AWFM Fact File

"Pension Death Benefits"

December 2015

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The way pension fund death benefits are treated has changed quite dramatically over the years and particularly in the last year or so. The rules are complicated and there is every chance of finding situations that don't necessarily fit this analysis but we have sought to provide an overview of the tax position and options for pension fund benefits on death.

This Fact File specifically relates to the taxation of Money Purchase pension schemes (cash based pension plans) including Income Drawdown and Annuity plans but not Defined Benefit Pensions (Final Salary Schemes etc.). At present the new rules do not apply to Defined Benefit schemes although we would expect this to change in the years to come to potentially address this imbalance.

Pre or Post age 75 – crucial for tax purposes
With the tax position of any payments, the most critical issue is whether the pension fund member dies before age 75 or after. Death before age 75 produces a completely tax free payment to beneficiaries, whether income or capital, providing the administration of death benefits is dealt with within 2 years from the death of the pension fund member. Conversely, after the age of 75, or if the administration of the death benefits lingers past 2 years from the death of the member, any payments made to beneficiaries will be taxed at the marginal rate of the recipient.

Tax treatment for 2015/16 tax year different
A further complication is that if lump sum payments are made in the 2015/16 tax year (before 6th April 2016) from a fund from someone who died after the age of 75. In the 2015/16 tax year the lump sum payment in this scenario will be taxed at 45%, whereas from the tax year 2016/17 onwards, a lump sum payment will be taxed at the marginal tax rate of the beneficiary.

The payments out also depend on the pension contract being used:

Annuity
If the deceased had purchased an annuity, the death benefits payable to a spouse or other financial dependent will be determined by the options taken by the deceased when they purchased the annuity. If for example, the deceased was married, they most probably built in a spouse's pension which produces an income to the spouse for the rest of their lives. Reference therefore needs to be made back to the original annuity policy schedule.

Typically the most common option is probably that the surviving spouse would receive exactly the same amount as the deceased, but it could be half or two-thirds of the initial income.

It is also possible that the individual took out some other form of annuity protection:

- Guarantee period – if they died within the initial guarantee period, the balance of income payments up to the end of the period will become payable.
- Value protection – on either a 1st death or a 2nd death basis this option would ensure that the amount invested into the annuity less any withdrawals will be returned to the estate. This option could be set at 100%, 75%, 50% etc. of the original amount invested into the annuity.

If the main annuitant died before age 75, the payments to the dependent or Estate will be tax free. If the main annuitant died after the age of 75, the income or capital payments generated will be taxable as income to those who receive the money.

Usually on 2nd death any guarantee period or value protection will have been exhausted and so more than likely, the pension payments will cease and nothing further will be paid.

Capped Income Drawdown, Flexi-Access Drawdown and Uncrystallised Fund Pension Lump Sum (UFPLS)
The main alternative to annuity purchase is one of these flexible options in drawing retirement benefits. These three "Drawdown" options are all treated the same essentially for death benefits and tax treatment. Those with relatively

small pension funds when they come to retire may well withdraw their tax free cash as well as the rest of the pension fund in one go (usually via UFPLS). For these individuals there will be no pension fund left when they die and so this Fact-File will not apply.

In the main however, individuals will use any of these options to provide themselves with a flexible pension income where the pension fund will remain invested. In these instances, if the pension fund member dies before age 75, the remaining pension fund can be paid out to beneficiaries entirely tax free. A lump sum payment can be made to the nominated beneficiary or the beneficiary can choose to continue with the pension fund, drawing an income from the fund if desired. Where the original holder of the fund was taxed on the income drawn from the fund, the nominated beneficiary will not be taxed on the income or capital payments.

However, if the member dies after the age of 75, the fund can still be passed onto a nominated beneficiary but the income or lump sum payment(s) made will be subject to income tax at the beneficiaries' marginal tax rate. This makes the lump sum payment option less attractive for larger pots on death after 75, as the tax paid could be up to 40%.

In either case the beneficiary can continue with a flexible pension or they can purchase an annuity for themselves:

- Beneficiaries' newly purchased annuity – this will be based on the beneficiaries' age, their state of health etc. If the purchase price is based on a fund from an individual who died before age 75, the annuity income payments will be tax free to the new beneficiary. If the original pension fund holder died after the age of the 75, the income payment will be taxable to the recipient. The same death benefits options exist for a beneficiary's annuity as for any normal annuity and the tax treatment of the death benefit would depend on the age the beneficiary who established the annuity died (age 75 or after).

- Maintain some form of Drawdown product – this option would potentially help to preserve the value of the pension fund for further potential beneficiaries but the fund would remain invested and so does carry ongoing investment risk. Again the taxation of the death benefits for future beneficiaries would depend on the age the current pension fund holder died.

For those with some form of Flexible Pension, if the original member dies before age 75, the beneficiaries' of the pension fund will not have to pay any tax on withdrawals. This is clearly a significant advantage over those who benefit from a pension fund from a member who dies after the age of 75 although this latter eventuality is likely to be the most common.

Nomination of Beneficiaries

Lastly, it should be noted that whilst it is now possible to nominate any beneficiary for a pension fund, not just a dependent of the member, pension scheme trustees (the pension administrator usually) will always offer the pension fund to any surviving dependent first and may in some cases overturn the nominations of a pension fund member. Despite any nomination, pension trustees are duty bound to pass death benefits to a spouse or other dependents.

Where a surviving dependent exists, in order to pass on the fund to a non-dependent beneficiary, such as children or grandchildren for example, the new beneficiaries would need to have been nominated in some form by the original pension member. Therefore, pension scheme trustees are now suggesting nominating children or grandchildren on "Expression of Wish" forms, even with only 1% to each beneficiary, so as to allow them flexibility to pass on a pension fund to non-dependent beneficiaries where there is a surviving dependent who does not need the pension fund.

Taking this point further, it seems that in order for a pension fund to be left to charity on death of the original member, there must firstly be no surviving dependents of the *original* member, and secondly the charity must have been nominated by the original member or surviving dependents. Without a nomination, it seems that pension scheme trustees are not able to pass a pension fund onto charity. Importantly too, if a payment were made to a charity on death of the original member, and the surviving dependents rejected the pension fund, the payment to charity would be made less a 45% tax charge! This therefore makes death benefit payments of pension funds to charity where surviving dependents exist incredibly unattractive. In these instances, payment of the pension fund to a charity or charities would be best left until after the death of any surviving dependents.

If you have any questions or need an independent review of your pension arrangements, please contact us to discuss your situation further.

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