THE TAX TREATMENT OF PENSION DEATH BENEFITS

Recent changes to the rules for pensions have radically changed the approach of advisers with regard to pension savings. The following notes are designed to give our current views as to the options available to clients.

SECTION **PAGE NUMBER**

1. DEFINITIONS

1.1 Beneficiaries

The Taxation of Pensions Act 2014 introduces new classes of potential beneficiary so we now have:

1.1.1 Dependants

Dependants meet one of the following criteria:

- Be married or in civil partnership with the deceased.
- A child of the member who is ≤ 23 at date of death.
- A person who in the opinion of the scheme administrator was financially dependant on the member when he or she died.

1.1.2 Nominees

A nominee is any person nominated by the member to receive death benefits other than a dependant.

1.1.3 Successors

A successor is a nominee of a dependant or nominee who is nominated to continue their flexi-access drawdown.

Where no nomination has been made the scheme administrator may make one.

All of the above are eligible for a lifetime annuity, flexi-access drawdown or lump sum payment, however, only a dependant can receive benefits from a scheme pension.

1.2 Status Of Fund

1.2.1 Uncrystallised

Funds which have not been taken as any form of income or tax free cash by the member prior to death.

1.2.2 Unused / Undrawn

Funds uncrystallised post the benefits crystallisation event (BCE) at age 75.

1.2.3 Crystallised

Benefits which have been taken as a lump sum and / or regular income or pension.

2. CONTRIBUTIONS

2.1 Personal Contributions

Contributions to a pension scheme are not normally treated as transfer of value for inheritance tax (IHT) purposes. They can, however, be considered as a lifetime transfer if the health of the member at the time the contribution is made is very poor and/or if the member dies within 2 years of making a very substantial contribution. Care, therefore, needs to be taken to ensure that if a very substantial contribution is made then documentation is available to prove the contributor is in good health at the time the investment is made.

2.2 Contributions Made For Other People

Gifts from one party to another in order to facilitate a pension contribution are potentially exempt transfers (PETs). So, for instance, a parent can give their offspring and/or grandchildren a gift of a pension contribution. In the case of minors, or those without earned income, the maximum would be £3,600 gross (£2,880 net) but for (say) children who are over 18 the gift could be up to 100% of their earned income.

It is even possible for the parent to make a direct contribution on behalf of their beneficiary. This is best explained by example.

George and Frances have a son named Fred who is a bit wayward. Fred earns good money and is a higher rate tax payer but is always getting into financial scrapes. George is concerned that if he and Frances give Fred substantial gifts now the cash will simply go to supporting Fred’s wayward ways.

Swallow Financial Planning (SFP) establish a pension plan for Fred. We have to check his circumstances and ensure a pension plan is suitable and Fred has to agree to sign the paperwork etc. Having got the paperwork, George writes a cheque out for the net of tax investment into the pension fund.

By way of example, if the net investment was £20,000 the figures would look as follows:

Parent makes PET (or *GOOI) of:	£20,000
Which is saving IHT (after 7 yrs.) of:	(£8,000)
So is a net loss to their estate of:	£12,000
The pension contribution of	£20,000
This is uplifted by HMRC to a gross contribution of:	£25,000
Adult higher rate tax child then claims tax relief of 20%	£5,000
So total benefit is	£30,000

* GOOI (gift out of income).

So everyone wins! George and Frances get £20,000 out of their estate, thus saving 40% IHT (provided they survive 7 years after making gift). The cash creates an investment of £25,000 for their wayward son which he cannot access until age 55. Son on the other hand receives immediate higher rate tax relief of £5,000 so sees an immediate benefit and if his income is in the 60% or 45% bracket he is even better off.

3. LUMP SUM DEATH BENEFITS

The tax treatment of lump sum benefits paid on death depends upon the pension type:

3.1 Uncrystallised or Unused Money Purchase Pension Funds (Personal Pension)

3.1.1 Uncrystallised - Death Before Age 75

This is the death of the previous beneficiary be that the member, or a successor.

