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Briefing

Taxation of pension death benefits

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A detailed look at the rules regarding the taxation of pension death benefits with effect from 6 April 2015

The death benefits that can now be provided from SSASs and SIPPs are more tax-efficient and available to more classes of beneficiaries following the introduction of the Taxation of Pensions Act 2014 and the Finance Act 2015.

This briefing note summarises the changes to pension death benefits; in particular, the taxation implications underpinning the rules and an explanation of how drawdown funds can be cascaded down the generations; for example, from member to dependant to successor, or from member to nominee to successor.

> The headline point is that where a member dies under age 75, their loved ones (in most circumstances) will be able to receive any remaining pension savings completely free of tax.

There are, of course, caveats to this general statement, such as availability of the member's Lifetime Allowance (LTA), which are explored below.

Please note that any dependant receiving a drawdown pension that was set up before 6 April 2015 will continue to have their withdrawals taxed as earned income.

Lump sum death benefits

If the member dies **before reaching age 75**, then lump sums are now paid tax-free (to an individual, trust, or non-individual recipient) provided payment is made within two years of death.

Payments made to individuals outside of this time frame are subject to the recipient's marginal rate of income tax and are paid to them as pension income, via PAYE. Funds not crystallised by the member prior to their death are tested against the member's available LTA, with any excess taxed at 55%.

Lump sum death benefits paid to a trust, or non-individual recipients outside of this time frame will, however, be subject to a 45% tax charge deducted by the scheme administrator at source, and will not be paid via PAYE.

If the member dies **having reached age 75**, lump sum death benefits paid to individuals are also subject to the recipient's marginal rate of income tax and paid to them via PAYE.

Lump sum death benefits paid to a trust, or non-individual recipients where the member dies on or after their 75th birthday will be subject to a 45% tax charge deducted by the scheme administrator at source, and not paid via PAYE.

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Where death benefits are paid to a trust, income and capital gains tax on investments within the trust will be taxed in the normal way, and a periodic inheritance tax charge may also apply, in the case of a discretionary trust. However, no inheritance tax or income tax should apply to later captial payments made to a beneficiary.

If a lump sum death benefit is paid from a drawdown fund relating to a beneficiary such as a dependant, rather than the original member, then the tax position depends on the age of the beneficiary on death.

Key Facts

- The scheme administrator decides which individuals or trusts can receive lump sum death benefits, even where there is no Expression of Wishes completed by the member.
- A registered charity can only receive a payment where there are no surviving dependants.
- Lump sum death benefits are generally free of tax if the member died before age 75. Some payments, however, may be subject to a 45% tax charge or taxed at an individual recipient's marginal rate of income tax, where payments are not made within two years of death, or if the member died aged 75 or older..

Drawdown death benefits

The classes of individuals that can receive drawdown pension death benefits are extended with effect from 6 April 2015. Those who benefit from a drawdown pension set up on the death of a member may themselves further nominate individuals to continue to receive a pension, following their death.

As such, a member may have dependants who can receive pension income on their prior death. The member may also nominate individuals (called nominees) to receive income. On the death of a dependant or nominee, pension income could be set up for their nominated beneficiaries (called successors).

DEPENDANT	NOMINEE	SUCCESSOR
A dependant is defined as: • The deceased member's spouse or civil partner; • A child under the age of 23*; • A child aged over 23 if they suffer from some form of impairment; and • An individual who was financially dependent on the deceased member.	The Taxation of Pensions Act 2014 introduced a new class of recipient – a nominee – who can benefit from a drawdown pension. A nominee is defined as an individual other than a dependant, who has been nominated by the member or by the scheme administrator. The scheme administrator cannot name a nominee whilst a dependant of the deceased member remains alive.	Another new class of recipient - a successor - can "inherit" the pension fund on the death of a dependant, a nominee, or a previous successor. A successor can be nominated by a beneficiary of the deceased member, or by the scheme administrator.

* Where a child of the member was in receipt of drawdown pension before age 23, and reaches age 23 on or after 16 September 2016, they can continue to recieve their drawdown pension beyond age 23.

On the death of a member of a money purchase pension scheme, (which includes a SSAS and a SIPP), the remaining funds can provide benefits to a dependant or to a nominee. On their death, a successor can inherit the remaining pension fund, and this process can continue down through the generations, if and until the funds are exhausted.

Withdrawals from a drawdown fund are taxed as earned income, but there is an exemption from income tax if:

- the member or previous recipient died before age 75; and
- the drawdown fund is set up within two years of the member's death.

