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Money Purchase Pensions – Death Benefit Options

Summary

April 2015 ushered in a new era of freedom and choice in pensions. Whilst most individuals will need to draw most or all of their pension funds to support their income during lifetime, 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.

The ability to pass on pension wealth 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 - unlike old rules, where lump sum death benefits were the only option for non-dependants. 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.

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

Choosing the right contract

It is important to check that your current contract can offer all the options you may want, as the option to move to a new contract may not be available after death.

Lump Sums

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 that have moved into drawdown or been used to buy an annuity) and uncryatalised 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). The tax treatment of death benefit lump sums largely depends upon whether the pension scheme member died 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.

If the member died before age 75

Lump sums paid to an individual are usually tax free.

If the source is uncryatalised funds and the value of the funds is more than the available LTA, a one off LTA tax charge of 55% will apply to the excess funds. If the source is crystallised funds (drawdown funds) then there is no LTA test (a test will have been made on entering drawdown, but any growth between this point and death will have escaped further LTA testing).
If the member died after age 75

The lump sum is taxable at the beneficiary’s marginal income tax rate.

There is no LTA test as all funds will already have been tested by age 75 at the latest.

Once outside the pension wrapper, lump sum death benefits will form part of the beneficiary's estate for Inheritance Tax, and any growth and income will be subject to the normal regime of income and capital gains taxes.

**Income Drawdown**

Flexi-access 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, whilst 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. In this way it is possible for pension savings to pass down through generations.

**Taxation**

Dependant's drawdown income, where income payments started before 6 April 2015, will continue to be subject to income tax.

The tax treatment of a beneficiary’s drawdown payments starting on or after 6 April 2015 largely depends on the age of the deceased member at death.

If the member died before age 75

Withdrawals can normally be made tax free.

If the source is uncrystallised funds and the value of the funds is more than the available LTA, a one off LTA tax charge of 25% will apply to the excess funds. If the source is crystallised funds (drawdown funds) then there is no LTA test (a test will have been made on entering drawdown, but any growth between this point and death will have escaped further LTA testing).

If the member died after age 75

Any withdrawals are taxable on the recipient at their marginal rate.

There is no LTA test as all funds will already have been tested at age 75.

**Beneficiary’s Lifetime Annuity**

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

An annuity can now 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 (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.
Taxation

The tax treatment of beneficiaries’ annuity payments starting on or after 6 April 2015 largely depends on the age of the deceased member at death.

If the member died before age 75

The pension can normally be paid tax free, provided it came into payment after 5 April 2015 (and for beneficiary annuities, the original member must have died after 2 December 2014).

There is an LTA test where the purchase was made from uncrystallised funds on death, but not for crystallised funds (drawdown) or where the annuity is a joint-life annuity.

If the member died after age 75

The annuity payments are taxable on the recipient at their marginal rate.

There is no LTA test as all funds will already have been tested by age 75 at the latest.

If a beneficiary was already receiving a survivor’s annuity before 6 April 2015, the pension will continue to be taxed as the recipient’s income.

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. If this is not the case, the benefits are not subject to a LTA test, but are subject to income tax.

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.
Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested.

Our views are based upon our understanding of current legislation in England & Wales. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances. You should not act on any of the information without seeking professional advice.

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