- There is **no restriction** as to whom the payment is made to.
- Tax free if the payment is made within the two year window.
- Benefits Crystallisation Event (BCE) test against the member's lifetime allowance (LTA) if the payment is made within the two year window. 55% LTA tax to pay on excess.
- No BCE test against the member's lifetime allowance (LTA) if the payment is made outside the two year window (note could pay to wait until outside two year window).

3.1.2 Unused - Death After Age 75

This is the unused fund where the member or a successor dies after age 75.

- There is no restriction as to whom the payment is made to.
- Payment is subject to the beneficiaries' marginal tax rates (post April 2016).
- No BCE test as benefits have already been tested at age 75.

3.2 Crystallised Money Purchase Plans In Drawdown (Personal Pensions)

3.2.1 Death Before Age 75

- There is **no restriction** as to whom the payment is made to.
- Tax free if the payment is made within the two year window.
- No BCE test as benefits already crystallised.

3.2.2 Death After Age 75

This is the unused fund where the member or a successor dies after age 75.

- There is no restriction as to whom the payment is made to.
- Payment is subject to the beneficiaries' marginal tax rates (post April 2016).
- No BCE test as benefits already crystallised.

3.3 Lifetime Annuities Protection (Conventional Guaranteed Annuities)

It is now possible to build into lifetime annuities a provision to pay a lump sum on premature death. For instance, an annuity might have a lump sum death benefit which provides for a return of surplus funds on premature death, i.e. (pension x 20) – payments received).

3.3.1 Death Before Age 75

- There is no restriction as to whom the payment is made to.
- Tax free if the payment is made within the two year window.
- No BCE test as benefits already crystallised.

3.3.2 Death After Age 75

- There is no restriction as to whom the payment is made to.
- Payment is subject to the beneficiaries' marginal rates of tax (post April 2016).
- No BCE test as benefits already crystallised.

3.4 Scheme Annuity Protection (DB Pensions And Large Schemes)

It is now possible to build into lifetime annuities a provision to pay a lump sum on premature death. For instance, an annuity might have a lump sum death benefit which provides for a return of surplus funds on premature death (i.e. (pension x 20) – payments received).

3.4.1 Death Before Age 75

- There is no restriction as to whom the payment is made to.
- Tax free if the payment is made within the two year window.
- No BCE test as benefits already crystallised.

3.4.2 Death After Age 75

- There is no restriction as to whom the payment is made to.
- Payment is subject to the beneficiaries' marginal tax rates (post April 2016).
- No BCE test as benefits already crystallised.

3.5 Uncrystallised Fund Pension Lump Sum (UFPLS)

By its nature the UFPLS is a one-off payment so the proceeds will fall into the member's estate.

3.6 Trivial Commutation (Mainly DB Schemes)

Trivial payments are those with a value of £30,000 or less.

3.6.1 Death Before Age 75

- Where this is a scheme pension **only dependants** can benefit.
- Tax free if the payment is made within the two year window ***and*** the recipient has not received any income from the scheme.
- Taxable at the beneficiaries' marginal tax rates, if some income has been paid already.
- No BCE test as benefits already crystallised.

3.6.2 Death After Age 75

- Where this is a scheme pension only dependants can benefit.
- Taxable at the beneficiaries' marginal tax rates.
- No BCE test as benefits already crystallised.

3.7 Charitable Lump Sum Benefits

To succeed with a tax free charitable donation the member, nominee, successor or dependant must die in drawdown prior to age 75 or post 75 BCE test with **no other dependants**. The deceased must have nominated a charity to receive the benefits (the administrator cannot make the choice for them).

4. INCOME DEATH BENEFITS

For income which starts to be taken post 2015 there are now 5 forms of continuing income after death.

DO NOT discount the idea of leaving the pension fund to provide income for your beneficiaries. Whilst a tax free lump sum into a trust or to a recipient may be attractive, where your beneficiaries are well off they may prefer to take the fund and hang onto it so they can pass same onto the next generation. For deaths subject to tax post 75 this may well be much more tax efficient than a lump sum which would push an individual into 45% tax (and trusts are subject to 45% tax regardless).

