Pension death benefits payable under money purchase schemes

The pension freedom rules introduced in April 2015, standardised the death benefit treatment for the different money purchase retirement options. Below we look at the type of death benefits payable and the tax implications under money purchase schemes.

1. Types of benefit (Fidelity may not offer all of these options)

Lump sums

- An uncrystallised funds lump sum death benefit can be paid from funds from which the member has not yet taken benefits.
- A flexi-access drawdown fund lump sum death benefit may be paid on the death of a member, dependant, nominee or successor while in flexi-access drawdown. Drawdown may be paid wholly or partly as a short-term annuity.
- A drawdown pension fund lump sum death benefit may be paid on the death of a member or dependant while in capped drawdown.
- A charity lump sum death benefit may be paid on the death of a member or beneficiary in drawdown or a member with uncrystallised benefits, but only if there are no surviving dependants of the member.
- An annuity protection lump sum death benefit may be available when an annuity is being paid. The maximum amount is the purchase price of the annuity, minus the total of annuity payments made to the member.
- A trivial commutation lump sum death benefit may be paid for pensions already in payment, when the value of a dependant's pension or remaining guaranteed instalments of the pension is no more than £30,000.
- Members of money purchase arrangements may also be provided with pension lump sum death benefits by their employers (for example, a multiple of salary) or may have a pension term assurance arrangement, for which tax relief is available if it started before 6 December 2006.

Pensions

- A beneficiary's annuity (or scheme pension paid in the form of an annuity) may be payable on the death of a member. This can be an annuity bought alongside the members' annuity and payable on their death or an annuity bought with the remaining uncrystallised or drawdown funds.
- Instalments of an annuity may continue until the end of a guaranteed period selected when the annuity was bought. There is no maximum length of a guaranteed period.
- A beneficiary's flexi-access drawdown may be set up for a dependant, nominee or successor.

2. Beneficiaries

Beneficiaries on the member's death in a money purchase arrangement can be:

- Dependants of the member.
- Nominees of the member or scheme administrator.
- Successors, where benefits on the death of the member or a previous beneficiary are in the form of flexi-access drawdown and the current beneficiary dies.

To maintain beneficial inheritance tax treatment, the scheme administrator must retain some discretion in the selection of beneficiaries – see section 6.

3. Income tax treatment of benefits paid following the death of the member under age 75

Uncrystallised funds

Money purchase death benefits payable from uncrystallised funds are free of tax, as long as they are within the lump sum and death benefit allowance (LSDBA) (where a member dies before age 75) and are paid (or a beneficiary's annuity or drawdown established) within the relevant two-year period. This is, within two years of the date when the scheme administrator first knew of the member's death (or could reasonably be expected to have known).

Payment of death benefits on death under age 75 is a relevant benefit crystallisation event (RBCE). If, when added to any other RBCEs, the benefits exceed any remaining LSDBA the excess for the RBCE is treated as taxable income for the recipient. In all other cases no charge applies.

Where the two year period is exceeded, a lump sum is treated as taxable income for the recipient. Drawdown or annuity payments are treated as taxable income of the recipient.

Crystallised funds

The lump sum and death benefit allowance (LSDBA) limits the value of the lump sum pension savings the member can leave their beneficiaries tax free if you die before the age of 75. The standard LSDBA is £1,073,100. Some people might have a higher allowance if they also had a higher protected lifetime allowance, or tax-free cash protections.

Where the member dies under the age of 75 and benefits are passed on within two years of the notification of death the LSDBA will apply as follows. If the member takes any tax-free cash from their pension while they're alive (including a serious ill health lump sum) then their allowance will be reduced by a relevant amount. If the pension savings, excluding those crystallised before 6th April 2024, they leave are more than their LSDBA, whoever is determined to be the beneficiary for them will have to pay tax on the extra amount if they take a lump sum, at their marginal rate of income tax.

The exception to benefits being paid free of tax is where a trivial commutation lump sum death benefit is paid. In this case, the whole lump sum is taxable as pension income of the dependant or individual entitled to receive it.

