Death benefit rules

All this information is based on our understanding of the Treasury and HMRC guidance. Tax rules can change in the future and the tax treatment depends on personal circumstances. **The guide and case studies are provided for professional advisers use only.**

Key points:

- Death benefits can be paid to any beneficiary.
- Where the deceased is under 75 and the death benefits are designated to a beneficiary within a two-year period, benefits will usually be paid free of tax.
- Where the deceased is over 75, benefits will be subject to tax.
- If the death benefits are not designated within two years and are from uncrystallised funds they will be subject to tax.
- If the death benefits are not designated within two years and are from crystallised funds where the member was under 75 they will not be subject to tax where taken as a beneficiary's drawdown pension.
- On the death of a beneficiary remaining funds can be passed on again, and it is the age of the beneficiary at date of death that dictates whether funds are taxable, not the age of the original member.
- Any dependant's pensions that were in payment at 5 April 2015 will continue to be taxed.
- There are benefit crystallisation events where uncrystallised funds are designated for a dependant's or nominee's flexi-access drawdown pension, or used to purchase an annuity, within two years of the member's death.

Who can receive death benefits?

Three separate classes of beneficiary can receive pension income from the deceased member's fund:

- Dependant
- Nominee
- Successor

If a beneficiary does not fall into one of these classes of beneficiary, they will not be able to receive death benefits as a pension.

These classes are not relevant to receipt of lump sum death benefits. There are no restrictions on the type of beneficiary who can receive lump sum death benefits.

A dependant is someone who was a dependant of the original scheme member at the time of their death. A dependant is a spouse, civil partner, child under the age of 23, an older child who was dependent due to physical or mental impairment, someone who was financially dependent on the member, or someone in a financial relationship of mutual dependence with the member.

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. There is no limit on the number of successors, so in theory the fund could be passed on for generations if it is not all taken out.

The scheme administrator has discretion as to how any death benefits are paid, and can make lump sum death benefit payments to any individual. Following the death of a member who has not made a nomination and does not have any dependants, the scheme administrator can nominate a nominee to receive an income from the 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?

Those eligible for pension death benefits will have the option of leaving the money invested and drawing a pension under the new flexi-access drawdown rules. This means they can take income as and when required, with no limits and no need for reviews.

After the death of the member, only dependants and nominees can take death benefits in the form of a pension. If the member has any surviving dependants or if the member nominated an individual to receive death benefits and the scheme administrator uses their discretion to pay death benefits to any other individual, then the beneficiary will not be able to take a pension income.

A similar restriction applies after the death of a dependant, nominee or successor. If the deceased made a nomination and the scheme administrator uses its discretion to pay death benefits to anyone else, the beneficiary will only be able to receive death benefits as a pension if they were a dependant of the original member.

All beneficiaries (whether or not a dependant of the member or nominated by the deceased) will have the option of taking the whole fund as a death benefit lump sum.

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

How will death benefits be taxed?

The tax treatment of death benefits will depend on two factors:

- The age of the deceased on their death.
- Whether or not the funds are designated to the next beneficiary within two years (with the exception of crystallised funds on death before age 75).

If the pension member dies before the age of 75 and funds are designated to their beneficiary (either a dependant or nominee) within two years, benefits will usually be paid tax-free – whether taken as a lump sum or flexi-access drawdown.

On the death of a dependant, nominee or successor it will be their age at death, not that of the original member, that determines whether the benefits are taxable.

The two-year time limit for designating funds to the next beneficiary begins with the earlier of the day on which the scheme first knew of the deceased's death and the day on which the scheme could first reasonably have been expected to have known of it.

If benefits are not designated within the two-year period stated above, then benefits will usually be taxed. The exception is where the deceased was under 75 and already in drawdown. In this instance the two-year rule does not apply if the beneficiary takes the death benefits as pension income. If the beneficiary takes a lump sum, and in all instances when the deceased was 75 or over, tax will apply. If benefits are paid to an individual, whether as income or a lump sum, they will be taxed at the recipient's marginal rate of Income Tax. If benefits are taken as a lump sum and paid to a trust, this 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.

Lifetime allowance test

Death benefits are tested against the lifetime allowance when they are paid or designated from the member's uncrystallised funds on death before age 75 . It is important to note that the test is always carried out against the deceased's lifetime allowance, and not that of the beneficiary. Any protection the deceased held can be used when carrying out the test. There are no further lifetime allowance tests on the subsequent death of a beneficiary.

Benefit crystallisation event (BCE) 7, tests uncrystallised funds that are used to make a lump sum payment. BCE5C tests uncrystallised funds that are designated to provide a flexi-access drawdown pension for a dependant or nominee. BCE 5D tests uncrystallised funds that are used to purchase a dependant's or nominee's annuity. These three BCEs only apply where funds are designated within the two year period, after this period there is no lifetime allowance test, but funds would be subject to tax at the recipient's marginal rate.

When BCE5C or 5D apply funds are always used to provide an income (as opposed to a lump sum), so the lifetime allowance charge on the excess fund will be 25%.

The responsibility for carrying out the lifetime allowance test on death lies with the deceased's personal representatives, not the scheme administrator. Any lifetime allowance charge that arises is chargeable on the recipient of the benefits.

It is possible that there will be multiple events of BCE5C, 5D and 7, for example if the member has nominated multiple beneficiaries and the funds are designated at different times. When this occurs the individual liable to any lifetime allowance charge is only liable for the portion of the total amount as deemed "just and reasonable" by an officer of HM Revenue and Customs.