4.1 Uncrystallised Or Unused Money Purchase Pension Funds (Personal Pension)

4.1.1 Uncrystallised Death Before Age 75

This is the death of the previous beneficiary be that the member, or a successor.

- There is no restriction as to whom the payment is made to.
- Tax free if the payment is made within the two year window.
- BCE test against the member's lifetime allowance (LTA) if the payment is made within the two year window. There will be 55% LTA tax to pay on excess.
- No BCE test against the members lifetime allowance (LTA) if the payment is made outside the two year window (note could pay to wait until outside two year window).

4.1.2 Unused Death After Age 75

This is the death of the previous beneficiary be that the member, or a successor.

- There is no restriction as to whom the payment is made to.
- Taxable at the beneficiaries' marginal tax rates.
- No BCE test as benefits have already been tested at age 75.

4.2 Crystallised Money Purchase Plans In Drawdown

Remember that taking the whole pension as a lump sum is only one option! Your beneficiaries may prefer to take drawdown tax free or subject to lower tax rates.

4.2.1 Death Before Age 75

- There is no restriction as to whom the payment is made to.
- Tax free if the payment is made within the two year window.
- No BCE test as benefits already crystallised.

4.2.2 Death After Age 75

- There is no restriction as to whom the payment is made to.
- Taxable at the beneficiaries' marginal tax rates.
- No BCE test as benefits already crystallised.

4.3 Lifetime Annuities Protection

This is the joint life/last survivor or proportionate payment to a beneficiary under a lifetime annuity contract from a non-occupational pension plan.

4.3.1 Death Before Age 75

- There is no restriction as to whom the payment is made to.
- Tax free if the payment is made within the two year window.
- No BCE test as benefits already crystallised.

4.3.2 Death After Age 75

- There is no restriction as to whom the payment is made to.
- Taxable at the beneficiaries' marginal tax rates.
- No BCE test as benefits already crystallised.

4.4 Scheme Annuity Protection (Defined Benefit Pensions And Large Schemes)

- Dependants scheme pensions **remain taxable on the recipient** (i.e. WDIR).
- There is no BCE test.

4.5 Trivial Commutation And Small Pots

Are by their nature paid as a lump sum.

5. INHERITANCE TAX (IHT)

The introduction of the nominee class of beneficiary would seem to open up pension funds to an attack for IHT since the current concession that pension funds are outside one's estate relies on the nomination form leaving discretion with the scheme administrator and a nominee request does not. HMRC has thus far confirmed that the IHT exemption will continue to nominees as well as decisions made by scheme administrators who refer to expression of wishes forms.

5.1 HMRC Stated Reasons To Attack The IHT Exemption

We have not seen a single attack on a deceased client's pension fund passing outside their estate, however, the following are areas which have been raised as possible issues:

- If a contribution is made when the contributor is in ill health HMRC could attack this as tax planning, not pension savings;
- If the plan is put into trust and/or significant changes are made to the beneficiaries which are beneficial from an IHT perspective when the contributor is in ill health, HMRC may attack the arrangement;

- If the contributor defers retirement and dies within 2 years of taking the action then HMRC may attack the arrangement unless it is crystal clear from the documentation that the reasons for deferring retirement were nothing to do with estate planning.

5.2 The Lifetime Allowance

Your lifetime allowance (LTA) is £1,073,100 million (2020/210 tax year) unless you have individual or fixed protection.

The inheritance tax treatment of death benefits has no effect on the HMRC tax treatment of the lifetime allowance. Therefore, if your death benefits exceed the lifetime allowance applicable to you, your beneficiaries will pay 55% tax on the benefits (see 6.1 below).

6. OTHER ISSUES RELATING TO THE TAX TREATMENT OF BENEFITS

6.1 Death In Service

Increasingly, we are seeing clients with large death benefits written under pensions legislation. People forget that these benefits are subject to the lifetime allowance which is £1,073,100 (2020/21 tax year).

The simple expedient of replacing these group schemes with a ***relevant life*** arrangement can avoid this tax trap.