Where benefits are paid more than two years after the notification of death or if the member dies after age 75, the beneficiaries have the same options, but they'll have to pay income tax on all the benefits and the LSDBA won't apply.

If a beneficiary (dependant/nominee/successor) subsequently dies under age 75 while in drawdown, the benefits paid to their successors are free of income tax. Note that it is the beneficiary's age at death that is the determinant, not the age at death of the original member.

The responsibility for assessing the payment against the LSDBA rests with the deceased's personal representatives, and with HMRC for determining any tax charge to collect directly from the beneficiaries. The scheme administrator pays the lump sums to the beneficiary(s) tax free.

4. Income tax treatment on death age 75 and over

Lump sums

Where either the member or beneficiary dies at age 75 or above, any remaining pension (whether it is uncrystallised, in drawdown or annuity) that is paid as a lump sum, is taxed as income of the recipient. The exception is where a charity lump sum is paid (see below).

Pension

If benefits are received, whether drawdown or annuity, withdrawals or income paid to the recipient are taxable as income where the member or previous beneficiary dies age 75 or over.

5. Charity Lump Sum Death Benefits

This is a lump sum that can be paid to a charity on the member or dependants' death. However, in order for a payment to be made in this way, the member must have no dependants and the member/nominee or successor must have nominated a charity before their death.

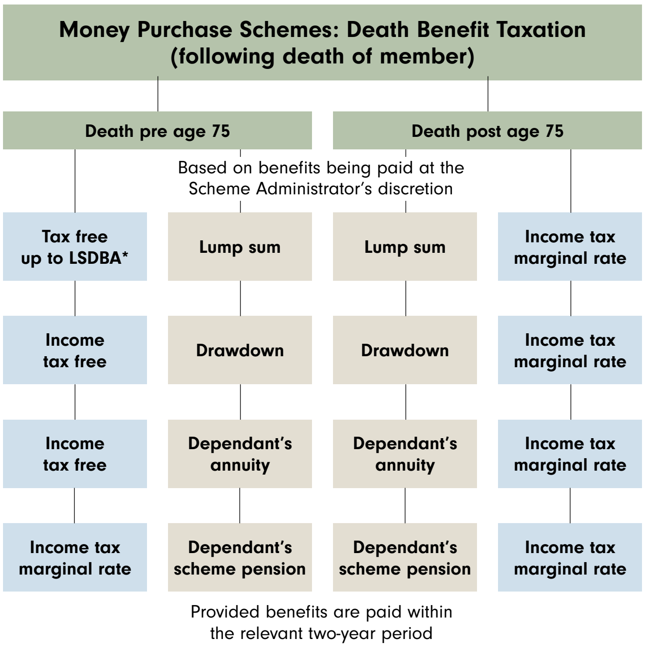
Payment of a charity lump sum can be paid from crystallised funds or uncrystallised funds irrespective of the members age. The payment is free of tax.

A charity lump sum death benefit is not a relevant benefit crystallisation event so its payment does not use up any of either the deceased member's or deceased beneficiary's lump sum and death benefit allowance.

6. Inheritance tax treatment

For most money purchase schemes, death benefits should be free of inheritance tax if the scheme administrator has discretion over the beneficiaries.

An inheritance tax charge could arise under any form of pension if HMRC considers that the member has transferred value out of the estate. Particular regard should be made to contributions and transfers made late in life or whilst in ill health. This is a complex and arguably contentious area of law and careful reference should be made to HMRC guidance manuals.



*Income tax marginal rate on amount above LSDBA

Exceptions:
- Trivial commutation lump sum death benefits are always taxable as pension income
- Charity lump sum death benefits are always paid free of tax

7. Expressions of wish

Where the scheme administrator has discretion over beneficiaries, the member can submit a non-binding expression of wish nominating who they wish to be considered to receive death benefits. The scheme administrator will take the expression of wish into account when exercising discretion.

It is important that it is kept up-to-date, especially if the member's circumstances or preferences in relation to who should receive benefits change.

It may be possible for a member to submit a binding expression of wish nominating who they wish to be considered to receive benefits, however the pension benefits payable would be deemed by HMRC to fall within that members estate in accordance with IHTA 1984/S5(2).

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