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The information contained in this document is based on our understanding of HM Revenue & Customs (HMRC) rules & practice. It is provided as a summary only; Readers should refer to HMRC's Registered Pension Schemes Manual, the draft Pensions Taxation manual and other suitable sources for full details. Whilst every effort has been made to ensure accuracy, no responsibility can be taken for actions taken, or refrained from being taken, as a result of this information.

Pension Freedoms Briefing Note – Death Benefits

The Budget of March 2014, together with the Autumn Statement of the same year, heralded the biggest change to the taxation of pensions since April 2006. We have summarised below some of the key points and taxation aspects surrounding death benefits as embodied within the Taxation of Pensions Act 2014 and Finance Act 2015. The latter brings the position on annuities broadly in line with that for drawdown.

This Briefing Note follows on from our Pension Freedoms Briefing Note on retirement options and contributions. These changes which apply, in the main, to Defined Contribution (DC) schemes, became effective on 6th April 2015.

We believe that the scheme rules of the Yorsipp SIPP, and those of the SSAS schemes we administer, are drawn up in such a manner as to facilitate the options under the new Freedoms. However, in any event, it is worth noting that the Government has introduced a permissive statutory override which allows trustees of schemes, if they so choose, to operate under the new rules without actually having to make amendments to scheme rules. In addition, where a scheme can offer the new Freedoms but does not do so, the member has a statutory right to transfer to a scheme that does.

Broadening the class of individuals who can receive a pension income from a deceased member's fund

Prior to 6th April 2015, there was no restriction as to whom authorised **lump sum death benefits** could be paid to (for example, this could include a trust nominated by the member); this continues to be the case from 6th April 2015.

However, before this date, only a dependant of the original member was able to receive an authorised **pension income** from any unused pension fund of a deceased member. This is subject to scheme rules of course. A "dependant" is defined in Finance Act 2004. Broadly this covers:

- The member's spouse or civil partner at the date of the member's death or, if scheme rules permit, at the date the member first started to take benefits.
- A child under the age of 23.
- A child over age 23 but who in the opinion of the Scheme Administrator was, at the date of the member's death, dependant on the member due to physical or mental impairment.
- Any other person who, in the opinion of the Scheme Administrator was, at the date of the member's death, financially dependent on the member or financially interdependent with the member (mutual dependence) or dependent on the member due to physical or mental impairment.

With effect from 6th April 2015, the class of beneficiary able to receive pension income from any unused pension fund following a **member's** death has been extended considerably. This can be any individual, including adult children & grandchildren, provided they fall into one of the following categories:

- Dependant (see above)
- Nominee

A **Nominee** can be any individual nominated by the member, or nominated by the Scheme Administrator who is not a dependant of the member. However, no individual nominated by the Scheme Administrator counts as a nominee at any time when there is a dependant of the member, or an individual or charity has been nominated by the member.

The legislation also introduces another class of beneficiary:

- Successor

A **Successor** can be any individual nominated by a Dependant, Nominee or Successor (beneficiaries) of the member, to receive any remaining funds on their death; or anyone nominated by the Scheme Administrator in such a situation. No individual nominated by the Scheme Administrator counts as a Successor of the beneficiary if there is an individual or charity nominated by the beneficiary.

This new broader definition allows unused pension funds, in theory, to be passed down through the generations from Successor to Successor.

The above illustrates the importance of ensuring up to date nominations/Expression of Wish forms are provided to the Scheme Administrator by members; and any beneficiaries following their death.

Scheme Administrator retains absolute discretion

It is important to note that the Scheme Administrator / trustee of a Registered Pension Scheme should retain absolute discretion as to whom they pay death benefits. As outlined above, whilst the legislation restricts the class of beneficiary that can receive a pension income from any remaining fund, the Scheme Administrator retains the option of paying a lump sum death benefit to any person. If this was not the case, and nominations were legally binding on the Scheme Administrator, death benefits could potentially be included in deceased's estate **for Inheritance Tax purposes (IHT)***. This could occur if a member had an unfettered right to bind the Scheme Administrator / trustees or had a power of nomination to dictate that they pay the death benefits to a specific person or their own estate.

See HMRC guidance; *IHTM17052 – Pensions: IHT charges: general power over death benefits*

In summary, whilst a Scheme Administrator will invariably take into account the information contained within an Expression of Wish form, and most often than not follow this, they are not bound to do so.

* In relation to IHT, the position post 5th April 2015 remains the same as previously. Pension death benefits will not normally be subject to this tax unless HMRC feels an action has been taken in particular circumstances to secure a tax advantage. A possible example may be abnormally large contributions in the two years prior to death where the member was in ill-health. This is a specialist area and appropriate advice should be sought for a client's given circumstances.

Any death benefits paid out a scheme to a recipient / beneficiary may of course subsequently form part of their estate for IHT purposes.

Changes to the taxation of death benefits from 6th April 2015

The key determinants pre 6th April 2015 surrounding the taxation of DC funds on death were:

- Did the death occur pre or post crystallisation and,
- Did death occur post age 75.

The former factor has now largely disappeared with the latter being the key, but not only, driver.

