New rules for death benefits

Martin Clarke, technical analyst at financial specialist, HFS Milbourne highlights how the new 'pension freedoms' affect death benefits for those in defined contribution pension schemes.

Pictured: Martin Clarke.

Lawyers involved in private client work need to be aware of recent changes to death benefits for those individuals in defined contribution pension schemes that have come into force as part of the new 'pension freedoms'.

From April 2015, individuals can pass on an unused defined contribution pension to any nominated beneficiary when they die, rather than paying the 55% death tax charge that may previously have applied on death of the pension scheme member.

Clients who wish to benefit from this update will need to ensure that their existing scheme can accommodate these changes as providers are under no obligation to extend the new rules to older pension plans. It might also be impossible to make changes after the pension holder's death so it is practical to review existing pension plans as part of an estate planning exercise.

So what's changed?

Individuals with a drawdown arrangement or with uncrystallised pension funds will be able to nominate a beneficiary to pass their pension to if they die.

If the individual dies before they reach the age of 75, they will be able to give their remaining defined contribution pension to anyone as a lump sum completely tax free, if it is in a drawdown account or uncrystallised.

The person receiving the pension will pay no tax on the money they withdraw from that pension, whether it is taken as a single lump sum, or accessed through drawdown.

Anyone who dies with a drawdown arrangement or with uncrystallised pension funds at or over the age of 75 will also be able to nominate a beneficiary to pass their pension to.

The nominated beneficiary will be able to access the pension funds flexibly, at any age, and lump sums paid in 2015/16 are taxed at 45%. Lump sums paid in subsequent tax years will be taxed at the recipient's marginal rate. Income drawdown death benefits will also be taxed at the recipient's marginal rate.

If the nominated beneficiary is a basic rate taxpayer the withdrawals can be limited to avoid breaching the higher rate threshold. Likewise, if the recipient is a non-taxpayer they can take out money tax free up to their personal allowance each year.

Nominees, dependents and successors

Pre 6 April 2015, the rules restricted those who could inherit a drawdown pension or annuity to dependants. The new rules expand the range of income beneficiaries to include "nominees" (anyone who is not a dependant, but is nominated by a member) and "successors" (anyone nominated by a nominee or successor) as well as dependants. The member may nominate more than one nominee.

This means that it is now possible for pension wealth to be passed to adult children within the pension wrapper rather than as a lump sum and there is no requirement for them to wait until they reach age 55 to access it.

Keeping funds in a pension, rather than being paid out as a lump sum, means that all the tax advantages can be retained, such as limited tax on investment income, no capital gains tax, no inheritance tax.

Plan ahead to avoid losing outs

To illustrate, take for example, Mr Jones, a widower who died aged 85 who had nominated his only child, Peter, to receive his benefits.

Peter, as a higher rate taxpayer, would pay at least 40 per cent tax on any benefits he took as income (or 45 per cent if he took the fund as a lump sum).

Peter would prefer that the fund was to be used to provide income to support his children at university who have no income. This would be a tax efficient use of the money as they could receive the first £10,600 each year tax free (2015/16 threshold) and pay basic rate tax on any further income up to the higher rate threshold.

Even though all parties are in agreement and Peter believes his father would have supported the change, if the scheme administrator uses its discretion to pay to the grandchildren, they can only receive the benefits as a lump sum, not as a pension.

The fact that this money can only be paid out as a lump sum means it will be taxed at 45 per cent if paid in 2015/16 and, assuming lump sums are taxed at marginal rates after this, it will be much more difficult to manage the tax liabilities than using a pension.

If Peter and his father had reviewed the nominations and established Peter's children as beneficiaries this would have solved the problem.

For clients concerned about passing funds on in a tax efficient manner, it is crucial that nominations are reviewed when circumstances change, for example, following a death or divorce, the birth of a grandchild or great grandchild. ■

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