If these conditions are not met, then income tax is payable as normal. The two-year window only applies on the member's death (not on the subsequent death of a dependant, nominee or successor).

As previously noted, income tax continues to apply to those dependants already in receipt of taxed drawdown income prior to 6 April 2015.

Where a fund is passed to a successor on the death of a dependant or nominee, the tax position of the payment of the fund to the successor depends on how old the dependant or nominee were when they died.

If the drawdown fund is set–up from funds that the member had not yet crystallised, then there is a test against the member's available LTA, with any excess funds subject to a 25% tax charge.

Key Facts

- The scheme administrator has to establish which individuals qualify as dependants, nominees or successors. The scheme administrator can only make nominations where there are no surviving dependants, or previously-nominated nominees, or successors.
- Only dependants, nominees and successors can be set up with a drawdown fund. Neither trusts nor charities can receive drawdown income.
- Withdrawals are exempt from income tax if the member (or previous recipient of the drawdown income) died before age 75, and are subject to income tax if not.
- Any dependant that received drawdown pension before 6 April 2015 will continue to have their withdrawals taxed as earned income.
- Income tax also applies if the drawdown fund is not set up within two years of death, and there may be an additional tax charge if there is insufficient LTA.
- Where a member dies under age 75 with uncrystallised funds and insufficient LTA, and the funds on death are used to provide a dependant's Flexi-Access Drawdown (FAD) within two years of the member's death, the dependant will not pay income tax on their FAD withdrawals. This is a more tax-efficient use of the funds in excess of the deceased member's LTA.

Annuity contracts

Whereas the Taxation of Pensions Act 2014 deals with the taxation of lump sum death benefits and drawdown death benefits under the current regime, the Finance Act 2015 sets out the death benefits potentially available under lifetime annuities, with effect from 6 April 2015.

As with all options available to determine the 'shape' of an annuity, the annuitant must select which death benefits are required at the point of purchase. These include:

- survivors' annuities - from 6 April 2015 it is possible for these to be paid to nominees and successors as well as to dependants (unless the annuitant died before 3 December 2014 – in which case, the 'dependants-only' restriction will continue to apply);
- ongoing annuity payments under a guaranteed payment period (where the period is no longer restricted to ten years for annuities purchased on or after 6 April 2015); and
- 'value-protected' lump sums - or lump sums payable in respect of any remaining guaranteed payments up to the value of £30,000.

Annuity payments to a survivor (and payments under a guaranteed payment period) may be subject to an income tax exemption where all of the following are true:

- the member's annuity payments started on or after 6 April 2015; and
- the member died on or after 3 December 2014; and
- the member died under age 75.

Lump sum payments (either 'value protection' or lump sums payable in respect of any remaining guarantee payments up to the value of £30,000) may also be paid tax-free, provided:

- the member's annuity payments started on or after 6 April 2015; and
- the member died under age 75; and
- the payment was made within two years of the member's death.

Otherwise, and with effect from 6 April 2016, the lump sum is taxed at the individual recipient's marginal rate of income tax and paid via PAYE.

Key facts

- Annuities may be set up to provide for a wider class of beneficiary than just dependants.
- Income payable to a survivor may be tax-free if the annuitant died before age 75.
- Certain conditions need to be met for this to apply.

LUMP SUM	DRAWDOWN	ANNUITY
WHO CAN BENEFIT?		
Any individuals Trusts Nominated charities (if no surviving dependants)	dependants nominees successors	dependants nominees successors
TAX TREATMENT ON DEATH BEFORE AGE 75*		
0%	0%	0%
TAX TREATMENT ON DEATH ON OR AFTER AGE 75		
Marginal Rate or 45%	Income tax	Income tax
OPTIONS ON DEATH OF RECIPIENT		
In recipient's estate	Lump sum payment or drawdown for a new successor	Depends on death benefit options included within annuity contract

* assumes death on or after 3 December 2014 (for Annuity), no breach of Lifetime Allowance and benefits settled within two years of death.

Deciding who receives death benefits

Our SSASs and SIPPs are set up as discretionary trusts, which means that death benefits paid from them are paid at the discretion of the trustees/operator and so should not suffer Inheritance Tax.

Note that where there have been unusual contributions in the two years prior to death, HM Revenue & Customs may determine that contributions have been paid to avoid inheritance tax and so seek to include the value of those contributions in the value of the deceased's estate.

The current regime means that completing an 'Expression of Wishes' form, and then keeping that form up to date, has become increasingly important; despite the fact that these forms are not legally binding. Maintenance of a comprehensive, and contemporaneous, Expression of Wishes form will greatly help the trustees/operator decide who should receive death benefits.