It is worth noting that where reference is made below to the **Special Lump Sum Death Benefit Charge** (SLDBC) this has been reduced from 55% to **45%** from 6th April 2015. It has been confirmed that this will apply at the recipient's marginal rate of income tax from 6th April 2016.

Uncrystallised funds/flexi-access drawdown funds/capped drawdown funds – death benefit options & taxation – Pre Age 75

On the death of the original pension scheme member pre age 75:

- Death benefits can be paid to any recipient as an authorised lump sum**. A Charity Lump Sum Death Benefit cannot be paid from uncrystallised funds or where there is a surviving dependant of the original member.
- Only beneficiaries falling into the categories detailed above (dependants and nominees) can receive an authorised pension income***. If no nomination has been made the scheme administrator can nominate a successor to receive income.
- Dependants may receive an authorised pension income even when no nomination / Expression of Wish exists.
- There can be more than one recipient / beneficiary.
- Where benefits are designated to a recipient or beneficiary within a two-year period, benefits will be paid free of tax; whether taken as an authorised lump sum or pension income.
- Subject to the restrictions outlined, eligible recipients will be able to choose how to receive their benefits.
- **Uncrystallised funds** designated to a beneficiary within the two year period, will be **subject to a Lifetime Allowance Test** with any LTA charge payable at either 55% (lump sum taken) or 25% (income taken). There can be multiple post-death BCEs; e.g. where there are multiple beneficiaries, and any LTA charge is apportioned appropriately.

- The liability for any lifetime allowance charge falls directly on the recipient, dependant or nominee as applicable. This may cause a cash flow problem where income as opposed to a lump sum is taken.
- For the purposes of testing against the LTA, uncrystallised funds paid as a lump sum are subject to BCE 7. Two new BCEs have been introduced BCE 5C and BCE 5D which apply where uncrystallised funds are designated to a beneficiaries (dependant or nominee) flexi-access drawdown plan or annuity respectively.
- Uncrystallised funds designated **after the two year period**; a.) Will not be subject to a Lifetime Allowance Test and b.) Will be subject to the SLSDBC if taken as a lump sum, or the recipient's marginal rate of income tax if taken as an income.
- The two year period for designating funds to a beneficiary begins upon the earlier of the day the scheme knew of the member's death, or when they could have reasonably been expected to have known it.
- **Crystallised funds** will **not be subject to an LTA test.**
- Crystallised funds designated after the two year period will be subject to the SLSDBC if taken as a lump sum, **but** still paid free of income tax if taken as an income.

The position on an **annuitant's** death broadly follows the above on or after 6th April 2015, subject to the terms of the actual annuity contract at outset. For example, value protection may afford an authorised lump sum death benefit and a survivor's annuity can be paid to a broader class of beneficiary. Similar considerations apply to a **Scheme Pension** set up under a DC Scheme.

Uncrystallised funds/flexi-access drawdown funds/capped drawdown funds – death benefit options & taxation – From Age 75

On the death of the original pension scheme member:

- Death benefits can be paid to any recipient as an authorised lump sum**. This will be subject to the SLSDBC.
- A Charity Lump Sum Death Benefit cannot be paid where there is a surviving dependant of the original member (this is not subject to the SLSDBC).
- Only beneficiaries falling into the categories detailed above (dependants and nominees) can receive an authorised pension income***. This income will be taxed at the beneficiary's marginal rate of tax. If no nomination has been made the scheme administrator can nominate a successor to receive income.
- Dependants of the **original** member may receive an authorised pension income even when no nomination / Expression of Wish exists.
- There can be more than one recipient / beneficiary.
- Death benefits will not be subject to a test against the Lifetime Allowance (any unused funds will have been tested at age 75, and any charge due deducted from the fund at that point).

The position on an **annuitant's** death broadly follows the above on or after 6th April 2015, subject to the terms of the actual annuity contract at outset. For example, value protection may afford an authorised lump sum death benefit and a survivor's annuity can be paid to a broader class of beneficiary. Similar considerations apply to a s**cheme pension** set up under a DC Scheme.

Death of a beneficiary in flexi-access drawdown / capped drawdown

Where, upon a member's death, a beneficiary entitled to authorised pension income chose to designate unused funds into a beneficiary's drawdown arrangement (flexi-access drawdown post 5th April 2015); and that beneficiary subsequently dies:

Any unused funds:

- Can be paid to any recipient as an authorised lump sum**
- Can be used to provide a beneficiary's (successor's) authorised pension income***
- Can be used to provide any dependants of the **original** member with an authorised pension income, even when no nomination / Expression of Wish exists.
- A Charity Lump Sum Death Benefit cannot be paid where there is a surviving dependant of the original member.
- There is no test against the Lifetime Allowance.
- The tax position will follow the same principles as above pre or post age 75; but determined by the age of the **beneficiary** at the date of death

**Uncrystallised Funds Lump Sum Death Benefit, Drawdown Pension Fund Lump Sum Death Benefit, Flexi-access Drawdown Fund Lump Sum Death Benefit, as appropriate.

***Beneficiary's Flexi-access Drawdown, Dependants / Nominees / Successors Annuities, as appropriate.