Dependants, nominees and successors

Some of the most significant changes from the pensions freedoms introduced in April 2015 were the ways to pass on pensions wealth.

Unused pension funds can be passed to whoever a pension scheme member nominates, whether they are related or not. If the pension scheme member dies before age 75, then there is no income tax to pay on receipt of these benefits. Furthermore, if when the beneficiary subsequently dies and there remains unused pension funds, then these too can be passed onto others (successors).

However, the rules surrounding who these benefits can be passed on to, and the format they may be passed on, are deceptively complex.

This factsheet explains how pension benefits can be passed on and explores the importance for members making sure there is an up-to-date expression of wish form.

The pension death benefit rules

The pension death benefit rules allow three possible types of beneficiary:

- Dependant - spouse, civil partner, someone under age 23, or someone financially dependent or interdependent with the member.
- Nominee – an individual nominated by the member or nominated by the scheme administrator but only where there is no dependant or nomination by the member.
- Successor – an individual nominated by the beneficiary or nominated by the scheme administrator but only where there is no nomination by the beneficiary.

The beneficiary has free will to nominate whoever they want to be a successor – they don't need to have a connection with the original member.

Pension funds can be passed onto beneficiaries (and successors) in different formats, which includes:

- a lump sum;
- flexi-access drawdown; or
- an annuity.

Or any combination of the three.

Whether tax will be paid on the benefits depends on the age of the owner (whether that is the member, the beneficiary, or successor) of the benefits at the time of death.

	Age of the owner (member, beneficiary, or successor) when they died	
Who are benefits paid to?	Before age 75	After age 75
Beneficiary or successor	No tax	Marginal tax rate of beneficiary/ successor
Trusts	No tax	45%

Any benefits paid to a registered charity are always tax free. A charity lump sum can only be paid where there are no surviving dependants of the member. If the lump sum is being paid because of the death of a beneficiary it must be paid to either:

- a charity selected by the member or,
- if the member had not chosen a charity, a charity selected by the beneficiary.

The scheme administrator cannot choose the charity receiving the payment.

The two-year rule

Pension funds have to be designated to beneficiaries within two years from the earliest of the scheme administrator first being notified of the member or subsequent owner's death (or when they could have reasonably known about their death).

If the designation of death benefit funds is outside this two-year window, then income tax is due on the payment of the benefits – regardless of the age of the member (or beneficiary/successor) when they die. However, no lifetime allowance charge will be due on any excess pension funds.

It's important to be aware of this rule. It can be tricky to sort out some death benefit cases, and work out to who the benefits should be paid. But if this takes too long to establish, then it will mean an unnecessary tax charge.

However, it could be that there are circumstances when someone has benefits in excess of the lifetime allowance when it may be beneficial to pay benefits outside the two-year timescale to reduce the tax charge they have to pay by avoiding the lifetime allowance charge. It could be HMRC decide to make changes to this in future.

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Example: Two year rule - Shirley

Shirley dies aged 73 with a £1.35m pension fund. She has no protection. She has nominated two beneficiaries to receive her pension funds on an equal basis – her daughter Liz, who is a higher rate taxpayer, and her grandson Daniel, who is a basic rate taxpayer.

Within the two years of Shirley's death, the scheme administrator designates £1m to the beneficiaries to be split equally. This is 100% of Shirley's lifetime allowance so no additional charge is due, and as Shirley died younger than 75, the benefits are paid out tax free.

Liz decides to take her share of the excess of £175,000 as flexi-access drawdown income. There is a 25% charge on the excess amount, but no income tax.

Daniel leaves his £175,000 share of the excess until after the two-year period has expired. In these circumstances there is no lifetime allowance charge (25%) to pay, although he will have to pay income tax of 20% on his drawdown income.

Example: The importance of nomination – Alice

Alice is married to Tony, they have two grown-up children – Fiona and Stephen.

On Alice's death, Tony decides he does not need any of her pension fund, and instead he would like Fiona and Stephen to each receive the pension fund benefits as an income.

Scenario one: Alice had completed a nomination form nominating Tony, Fiona and Stephen

Tony is Alice's dependant – as they were financially interdependent on each other. However, as Alice has included her children on the nomination form, the scheme administrator has the discretion to pay the pensions benefits as drawdown to Fiona and Stephen only (as Tony has decided not to take any benefits).

Scenario two: Alice had completed a nomination form nominating only Tony

As Alice has only included Tony on her nomination form, the scheme administrator has no discretion to pay out the pension funds as drawdown to Fiona and Stephen. However, the scheme administrator can pay out the funds as a lump sum to the two children.

