

ADVISER UPDATE

Pension death benefit rules

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Key points

- Death benefits can be paid to any beneficiary
- Where the deceased was younger than 75, and the death benefits are designated within a two-year period, benefits will usually be paid free of income tax.
- Where the deceased was over 75, benefits will be subject to income tax.
- On the death of a beneficiary, remaining funds can be passed on again. Whether they are subject to income tax depends upon the age of the beneficiary when they died.
- If the member had not made a nomination, and there is a dependant, then the funds may only be paid out as a lump sum to any other (non-dependant) beneficiary.
- Under current rules pension benefits are usually exempt from inheritance tax (IHT), but there may be situations where IHT may apply. In the Autumn Budget 2024 it was announced that from 6 April 2027 unused pension funds will be included in the deceased's estate for the purposes of calculating IHT.

IMPORTANT

This information is based on current understanding of pension tax rules. This is provided for information only; we do not provide advice.

Tax rules may change in the future and the tax treatment depends on personal circumstances. This guide and case studies are provided for professional advisers' use only.

Who can receive death benefits?

Lump sum

Anyone can receive lump sum death benefits; there are no restrictions on the type of beneficiary.

Income

The following types of beneficiaries can receive pension income when someone dies:

- dependant;
- nominee; and
- successor.

If the person doesn't fall into one of these classes, they are unable to receive pension death benefits as an income.

Dependant

A dependant is someone who was a dependant of the scheme member at the time of their death. A dependant can be:

- a spouse or civil partner;
- a child under the age of 23 or an older child who was dependent due to physical or mental impairment;
- someone who is financially dependent on the member due to physical or mental impairment; or
- someone in a financial relationship of mutual dependence with the member.

Nominee and successor

A nominee can be anyone nominated by the member.

A successor can be anyone nominated by a dependant, nominee or successor to receive any remaining benefits on their death. A successor can nominate another successor and so on. So, in theory, the pension fund could be passed on for generations if it's not all withdrawn.

Role of scheme administrator

The scheme administrator has discretion as to how death benefits are paid out, and can make lump sum death benefit payments to any individual. If a member has not made a nomination, and has no dependants, the scheme administrator can nominate a nominee to receive an income from the pension fund.

Following the death of a dependant, nominee or successor who has not made a nomination, the scheme administrator can nominate a successor to receive an income from the fund. Alternatively, if there are any surviving dependants of the original member, the scheme administrator can use its discretion to pay death benefits to them.

How can benefits be taken?

If beneficiaries are eligible to take income from the pension fund, then they can leave the money invested and draw an income from a flexi-access drawdown plan as and when they need to.

There can be multiple beneficiaries, and beneficiaries do not all have to choose the same way of taking death benefits.

Only dependants of the member, or someone they have nominated, or a successor can take an income from the drawdown plan.

If the member has any surviving dependants or if the member nominated an individual to receive death benefits, and the scheme administrator uses its discretion to pay to another person, then that person cannot take a drawdown income.

Likewise, if a beneficiary has made a nomination and the scheme administrator uses its discretion to pay to another person, then that person cannot take a drawdown income unless they were a dependant of the original member.

How will death benefits be taxed?

Whether death benefits will be subject to income tax depends upon two factors:

- the age of the deceased when they die; and
- whether the funds have been designated to the next beneficiary within the two-year time limit.

If the deceased dies before age 75

If the deceased dies before age 75, then benefits will usually be paid tax free (whether it is taken as an income or a lump sum).

However, if the member was taking drawdown, and the beneficiary then takes a lump sum, the lump sum will be subject to income tax if the funds have not been paid out within two years (see below).

If the member was taking drawdown, and the beneficiary also takes drawdown, then the benefits will be paid free of income tax, regardless of when the funds are designated.

Two-year limit to designate funds

If the member had not crystallised funds, and the benefits aren't designated within two years, then benefits will usually be subject to income tax at the beneficiary's marginal rate even if the member was under 75 when they died. (The exception is where the deceased was under 75 and already in drawdown, and the beneficiary also takes drawdown – see above.)

The two-year time limit for designating funds to the next beneficiary begins when the scheme first knew – or could reasonably have been expected to know – of the deceased's death.

If the deceased dies aged 75 or above

If the deceased was 75 or older on death, then the benefits will be subject to income tax at the beneficiary's marginal rate.

Paying to a trust

If the benefits are paid to a trust and are to be taxed, they will be subject to the special lump sum death benefits charge at 45%. When distributions are later made from the trust, a tax credit is attached in respect of the 45% tax already paid. This can be offset against the recipient's other income in the tax year.

Dependant, nominee, or successor dies

If the dependant, nominee, or successor dies, then it will be their age – and not that of the original member – that determines whether the benefits are taxable.

Lump sum and death benefit allowance test

If the deceased member was under 75 and the beneficiary takes the death benefits as a lump sum this payment will be tested against the deceased's available lump sum and death benefit allowance (LSDBA).

The standard LSDBA is £1,073,100, but any tax-free amounts the deceased took in their lifetime will be deducted from this allowance first, with the balance available to cover any lump sum death benefit payments.

Where the allowance is used up, any excess death benefit lump sums will be taxed as income for the recipient.

There is no test if the deceased was over 75 (all death benefits will be subject to income tax regardless), and there is no test if the beneficiary takes death benefits as a pension income.

