modern arrangement that has done so, but that is regulated advice and you need to avoid getting involved.

The value and type of pension scheme are also relevant if you are providing your client with an inheritance tax planning strategy.

Many of the older style pension schemes are contract-based plans, such as retirement annuity contracts (often known as section 226 plans) and buyout policies (often known as section 32 plans). These are not inheritance tax-free, unlike most money purchase pension schemes that are set up under a trust or master trust. These old legacy policies are unlikely to have the tax-free income option, but will also form part of a client’s estate if they die. These types of policies must be individually placed into a discretionary trust, often know as a spousal bypass trust. If you do this the value should be out of the client’s estate for inheritance tax.

There is a further twist you need to be aware of. If you are trying to help plan the affairs of a client who is terminally ill, if they die within two years of placing the plan into trust, a transfer of value can arise and the value may be included in the estate. The same applies if a client is terminally ill and you have suggested they seek regulated advice to transfer their pension scheme to an arrangement that has adopted the new rules to pay tax-free income to their dependent. This could change the inheritance tax-free status of the plan if the client dies within two years.

The new regime creates a great opportunity for planners, but the clear message is that you need to have an understanding of the type of arrangement your client has, so you may need to modify your client questionnaire. If your client wants complete flexibility, seek advice well before they are diagnosed with a terminal illness. As I said in my title: tax-free income for life, but with a catch.