Scenario three: Alice had not completed a nomination form.

As Alice had not completed a nomination form, but there was a dependant, then the scheme administrator can only pay drawdown to Tony. Again, they have discretion to pay the funds as a lump sum to the two children.

Example: Age 75 – Jason

Jason is 74 years old and is married to Isabell, a higher rate taxpayer. They have a 17 year old son Ben, who is planning on going into higher education.

Until now, Jason had nominated Isabell to receive an income with his drawdown plan on his death. And if Jason had died before his 75th birthday, then Isabell would not have had to pay income tax on the drawdown income.

As he approaches his 75th birthday, Jason changes his nomination form to say only Ben should inherit his pension funds. This means Ben may not have to pay income tax on any benefits should Jason die over the next few years.

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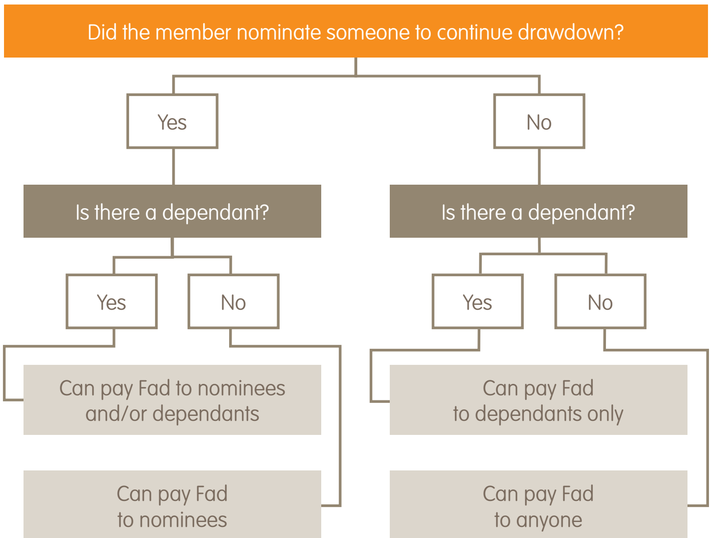
The importance of nomination

One of the most appealing aspects of pension savings is that on death they usually sit outside the estate when calculating inheritance tax. This is because pension schemes are set up as discretionary trusts. Therefore, when a pension scheme member dies they cannot dictate who receives unused pension funds, instead the scheme administrator has the discretion to decide who the beneficiary(ies) or successors are.

However, the member (or beneficiary/successor) can express their wishes about who should inherit pension funds, and, because of the tax rules, it's important that they complete a nomination form. If they do not nominate someone, then the scheme administrator may not be able to pay pension income to that person – particularly if there is a dependant:



It's important to remember, the scheme administrator always has discretion to who the benefits should be paid. And that they always retain the discretion to pay a lump sum to anyone regardless of who has been nominated and whether there are any dependants.

Members should make sure they keep their nomination (or expression of wish) forms up-to-date. It's important they nominate who they want to receive benefits. Giving a percentage split of how the funds are distributed is not as important – but recording the names of who they wish to benefit is.

Age 75

The tax treatment of death benefits changes depending on whether the member (or beneficiary or successor) dies before the age of 75 or after. If they die before, then (usually) there will be no tax paid on the pension funds passed on. But if they die after age 75 the beneficiary or successor may have to pay tax (at their marginal rate of tax).

As they approach their 75th birthday, members (and beneficiary(ies) and successors) will want to review their nominations of who will inherit pension funds, and possibly make changes to mitigate tax paid.

If you only read one thing read this:

- On the death of a member, pension funds can be passed onto a beneficiary (which could be a dependant or nominee), and then subsequently onto a successor.
- If the member (or beneficiary or successor) dies under the age of 75 then there is no income tax paid when the beneficiary or successor takes the benefits. If the member (or beneficiary or successor) is over age 75, then the beneficiary (or successor) pays income tax when they take the benefits at their marginal rate of income tax.
- If the pensions funds are not paid within two years of the member's death (or when the scheme administrator could have reasonably known about the death) then income tax will be due when the benefits are paid out (regardless of the age of the member/beneficiary when they died).
- It is important to complete and update a nomination or expression of wish form. Scheme administrators may not be able to pay benefits in the form of drawdown without a nomination.
- Age 75 is an important milestone – and members (or beneficiaries or successors) may want to review their nomination form to mitigate possible income tax.

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