the knowledge : retirement planning

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death and taxes

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Adrian Walker assesses the court case of Patricia Arnold (deceased) v HM Revenue & Customs (HMRC) and what the outcome means for IHT charges on pension death benefits.

The case of Patricia Arnold has highlighted the issue of an investor failing to exercise a right to take benefits from her pension before she died. It resulted in HMRC applying an IHT charge on a large part of the benefit paid to her beneficiaries when she died, provoking much debate.

Let's look at the background to the case.

- On 6 November 1995 Mrs Arnold (then aged 53) transferred existing pension rights into the NPI personal pension scheme, declaring a trust for the policy. This named her children (not financial dependants) as the beneficiaries of any lump sum death benefit on her death.
- The 'normal retirement date' set under her policy was 8 September 2002 (at age 60). However, the terms of the policy allowed her to take retirement benefits between her 50th and 75th birthdays.
- In April 2002 Mrs Arnold was diagnosed with advanced ovarian cancer. She died on 3 July 2003, 15 months after her original diagnosis.
- NPI had written to Mrs Arnold in May 2002 asking her if she wished to take her retirement benefits. She did not respond to this letter.

She had twice previously declined an offer to take benefits before reaching 60, while she was in good health, as she did not need the income from her pension fund then. There was no written evidence that she regarded 60 as her retirement date and had deliberately planned to defer drawing pension benefits.

- Prior to 6 April 2006, HMRC practice in this area meant that the omission rule would apply only if:

- within two years of death, the member made an actual pension disposition, and
- at the time of the disposition the member did not believe they would survive for another two years.

In the pre A-Day statement of practice contained in the 1992 Tax Bulletin, HMRC confirmed that they would look at arrangements:

"where the policyholder became aware that he or she was suffering form a terminal illness, or was in such poor health that his or her life was uninsurable at or after the time the policyholder:

- took out a new policy and assigned the death benefit on trust; or
- assigned on trust the death benefit of an existing policy; or
- paid further contributions to a single premium policy or increased contributions to a regular premium policy where the death benefit had previously been assigned on trust; or
- deferred the date for taking retirement benefits."

Even in those situations, they would not pursue a claim where the death benefit became payable to a surviving spouse/civil partner, financial dependants or charity. Neither would they normally continue a claim where the policyholder survived for two years after making any of these arrangements, although they reserved the right to examine each case individually.

Much early press commentary focused on the issue of an omission to exercise a right at 'a policyholder's normal retirement age'. The commentaries expressed concerns that it is the normal retirement age which is the key driver to the outcome of this court case, and concerns on how this will impact clients who defer withdrawing benefits beyond their selected retirement age.

I do not believe this to be relevant to the judgement and have set out below the key points of relevance arising from the case:

1. The member's health position. Where a change in a member's health results in life expectancy of less than two years, they are able to draw benefits under a registered pension scheme, regardless of age, through either:

a. a serious ill health lump sum, where life expectancy is less than 12 months

or

b. an early retirement ill-health pension, where life expectancy is greater than 12 months.

Both benefits fall into the individual's estate, increasing the estate value for inheritance tax purposes.

In this case Mrs Arnold, having received the diagnosis of a terminal illness, elected not to draw benefits from her policy and died within two years of the diagnosis.

2. Death benefits held under trust

When Mrs Arnold set up membership of the NPI scheme she wrote the death benefits under trust for the benefit of her children, who were not financial dependants due to their age. This signalled a definite intent that Mrs Arnold wished to exclude those benefits from her estate for IHT purposes.

The decision not to take benefits at the time of the diagnosis resulted in a decrease both in the value of her estate for IHT assessment, and in the benefit of the estate for other individuals, ie her children.

I believe that the decision reached by the court in this case does not signify a change to existing HMRC practice, nor a more aggressive approach from them to such situations. However, it does highlight the need for clients to receive continuing advice in relation to the structure of their pension arrangements where their health situation changes.

It is important to remember that, where such changes arise, no charge to inheritance tax will arise where there was an omission to exercise the right to draw benefits from a registered pension scheme if the death benefits are:

- paid to a spouse or civil partner
- paid to a person or persons who were financially dependant on the deceased
- paid to charity
- where the estate of the deceased member, taking into account the value of the pension fund, would fall below the IHT threshold of currently £325,000.

Where none of the above are applicable there will be a need to discuss the client's retirement options and, should they choose not to take benefits, to advise the potential beneficiaries of the likelihood of an IHT charge being applied to any lump sum death benefits they may receive.

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