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Technical Briefing Note

Pension Freedoms – Death Benefit Changes

Clients Must Review Their Options

The pension changes that took effect from 6 April 2015 have revolutionised how individuals are able to take their pension savings. Clients wanting to benefit from the new freedoms will need to ensure that their existing pension plan can offer all available options. For example, there will be a number of older schemes which cannot offer inherited drawdown. Pension providers are under no obligation to extend the new freedoms to older versions of pension plans that may have been designed many years ago.

Issues to consider

Dying while stuck in a pension scheme that does not offer the new freedoms or with an outdated death benefit nomination may be impossible to correct after the client's death so it could be argued that a client's pension plans should be reviewed as part of an estate planning exercise.

The changes to defined contribution pension death benefit rules should trigger the need to review how pension wealth is passed on and what action needs to be taken to ensure that the desired outcome is achieved.

The pre 6 April 2015 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. Dependants and nominees can nominate any remaining funds on their death to a successor. Nominations are not binding on the scheme administrator/trustees.

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. Neither does it impact on the adult child's own lifetime allowance.

Retaining 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.

Where the pension scheme member dies before the age of 75 there is no tax charge on any death benefits whether they are paid as a lump sum or as drawdown payments. Where the member dies at age 75 or above lump sums paid in 2017/18 are taxed at the recipient's marginal rate. Income drawdown death benefits will also be taxed at the recipient's marginal rate.

In situations where the member was aged 75 or above at the time of death, 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. Nominated beneficiaries have the ability to pass on again any residual funds and have unrestricted access whenever required. There really are few reasons to withdraw funds until they are needed.

The legislation sets out very specific rules about the circumstances in which the scheme administrator can nominate a beneficiary to receive an income. A death benefit nomination helps to guide the scheme trustees/administrator when exercising their discretion and they will be guided by the last instructions they have received.

The trustees/administrator retains complete discretion to designate benefits to any beneficiary, whether nominated by the member or not. But if the beneficiary is not dependent and not nominated, they may only be able to receive the benefits as a lump sum. The flexi-access drawdown option would only be available if the scheme member has not nominated anyone else and has no dependants.

Case Study

So what does this mean in practice? A case that illustrates the implications of this is that of a Mr Jones, who died aged 85. His wife predeceased him and he had nominated his only child, Peter, to receive his benefits.

Peter is 55 and a higher-rate taxpayer, so he would pay at least 40 per cent tax on any benefits he took as income. Peter has two children, aged 18 and 20, who are at university and have no income.

Peter does not need the income and would rather the fund was used to provide income to support his children while they are at university and starting their careers. This would be a more tax-efficient use of the money as they could receive the first £11,500 each year tax-free (2017/18 threshold) and pay basic rate tax on any further income up to the higher-rate threshold 2017/18.

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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 40 per cent if paid in 2017/18 and, it will be much more difficult to manage the tax liabilities than using a pension.

If Peter and his father had reviewed the nominations after 6 April 2015 and included Peter's children as beneficiaries this would have solved the problem.

Summary

It is crucial that nominations are reviewed when circumstances change. In addition to reviewing nominations following a death or divorce, it may now be appropriate to review how benefits are distributed after the birth of a grandchild or great-grandchild.

For clients concerned about passing funds on in a tax-efficient manner, reaching the age of 75 is an obvious point when nominations may need to be changed.

Nominees and successors have complete freedom in how they deal with the pension fund and it is possible that they could exhaust the remaining fund in a frivolous manner. If the pension scheme member is concerned about safeguarding the pension fund they may wish to consider establishing a spousal by pass trust as an alternative.

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