

Wills, Trusts and Probate Briefings

## Pension Scheme and death in service benefits - Avoiding Inheritance Tax

### Lump sums

Anyone working for an organisation with good pension arrangements, including payment of a lump sum on:

- death in service, or
- death after retirement

needs to think about the inheritance tax implications if, as is usual, their spouse or civil partner is entitled to benefit from their pension.

No inheritance tax is payable on any benefits that a person leaves to their spouse or civil partner, because transfers between partners in a marriage or civil partnership are exempt. But tax could be payable on the subsequent death of their spouse (or civil partner), at 40%, on the whole of their estate, including the pension money.

It will not be payable if the amount chargeable to inheritance tax on their death is below the inheritance tax threshold. This is subject to annual revision by the government but is currently (2009-10) set at £325,000 per person.

However, a recent change in the law means spouses or civil partners who inherit assets from partners who died on or after 9 October 2007 may, in planning their bequests, make use of both:

- their own inheritance tax exemption, at whatever rate prevails when they die, and ALSO
- the unused proportion of their late partner's exemption, if any.

For example, a wife who inherited the whole estate of her husband, who died in 2009-10, for instance, would be able to use:

- the whole of her own inheritance tax exemption at the date of her death, plus
- the whole of his, upgraded so it also equalled the amount of the exemption at the date of her death,

If the exemption had remained the same between their two deaths, that would make £650,000 available to shelter her estate when she passed it on.

If, however, her husband had made bequests worth £120,000 to former wives, children or other beneficiaries, and only left her the remainder, she would only be able to use:

- her own exemption, plus
- 63% of his ( $£325,000 - £120,000 = £205,000 / £325,000 = 63\%$ ).

Again, the 63% would be applied to the exemption prevailing in the year in which she dies.

### Mitigation

Even if the second estate exceeds the cumulative exemptions of both partners, with or without discounts for bequests outside the partnership, it is possible to shelter a lump sum paid as part of an employee's pension or life assurance benefits:

- The employee must agree that the lump sum shall go to a discretionary trust - known as a 'spousal by-pass trust'.
- Ideally, this trust will be set up when the right to the lump sum payment on death is created. However, it can be done later - although it is inadvisable to wait until there is a significant risk that the lump sum will be payable in the foreseeable future.
- Potential beneficiaries - typically the wife or civil partner, and any outstanding children - should be named in the deeds.
- The trustees will be empowered to use their discretion to pay or lend the capital or income to any of the potential beneficiaries.

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This document was created on 06 May 2010

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- Trustees might, for instance, be the surviving spouse (or civil partner), and a professional trustee.
- The trust deeds will typically provide that the trust shall be wound up on the death of the surviving partner, and the remaining assets be distributed to the remaining beneficiaries.
- The trust will be subject to a 10-year periodic charge equivalent to 0.6% pa, and capital gains tax at the rate applicable to trusts (18% in 2008-09).

This arrangement permits payments from the lump sum to the surviving spouse (or partner) as and when required, and eventual payment of the remainder to the other beneficiaries, at rates of tax very much lower than the 40% that would be charged if the payments were chargeable to inheritance tax.