Responsibility and payment of any tax charge

The lump sum would be paid out gross from the pension scheme, and the information relating to the payment would be passed to the deceased's personal representatives. If the member died before age 75 and uncrystallised funds are used to make a lump sum payment, any amount above the member's available LSDBA is subject to income tax chargeable on the recipient of the benefits.

The amount of tax due on the chargeable amount will be calculated by HMRC at the rate of income tax the recipient pays.

Statutory permissive override

When the pension freedoms were introduced in 2015, it was up to each pension scheme to decide whether to adopt the freedoms. Some older pension schemes or individual contracts did not.

When a member of one of these schemes or contracts dies, then beneficiary's drawdown may not be available to the beneficiary – meaning they can only take benefits as a lump sum. If income tax is due on the benefits, a lump sum may not be the most tax-efficient solution.

However, a statutory permissive override to scheme rules exists in the Finance Act 2004. This allows defined contribution schemes to offer flexible death benefits otherwise not permitted in their scheme rules. Payments are not paid out to the beneficiary; instead the beneficiary can then apply for a drawdown-to-drawdown transfer to another scheme.

The receiving scheme needs confirmation of:

- the funds designated into the beneficiary's FAD in the beneficiary's name;
- the date of designation; and
- whether the funds are taxable or not.

Inheritance tax and pensions

Under current rules pension benefits are normally exempt from inheritance tax (IHT). However, there are situations where there may be IHT implications.

On transfer of pension benefits from one scheme to another, the member can theoretically direct that transfer is made to an arrangement where the estate would be entitled to the death benefit.

Therefore, if a transfer is made whilst the member knows they are in ill health, and the member dies within two years of their transfer, then this has to be reported on the IHT 409 form.

HMRC reviews each case individually, taking into account its specific circumstances. It will consider the transfer of value from the transferor's estate, which broadly is the difference in the value between the value of the death benefits and retirement benefits in the receiving scheme. This value is therefore lower than the transfer value.

In the Autumn Budget 2024 it was announced that from 6 April 2027 unused pension funds will be included in the deceased's estate for the purposes of calculating IHT. Under the proposals any IHT due from the pension would be deducted first, then income tax deducted if applicable as per the death benefit rules stated above.

Planning points based on current rules

Succession planning

It's important for your clients to regularly review who they have nominated to receive their death benefits. It's also important that anyone taking beneficiary's flexi-access drawdown also make a nomination, given the flexibility to pass on benefits.

Some clients may want to change their nomination on their 75th birthday if they are concerned about passing funds on in the most tax-efficient way.

Case study

Mr Smith is married and both he and his wife are basic rate taxpayers. They have two grown-up children who are both higher rate taxpayers, and three grandchildren, aged 18, 12 and 9, who are all non-taxpayers.

Mr Smith wants to make sure his wife has sufficient funds to live on after his death but, as his pension fund is substantial, he does not believe she would need the entire fund to live comfortably for the remainder of her life. He wants to pass his fund on in a tax-efficient manner.

He completes an expression of wish leaving 70% of his fund to his wife, and 10% to each of his grandchildren.

Mr Smith dies aged 80. As he was over 75, Mrs Smith will pay basic rate tax at 20% (provided she doesn't take income above the threshold for higher rate tax).

As non-taxpayers with no other income, each of his grandchildren can take up to £12,570 (personal allowance) without paying any tax. They do not need to take any income if they don't need it.

Unfortunately, Mrs Smith only lives for another two years following her husband's death. She has nominated her two children, Janet and John, to be beneficiaries on an equal basis. As Mrs Smith is only 74 at the time of her death, her two children can take the benefits free of income tax.

Had Mrs Smith lived beyond age 75, she may have reviewed her nomination if she believed her children did not need the entire fund and she was concerned about passing funds on in a tax-efficient manner. She may have decided to allocate some of the funds to her grandchildren instead.

Making sure nominations are updated

Our (post-2015) nomination form nominates all Eligible Benefits Recipients under our scheme trust deed and rules as persons the scheme administrator should consider paying death benefits to. This means that where this form has been completed, and the decision is to pay benefits to any extended family member they will have the option of taking benefits as flexi-access drawdown.

However, if this form has not been completed, or you have pensions with other providers then a scheme administrator can only nominate a non-dependant beneficiary to receive the benefits as flexi-access drawdown where the deceased has not nominated anyone. (Dependants of the original member can receive benefits as flexi-access drawdown regardless of whether they were nominated by the deceased.)

Case study

Mr Williams dies aged 85. His wife has predeceased him and he has nominated their only child (John) to receive his benefits. He last updated his nomination when his wife died in 2014.

John is 55 and a higher rate taxpayer, so he would pay at least 40% income tax on any benefits. John has two children who are 18 and 20 and who are currently studying at university with no income.

John does not need the income and would rather the fund was used to provide an income to support his children whilst they are at university. This would be more tax-efficient as they could receive the first £12,570 each year tax free, and pay basic rate tax on any income above this up to the higher rate threshold.

Even though all parties are in agreement, and John believes his father would have supported this change, because Mr Williams's nomination states John is the beneficiary, the scheme administrator cannot override this to designate the funds to provide an income for John's children.

The scheme administrator does have the ability to pay the funds to John's children. But this can only be as a one-off lump sum and any amount above £12,570 would be taxed.

This information is based on current understanding of HMRC tax rules.
Tax treatment, including tax relief, depends on your individual circumstances and rules may change.