Standard Life

Pension Post

Updated January 2020
For financial advisers only

Tony Gilhawley of Technical Guidance Ltd, gives an overview of ill health and retirement benefits which might be helpful when advising clients who are dealing with serious illness.

Ill health and retirement benefits

The onset of serious ill health

When a client becomes seriously ill at any age, there can be a rush to 'protect' the capital accumulated in pension arrangements by advising immediate maturity of benefits. But be careful to consider all of the options and put these to the client in writing. Sometimes the best option may be to do nothing.

Serious ill health can occur at any age. Access to retirement funds is generally available at any time on permanent incapacity[1] on RACs and PRSAs and on 'ill health'[2] under Buy Out Bonds and occupational pension schemes.

Of course benefits can be accessed from 50 onwards, regardless of health, on normal early retirement from an employment under Buy Out Bonds, PRSAs, and occupational pension schemes.

[1] Becoming permanently incapable through infirmity of mind or body of carrying on the client's own occupation or any occupation of a similar nature for which they are trained or fitted

[2] Physical or mental deterioration which is serious enough to prevent the client from following their normal employment or which very seriously impairs their earning capacity. It doesn't mean simply a decline in energy or ability.

Options

The three broad options where a client has become seriously ill can vary by the type of pension arrangement and include:

- Do nothing; leave things as they are
- Make benefits 'paid up' but do not access them at this stage; this is relevant in the case of occupational pension scheme funds
- Mature the benefits through either ill health or normal early retirement

It's important to consider the impact on dependants, such as the client's spouse/civil partner and children, of the different options; in particular what benefits will be payable under each option and how the benefits will be taxed in their hands should the client die in the near future.

PRSAs and RACs

I'll refer here to PRSAs, but it also includes RACs.

If the PRSA is not matured before death, then on later death before age 75 the full value of the PRSA is payable to the estate as a lump sum. How it'll be taxed will depend on who inherits it.

If the PRSA is matured shortly before the client dies, then we can assume that 25% of the fund (after deduction at maturity of any standard rate tax on the 25% lump sum) will be in their estate on death, but the balance we can assume will be in an AMRF/ARF or held as a vested PRSA:

If inherited by:	PRSA not matured before death	PRSA matured before death: 25% after tax lump sum + ARF
Spouse/civil partner	**Lump sum:** 100% tax free	**25% lump sum:** tax free **ARF:** withdrawals taxable under PAYE
Adult child	Taxable inheritance @ 33% but with benefit of any available €335,000 CAT threshold	**25% lump sum:** taxable inheritance @ 33% but with benefit of any available €335,000 CAT threshold **ARF/vested PRSA:** 30% income tax; no benefit of any available €335,000 CAT threshold as exempt from inheritance tax
Minor child	Taxable inheritance @ 33% but with benefit of any available €335,000 CAT threshold	**25% lump sum or ARF/vested PRSA inheritance:** taxable inheritance @ 33% but with benefit of any available €335,000 CAT threshold

So there are many scenarios where the inheritance of the unmatured PRSA funds on death before age 75 with give a better 'net' after tax outcome to the surviving spouse/civil partner and/or adult children than inheriting the matured benefits.

In effect maturing the PRSA benefits can, from the spouse/civil partner's point of view, change the tax status of 75% of the funds from tax free to taxable (as later ARF/vested PRSA withdrawals). But there is the benefit of gross roll up in the ARF or vested PRSA which may outweigh some of the disadvantages of taxable withdrawals. However the perception shortly after death may well be that the next of kin would have done much better if the PRSA had not been matured before death.

And for some adult children taking the PRSA benefits can change what would otherwise have been a tax free inheritance (assumed under the available threshold) into one taxable at 30% (as an inheritance from an ARF or vested PRSA).

PRSAs which are not matured before age 75 are taxed on death after age 75 as if the PRSA has vested.

DC occupational pension scheme – active benefits

Assuming the client is an active member of a DC occupational pension scheme, i.e. still in employment and accruing retirement benefit, there may be three options to consider for a seriously ill client:

- Do nothing; stay in service if possible. Benefit paid out as a death in service benefit
- Cease pensionable service (if not actual service), and so turn the accrued fund into a statutory preserved benefit; but do not take early retirement
- Take early retirement; we will assume in the table below that the ARF option is chosen

	Death in service	Preserved benefit	Early retirement: 25% after tax lump sum + ARF
Benefit payable	A lump sum up to 4 x final remuneration; balance **must** be used to purchase dependant's taxable pensions within Revenue limits	Full accrued fund payable to estate as a lump sum Assumed lump sum death in service benefit not payable	**25% lump sum:** + 75% in ARF
If inherited by:			
Spouse/civil partner	**Lump sum:** 100% tax free **Pension:** taxable under PAYE	100% tax free	**25% lump sum:** tax free **ARF:** withdrawals taxable under PAYE
Adult child	**Lump sum:** taxable inheritance @ 33% but with benefit of any available €335,000 CAT threshold	**Lump sum:** taxable inheritance @ 33% but with benefit of any available €335,000 CAT threshold	**25% lump sum:** taxable inheritance @ 33% but with benefit of any available €335,000 CAT threshold **ARF/vested PRSA:** 30% income tax; no benefit of any available €335,000 CAT threshold as exempt from inheritance tax
Minor child	**Lump sum:** taxable inheritance @ 33% but with benefit of any available €335,000 CAT threshold **Pension:** taxable under PAYE	Taxable inheritance @ 33% but with benefit of any available €335,000 CAT threshold	**25% lump sum or ARF/vested PRSA inheritance:** taxable inheritance @ 33% but with benefit of any available €335,000 CAT threshold