6.2 Scheme Rules

Although it seems unlikely scheme rules will not have been changed to accommodate the new tax regimes it has to be pointed out that scheme rules override many tax rules and so could prevent the new freedoms being available to you.

6.3 Overseas Schemes

Most of the schemes used (e.g. QROPS, RNUKS) have broadly similar tax rules for payments to beneficiaries. Check with your scheme provider for further information.

7. GETTING YOUR BENEFITS TO THE RIGHT BENEFICIARIES

If you have a large estate then planning the death benefits from your pension plan should be part of a global IHT strategy where you take specialist legal and taxation advice.

7.1 Nomination Forms And Global Trust Schemes

Most pension funds are set up under a global trust. This means that in the event of the death of a contributor the trustees of said trust have absolute discretion as to where the funds go. This means that where the trustees have such discretion death benefits will not normally fall into part of a deceased's person's estate and the scheme administrators/trustees have up to 2 years to arrange the death benefits to be paid to beneficiaries.

A nomination form is nothing more than a request to trustees that they consider your wishes post your death. The trustees are not obliged to follow your wishes, but in reality nearly always do.

We have been using a much wider wording in recent nominations to try and give clients the maximum flexibility for instance:

If she is alive my preference would be to let my wife continue to draw upon my pension for her lifetime, however, if Frances has pre-deceased me then I would like my children and / or grandchildren to benefit. My financial advisers, Swallow Financial Planning, will be able to provide you with details of any beneficiaries and current addresses and I would appreciate it if you would listen to their advice as to which beneficiary should receive any income / funds remaining.

7.2 Creating Your Own Discretionary Trust

The alternative to using the nomination form would be to create your own discretionary trust (sometimes called a spousal bypass trust) for one or several of all your pension funds. This can be an expensive exercise (typically £400 for a simple trust).

This would only really be an option up to age 75 since after 75 lump sum benefits to a trust are taxed at 45%.

The tax treatment of a trust is worse than simply passing the pension benefit to a chosen beneficiary since once the pension fund is in the trust ongoing investment is subject to discretionary trust taxation.

Any capital growth within the trust over and above the trust annual exemption (currently £6,150) will be taxed at 28%. Any income over £1,000 will be taxed at 45%.

Depending on the amount of money in the trust, there may be inheritance tax charges – periodic charges every 10 years and an exit charge if the beneficiaries take the money out.

If you simply nominate the pension income the growth remains tax free within a pension fund and the income is tax free.

Nonetheless, a trust may well be appropriate if you have specific requirements. The surviving spouse may be in a nursing home and you want to prevent local authority attack, there may be a minor or special needs individual or a complicated IHT position all of which can be planned for with your legal and taxation advisers.

7.2.1 Residential Nil Rate Band

We have recently learned however that your pension fund will be included within your estate for the purposes of the Residential Nil Rate Band (RNRB) if the death benefits are not put into trust. This could be costly for inheritance tax purposes. Moreover, the use of a trust can add flexibility when deciding who should inherit the pension.

7.2.2 Possible Nomination Wordings With Pensions Trust

Again, flexibility can be given by judicious use of the nomination form:

If I should die before the age of 75 I would like to nominate my pensions trust. Should I die after age 75 then I would like my fund to benefit my gardener Fred Titmus if he is still alive, failing that pay a lump sum to the cats home registered charity number 12345. My financial advisers, Swallow Financial Planning, will be able to provide you with details of any beneficiaries and current addresses and I would appreciate it if you would listen to their advice as to which beneficiary should receive any income / funds remaining.

8. OTHER NOTES

We have a number of other notes relating to the tax treatment of pension funds, they can be found on our website under Library.

Please note that whilst every effort is made to ensure that the information contained within this explanation is correct, these notes are by necessity brief and of a generalised nature. Clients should seek specific personalised advice prior to undertaking any arrangement. These notes are named 09.2020 The Tax Treatment Of Pension Death Benefits and were last updated in September 2020. Whilst we have done our best to ensure facts are current to this date laws and options are changing constantly so always check before action.

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