Payment of death benefits where death occurred prior to 6 April 2015

Where a dependant has received a dependant's pension at any point prior to 5 April 2015 this will continue to be taxed at their marginal rate.

If funds have been designated to a dependant for a dependant's pension on or before 5 April 2015 but income payments do not start until on or after 6 April 2015 these funds will be tax-free where the deceased was below age 75.

Where a member, or dependant, died below age 75 on or before 5 April 2015 but the funds were not designated until on or after 6 April 2015 then benefits can be paid out tax-free, provided the designation is made within the two-year period, or from crystallised funds. These funds can be designated to the new classes of beneficiary under the new rules, provided the conditions around dependency or nominations have been met.

Planning points

Succession planning

It is important for your clients to regularly review who they have nominated to receive their death benefits. It is also important that any clients in receipt of a beneficiary's pension make a nomination, as there is great flexibility in terms of how funds remaining on their death are distributed. It may also be the case that some clients may wish 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 dies at aged 80 with a substantial pension fund. He has the following family:

- Mrs Smith, wife, 72, basic rate taxpayer
- Janet, daughter, 50, higher rate taxpayer
- John, son, 47, higher rate taxpayer
- Adam, grandson, 20, non taxpayer
- Bella, granddaughter, 18, non taxpayer
- Charlie, grandson, 12, non taxpayer
- Darcy, granddaughter, 9, non taxpayer

Mr Smith wants to ensure his wife has sufficient funds to live on after his death, but as his 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 therefore completes an expression of wish leaving 60% of his fund to his wife, and 10% to each of his grandchildren.

When he died Mr Smith was over 75, meaning any benefits paid out are taxable at the recipient's marginal rate. Mrs Smith will therefore 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 £11,500 out each year (2017/18 personal allowance) without paying any tax. There is no requirement for them to take any income if they do not need it. If they did become higher rate tax payers in the future they could opt to leave the money in a pension even until their retirement when their tax rate may drop.

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 the beneficiaries of the fund on a 50/50 basis. As Mrs Smith is only 74 at the time of her death, Janet and John can take the benefits out free of Income Tax, despite the fact the funds originated from Mr Smith.

Had Mrs Smith lived beyond age 75 she may have considered reviewing 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 found it appropriate to allocate some of the funds to her grandchildren and, if great-grandchildren had arrived, to them also.

Potential inefficiency where nominations are not updated

When making nominations one of the key points to bear in mind is that the 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 his only child (John) to receive his benefits.

John is 55 and a higher rate tax payer, so would pay at least 40% tax on any benefits. John has two children who are 18 and 20 and are currently 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 and starting their careers. This would be more tax-efficient, as they could receive the first £11,500 each year tax-free (2017/18 threshold), 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' nomination states that 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 £11,500 would be taxed.

Where the lifetime allowance is exceeded

In the event of a member dying before the age of 75 with uncrystallised funds there will be a BCE if benefits are designated within two years. As the lifetime allowance charge is 55% on lump sums and only 25% when the funds are used to provide an income, it may be more efficient to take income in cases where the lifetime allowance is exceeded and there is no/limited protection. In this scenario the income will be tax-free once the 25% lifetime allowance charge has been paid, and under flexi-access drawdown there is no limit on the amount of the fund that can be withdrawn at one time.

In circumstances where the beneficiary is a nil or basic rate tax payer, it may be more tax-efficient to wait for two years before designating any funds above the lifetime allowance, as after this period there would potentially be no lifetime allowance charge and, provided the higher rate tax threshold isn't breached, funds will only be taxed at 0/20% when withdrawn.

Case study

Mrs West dies aged 60 with an uncrystallised fund of £1.5million. She does not hold any protection.

She has two beneficiaries with the fund to be split equally. One recipient is a higher rate taxpayer, the other is a basic rate tax payer. There will be a benefit crystallisation event when funds are designated within two years of Mrs West's death, regardless of whether death benefits are paid as a lump sum or pension.

Within the two-year period £1million of the fund is designated to Mrs West's beneficiaries and split 50/50. This can be paid tax-free and each beneficiary can choose whether to leave this invested and take flexi-access drawdown in the future, or to take as a lump sum.

The higher rate beneficiary chooses to have their remaining share (a further £250,000) designated for flexi-access drawdown at the same time, and the lifetime allowance charge of 25%* will be deducted from this amount when it is designated as this part of the fund is deemed to breach the lifetime allowance. The remaining funds can be taken tax- free at any time because Mrs West died before she reached age 75.

The basic rate beneficiary chooses to leave their remaining share (£250,000) in the fund and for it not to be designated to them until after the two-year period has elapsed. This means that no lifetime allowance test takes place. After this time the funds can be designated to them for flexi-access drawdown and they can withdraw them as and when they like. As they were designated outside the two-year window they cannot be paid tax-free, but the basic rate tax on the withdrawals (provided they do not exceed the higher rate threshold) is less than the lifetime allowance charge would have been.

The mechanics of the lifetime allowance charge explained above are based on an interpretation of the new rules, but it is worth noting that where there are multiple post-death benefit crystallisation events the liability of each beneficiary on the portion of the total lifetime allowance charge payable is "as appears to an officer of Revenue and Customs to be just and reasonable."

*The lifetime allowance charge is 25% on funds used to provide a pension income (at time of writing).

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