Case studies

1. 45 year old, unvested, with spouse and young children.

(a) Mr Selby unfortunately dies in an industrial accident at his place of work. His completed Expression of Wishes form nominated his spouse as the sole recipient of his pension fund. As Mrs Selby was dependent on Mr Selby as a non-working mother, the BW SIPP Operator used its discretion to pay Mr Selby's entire pension fund to her, free of both inheritance tax and an income tax charge.

(b) Alternatively, if Mr Selby had established a discretionary trust prior to his untimely death and nominated the trust on his Expression of Wishes form, the BW SIPP Operator could transfer the entire fund value on death to the trust, rather than to his spouse. This could then offer the following future benefits to Mrs Selby and her children;

   (i) The fund does not then form part of Mrs Selby's estate, for inheritance tax purposes;

   (ii) As a trustee and potential beneficiary of the trust, Mrs Selby could take an interest-free loan from the trust to fund, for example, school fees for her children. The loan would then form a debt on her estate for inheritance tax purposes; and

   (iii) As the children would also be potential beneficiaries of the trust, monies could be distributed on their behalf at a future date to fund, for example, university fees.

2. 55 year old, unvested, with independent children.

(a) Mrs O'Sullivan is divorced and has two children who are no longer financially dependent upon her. She dies at age 55 following a short illness. Her Expression of Wishes form only nominates her ex-husband, as she did not update it following their separation. However, as the BW SIPP Operator has ultimate discretion over who the death benefits are to be paid to, its subsequent investigations into her marital status lead it to distribute her BW SIPP fund as equal lump sums to her two children, within two years of her death. The two lump sums are not therefore subject to either income tax or inheritance tax.

(b) Alternatively, the BW SIPP Operator could have used its discretion to set up income-tax free FAD payments to the two children. Care should be taken to ensure that these payments are not aggregated with their other sources of (taxable) income, to avoid putting them into a higher income tax bracket, and possibly affecting their personal allowance.

3. 65 year old, vested, with spouse and independent children.

(a) Mr Hendry has recently retired from work and has vested his BW SIPP fund into FAD, from which he is drawing a regular monthly income. Unfortunately, he then dies, and his Expression of Wishes form nominates 60% of his fund to his surviving spouse, aged 64, and 20% to each of his two financially independent children. As he has died under age 75, the death benefits are payable free of income tax. The BW SIPP Operator subsequently ascertains that Mrs Hendry was financially dependant on Mr Hendry, as her only other source of income was a relatively small state pension. The BW SIPP Operator therefore uses its discretion to distribute the entire fund on death to Mrs Hendry, in the form of an income tax-free lifetime annuity, so as to provide her with a known, guaranteed income for the rest of her life.

(b) At the point of purchasing the annuity, Mrs Hendry chose to include a 20-year guaranteed payment period within its 'shape'. Mrs Hendry subsequently died aged 74, meaning that ten years of the guaranteed payment period remained. As the lump sum equivalent of the remaining guaranteed payments was less than £30,000, this was shared equally between the two children, and because Mrs Hendry died under age 75, the lump sum payments were free of income tax.

4. 75 year old dependant, widowed, with independent children and grandchildren.

(a) Mrs Robertson is in receipt of drawdown payments from her deceased husband's BW SIPP fund, which commenced on 7 April 2015. She completes an Expression of Wishes form, leaving 50% of her fund to each of her grandchildren, who are both at university and do not pay any income tax.

She dies a year later, aged 76. The BW SIPP Operator uses its discretion to commence FAD payments to each of her grandchildren, with the intention of exhausting the fund before they each attain age 23, (although legislation now enables them to continue to receive these income payments beyond age 23, if preferable).

Based on the amounts received relative to their personal allowances, the grandchildren pay no income tax on the drawdown funds received, and use the money to pay-off their university tuition fees, and related maintenance loans; so enabling them to graduate with no accrued debts.

(b) Alternatively, as Mrs Robertson leaves no surviving dependants, she nominates her favourite charity on her Expression of Wishes form. On her death, the BW SIPP Operator uses its discretion to pay a Charity Lump Sum Death Benefit to her nominated charity which, despite her age of death, is not subject to the usual 45% income tax charge.

Action points

- Decide how you would like your pension funds to be applied on your death.
- Complete an Expression of Wishes form, or otherwise notify the trustees or scheme administrator.
- Keep your decision under review, especially following life events such as marriage, children, divorce or death of a loved one.

This document is for information only and should not be construed as advice.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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