DEATH BENEFIT OPTIONS FOR MONEY PURCHASE PENSIONS

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Although pensions are primarily used as a tax efficient way to save towards income once you stop work, not everyone will use all their pension fund before they die. The way in which the death benefits for money purchase pensions are treated offers a very tax efficient method of passing wealth through generations.

The current arrangements are very historically generous, and you should be aware that, as ever, legislation may change in future.

This note gives a summary of how money purchase pension death benefits are taxed.

SUMMARY

April 2015 ushered in a new era of freedom and choice in pensions. Whilst most individuals will need to use most or all of their pension funds to support their lifetime income, some will be able to use the new pension freedoms to pass funds between the generations. For those in a scheme that allows drawdown, this can be a particularly tax efficient way of passing on benefits (subject to future legislation change of course).

The ability to pass on pension wealth to a beneficiary doesn't stop after the original member's death. A beneficiary can nominate their own successor who can take over the drawdown fund following their death. This can allow accumulated pension wealth to potentially cascade down the generations, whilst continuing to enjoy the tax benefits that the pension wrapper provides.

This Research Note covers the main death benefit options for money purchases schemes (and resulting tax issues):

- Lump sum
- Flexi-access drawdown
- Beneficiary's lifetime annuity

The choice is not necessarily all or nothing - the same pension pot may provide benefits in different ways.

It is important to **check that your current pension plan can offer all the options you may want**, and that your '**nomination of beneficiaries**' or '**expression of wishes**' form is completed and reflects your wishes, as otherwise your preferred death benefit option may not be available.

Scheme pensions and the special rules which dictate the death benefits available from contracted out rights (that is, GMP or Section 9(2B) are not covered in this Note.

LUMP SUM

Any funds remaining on the death of the original member (or a beneficiary who had inherited a pension fund), may be paid out as a **lump sum**. This can include both **crystallised funds** (funds that have moved into drawdown or been used to buy an annuity) and **uncrystallised funds** (funds that have had no pension income drawn from them yet).

Lump sum death benefits can be paid to any individual, a trust or charity (if there are no surviving dependants).

Once lump sum death benefits have been paid, the funds are **outside the pension wrapper** and will form part of the beneficiary's estate for Inheritance Tax. Any growth and income on the fund will be subject to the normal regime of income and capital gains taxes.

INCOME DRAWDOWN

Where a pension fund is uncrystallised, or already in drawdown, then **beneficiary's drawdown** is one of the ways a beneficiary can use an inherited fund. If chosen, it will allow funds to remain in the pension scheme under an arrangement set up for the beneficiary.

The beneficiary may then draw from this pot at will, with any **withdrawals subject to income tax** on the beneficiary **only where the member died after age 75** – otherwise the withdrawals are free from income tax. The funds remaining undrawn continue to benefit from the largely income and capital gains **tax free growth environment** provided within a pension.

Drawdown arrangements can be provided for any individual (not just a dependant), but not for bodies such as charities or trusts.

The beneficiary may also nominate who they would like to benefit from any remaining funds when they die, with the taxation position on death depending on the beneficiary's own age at death (there are no further LTA tests on the fund though). In this way it is possible for pension savings to pass down through generations.

BENEFICIARY'S LIFETIME ANNUITY

A lifetime annuity may be an attractive option for beneficiary who needs a secure level of income.

An annuity can be used to provide a pension for any individual (not just dependants), irrespective of their age.

It can be purchased together with a lifetime annuity by the original member in their lifetime (as a joint annuity) or purchased after the member's death by the beneficiary (as a dependant's, nominee's or successor's annuity).

A lifetime annuity cannot be set up to pay to a charity or trust.

INCOME TAX CHARGES ON DEATH

The income tax treatment of pension death benefits depends upon whether the pension scheme member dies before or after age 75. Please note that it is the immediately preceding member's age which is relevant, not the original member if the pension fund has already been inherited.

The government have announced that Lifetime Allowance charges will no longer apply from April 2023, although this policy remains subject to potential change by future governments. Without a potential Lifetime Allowance charge, it remains to be seen whether the current generous treatment for death before age 75 will remain.

	Income tax on receipt by the beneficiary
Death before age 75: Un/Crystallised Fund	Tax free [1]
Death after age 75: Un/Crystallised Fund	Taxable at the beneficiary's marginal income tax rate

Notes:

1 **Two Year Rule**:
Lump sum and income benefits paid before age 75 are only free from income tax if paid within 2 years after the date at which the scheme administrator is informed of the death, or could be reasonably expected to be first aware of the death.

PENSION DEATH BENEFIT NOMINATIONS

Being in a scheme which offers lump sum and pension death benefit options doesn't necessarily mean that all beneficiaries will have all the options available to them – this can also depend on the death benefit nominations made by the deceased member.

A death benefit nomination helps to guide the trustees or pension provider when exercising their discretion over where and how to pay death benefits.

Nominated individuals will have the choice of a lump sum or a pension (via income drawdown or a lifetime annuity) whereas nominated charities and trusts can only receive lump sums.

Having an up to date nomination in place can speed up the payment of death benefits.

An anomaly in the legislation also means that in some cases, the full range of death benefits won't be available. This is because income death benefit payments, for example via Flexi-Access Drawdown (which will generally be the most tax efficient), cannot be provided to non-dependant beneficiaries, such as adult children, if:

- they haven't been nominated to receive benefits, and
- there is a surviving dependant (usually a spouse).

It is therefore extremely important to review nominations and keep them up to date.

FIND OUT MORE

If you have any questions about our investment methodology, or would like some financial planning or investment advice, the clarity team are here to help.

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