Death benefits

One of the most interesting aspects of the retirement reforms is the death benefit rules.

The improvements in the tax treatment mean pensions now play a key part in inheritance tax planning. As people other than 'dependants' can now inherit pension funds, this allows clients to plan how to pass on pension wealth down the generations.

The two-year payment rule

Funds on death before age 75 must either be paid out as a lump sum or else designated as drawdown (for the dependant, nominee, or successor). But this must be done within two years of the member's death. Otherwise the funds will be taxed as if the member had died after age 75.

The rules

The tax position of pension death benefits significantly improved from 6 April 2015. The main difference in the tax treatment is if the member dies before age 75 or after.

The tax treatment of annuity income on death brought in line with flexi-access drawdown (Fad) plans, so the restriction that income can only be paid to a 'dependant' was removed. Joint-life annuities can be paid to any nominated individual when the main annuitant dies. But unlike drawdown, when the beneficiary dies the annuity income cannot be passed onto anyone else. With drawdown it's possible to continue passing on the fund until it runs out.

	Die before 75	Die after 75
Lump sums if no money has yet been withdrawn (uncrystallised funds)	Tax-free	Marginal income tax The fund can be paid to a trust as a lump sum less a 45% tax charge
Lump sum from drawdown	Tax-free	Marginal income tax The fund can be paid to a trust as a lump sum less a 45% tax charge
Income from drawdown	Tax-free	Marginal income tax
Income from annuities	Tax-free	Marginal income tax
Annuity protection lump sum	Tax-free	Marginal income tax The fund can be paid to a trust as a lump sum less a 45% tax charge

Changes from budget 2016

In the budget 2016, the government set out plans to make several changes to pensions death benefits, to:

- allow those in serious ill health to take lump sums from their drawdown pension even if the pension had been accessed (previously money could only be taken from uncrystallised funds);
- those who have less than a year to live, who are now able to take their money from their pension pot tax-free up to age 75, or taxed at their marginal rate of income tax after age 75 (previously it was a flat rate of 45%);
- pay charity lump sums from uncrystallised money even if the member is under age 75 at death (previously this was only allowed if the member was over age 75); and
- allow dependants under the age of 23 who would previously have had to use all their funds by age 23 to be able to continue to access these funds as they wish after their 23rd birthday.

Importantly, it's the date of the first payment of death benefits that determines what tax is to be deducted, rather than the date the member dies. So even if someone died before 6 April 2015, then it's possible to ask the scheme administrator to delay the payment of the benefit until the new rules take force, and so take advantage of the better tax regime.

Dependants, nominees and successors

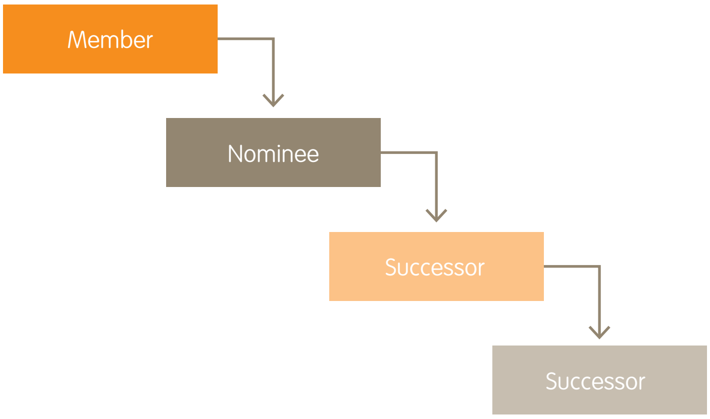
Under the pension death benefit regime it is possible to pass on death pension benefits – either lump sum or income from either drawdown or annuity - to anyone the member chooses.

Before April 2015, the pension fund could only be inherited by dependants (normally a spouse, partner or a child under 23). Now, the member can choose for a dependant to inherit, or they can choose a 'nominee' – who can be anyone nominated by the individual (even if they are not related to them). If the member made no nomination and there are no dependants, the scheme administrator can nominate an individual to become entitled to the funds.

Death benefits

That beneficiary can also nominate a successor to 'inherit' the pension funds on their subsequent death. A successor can again be anybody. If no nomination has been made by the beneficiary then the scheme administrator can nominate someone.

If there are any funds still remaining, then it's possible for the successor to nominate yet another successor. Again, this can be anybody. This way it's easy to see how pension wealth can cascade down the generations – or indeed, more widely.



Uncrystallised funds

Where no money has yet been withdrawn (uncrystallised funds), beneficiaries can use the inherited funds to take a lump sum, take income from a Fad, or buy an annuity. However, successors – see above – cannot use uncrystallised funds to take income from Fad. They can only take a lump sum or buy an annuity.

A new Benefit Crystallisation Event (BCE) was introduced from 6 April 2015 for uncrystallised funds. This is used when a member dies before age 75 and their remaining uncrystallised funds are designated for a dependant's or nominee's Fad. The amount tested against the member's lifetime allowance is the amount that's designated. The liability for any charge that arises falls on the dependant or nominee, which again can be anybody. If no nomination has been made by the beneficiary then the scheme administrator can nominate someone.

IHT and pension death benefits

Usually any pension funds are free of inheritance tax (IHT) as they are paid out under the discretion of the trustees or a scheme administrator. If the member dies before age 75 – and the benefits are tax-free – then it's obvious that keeping funds within the pension wrapper is a tax-advantageous way of passing wealth to the client's family.

Even if the member dies after age 75, then it's probable the beneficiary's marginal tax rate will be lower than the IHT tax rate of 40% - for example in the case of grandchildren. Again, keeping the funds within the pension wrapper may mean more money can be passed to the family.

If you only read one thing read this

- The tax treatment of pension benefits depends upon the age the member dies. If the member dies before age 75, then pension benefits can be paid out tax free. If the member is older, benefits will usually be taxed at the recipient's marginal rate of tax.
- It's possible to nominate anyone to receive the funds on death – giving clients much wider scope to plan, for example passing pension funds to (grown-up) children or grandchildren rather than being forced to leave them to a spouse.
- Unused pension funds can potentially be passed from the member to the nominee to a successor to another successor and so on.
- While legislation allows this flexibility, it's up to schemes and pension providers to decide what options to offer members.
- Nucleus provides the full flexibility possible under the new rules.

Scotland, NI and north west England 0131 226 9815
North east and south east 0131 226 9808
Midlands, south west and Wales 0131 226 9804
London and south 0131 226 9801