Creating a preserved benefit, i.e. either leaving service or a termination of pensionable service without a termination of actual service, can lead to the surviving spouse or civil partner inheriting the entire fund (not limited by 4 x final remuneration limit) tax free through the client's estate, because of s30(3) Pensions Act 1990.

Where the client is very seriously ill with a remaining expectation of life of less than 12 months, there may be another option, ill heath retirement using the death's door full commutation, i.e. a lump sum on the traditional benefit option of, say, 150% x final remuneration with the balance being paid as a lump sum less 10% income tax.

While not as attractive tax wise as the surviving spouse or civil partner inheriting the full preserved benefit tax free, it does allow the client access to the funds now while they are alive which may be important to some clients in that unfortunate situation.

Bear in mind, however, that:

- the cessation of pensionable service to create the preserved benefit may lead to a loss of any death in service benefits, over and above the return of the fund on death. So this may have to be also taken into account
- termination of service will lead to the loss of death in service benefits and possibly other employment related valuable benefits such as employer paid health insurance, Permanent Health Insurance benefits, membership of voluntary life assurance and salary protection scheme benefits, etc
- ill health retirement requires meeting the ill health definition in the scheme rules and will involve a permanent termination of employment and hence loss of death in service and other employment related benefits as well as future earnings

Annuities

If advising maturity of DC benefits consider enhanced and capital protected annuities either as part of the traditional benefit option or to be bought with ARF funds, as well as annuities with a significant reversion, for example, 75% at least, where the client has a spouse or civil partner.

Don't assume annuities have no role to play.

DB scheme benefits

In the case of DB scheme benefits:

- the ARF option at retirement will not be available (assuming the client is not a proprietary director member) if benefits are taken on ill health retirement
- membership of the scheme may be compulsory for employees and hence the option of creating a preserved benefit while remaining as an employee may not be available
- great care should therefore be taken in comparing the death in service package of survivor benefits with that of the retirement and death in retirement benefits. Retirement in particular will lead to a loss of the death in service lump sum

Where the client is too unwell to work on, they can potentially:

- leave service with a preserved benefit i.e. not early retirement, or
- take early retirement benefits; where expectation of life is less than 12 months, the death door full commutation may be available, but again look out for possible loss of survivor's pensions which this might entail
- ill health early retirement may involve a much higher pension and lump sum than under a preserved benefit on leaving service, with the likely crediting of future service
- if the client is taking early retirements benefits, there may be an option to surrender part of their pension at retirement in order to provide a survivor's pension for their spouse/civil partner or to enhance such a pension. If available this option may be valuable and should be considered
- if the client leaves service with a right to a preserved benefit rather than take early retirement, the full transfer value of this preserved benefit is usually payable to their estate on later death, with no reduction even where the scheme does not meet the funding standard. However, some DB schemes which provide a Spouse's pension on death before NRA, may opt not to pay a transfer value on death before NRA but instead pay the reduced Spouse's pension. So check if this applies.

Letter of wishes

Where a client is not taking early retirement or has a preserved benefit in an occupational pension scheme, so that on death there is a death in service lump sum payable, such clients are well advised to draft or update a Letter of wishes to the trustees outlining their wishes in relation to the use of death in service funds on death.

Buy Out Bonds

While BOBs are not an occupational pension scheme under the Pension Act and hence not directly covered by s30(3), which provides that on death the full value of a preserved benefit is payable to the deceased's estate, it is the practice in the industry to administer them as if they were a preserved benefit, where the BOB was funded by a transfer value in respect of a preserved benefit in a scheme, and hence, on death, the full fund is payable to the deceased's estate.

Therefore, the options are generally as above for occupational pension schemes, but without the option of 'death in service'.

Recording all the options in writing

It is important in advising seriously ill clients on the possible maturity, or otherwise, of their retirement benefits to:

- also involve, if possible, the client's spouse/civil partner and/or one or more children in the process, so that whatever decision is made is accepted and known to the likely beneficiaries on death
- record in writing all the options and the tax consequences for each potential class of beneficiary involved, so that an aggrieved child or widow can not come back at you some time later, after the client has died, to complain about the outcome for them
- record the client's decision in writing.

Be careful

The message is to be careful when advising seriously ill clients about their retirement benefits. Think through the possible outcome for the client's next of kin, in particular how benefits may be taxed in their hands, should the client die.

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