# Pension death benefits: Reduced taxation and increased flexibility

Ahead of the UK government's next budget on 16 March, pensions are the subject of much discussion. It is widely expected that the limits for tax relief on pension contributions will be reduced in one way or another. We are therefore recommending, where possible, that clients maximise their contributions now.

Pensions are one of the most tax efficient investment wrappers available in the UK. Like ISAs, the underlying investments are not subject to Income or Capital Gains Tax, and most pension schemes fall outside the scope of Inheritance Tax. This article looks to provide an update regarding the recent changes to tax on death benefits and the opportunities that this provides.

The Taxation of Pensions Act came into force in December 2014 and introduced a number of significant changes to the taxation of death benefits post 5 April 2015. Alongside the relaxation of the tax on pension death benefits (as outlined below), the options available to a member's beneficiaries on death have increased significantly.

Whilst pensions are an extremely tax efficient means of saving for retirement, the recent changes have resulted in them becoming an effective means of passing assets on to future generations.

The position described below relates to defined contribution schemes, with any pension income taken in the form of 'drawdown'. The position in relation to annuities and scheme pensions would depend on the specific policies and their scheme rules.

**Taxation**

Prior to the changes introduced in April 2015, upon a pension scheme member's death before the age of 75, any crystallised pension funds paid as a lump sum to the member's beneficiaries (or into a trust) would be subject to tax at 55%. Any benefits paid as a dependent's pension income (for example, via an annuity or drawdown) would be subject to tax at their highest marginal rate. Under the new rules, any payments upon the death of a member before the age of 75 will be tax free provided the benefits are allocated within a two year period.

Upon the death of a member post age 75 under the pre April 2015 rules, any benefits paid as a lump sum (whether from crystallised or uncrystallised pension funds) would be subject to tax at 55% and any benefits paid as an income would be subject to the beneficiaries' marginal rates of tax. Under the new rules, all benefits (whether a lump sum or income) paid to a member's beneficiaries post age 75 will be subject to their marginal rates of tax.

This reduction (and simplification) of the tax on pensions death benefits greatly improves the flexibility to pass assets onto future generations tax efficiently. Furthermore, as discussed overleaf, any beneficiary can now opt to leave their inherited benefits untouched, and pass them onto to their own beneficiaries as a pension in the same tax efficient manner.

## Pension options

Before 5 April 2015, only a spouse or 'dependents' would be eligible to inherit death benefits in the form of a pension income. Any other beneficiary that was not classed as a dependent would only have the option to receive the pension funds as a one-off lump sum, potentially subject to tax at 55%. Furthermore, any lump sum benefits paid to the beneficiary would immediately fall within their estate.

Following the changes any residual death benefits can be assigned to any beneficiary, even if they are not dependents of the policy holder. The beneficiary will have the option to draw on these in the form of an income or a lump sum, or simply leave the funds untouched and subsequently pass them on to their own beneficiaries upon their death.

Please note that the final decision as to how benefits will be paid falls on the pension scheme trustees and it is important to check the position with your pension providers on an individual basis.

## Subsequent death of a beneficiary

Under previous rules, upon the subsequent death of a beneficiary who is drawing on a former member's pension, the only option available to the subsequent named beneficiaries would be to receive a lump sum net of 55% tax (for example, if a widow was drawing an income from her late husband's pension and had nominated any residual benefits to be passed to her two children upon her death, the pension benefits could only be paid to the children as a lump sum after 55% tax).

The revised rules remove this restriction and allow the assets to pass on to subsequent generations in the form of a successors pension, which the beneficiary could choose to draw an income from at any age (or leave invested within the pension wrapper). The pension benefits could theoretically pass on from beneficiary to beneficiary, through multiple generations, without ever being subject to Inheritance Tax (pension schemes are typically structured as a trust, and therefore not within a person's estate).

The tax position of any pension benefits which are subsequently passed on will depend on the age at which the beneficiary died, not the original pension member.

## Nominations

In order to ensure that your loved ones get the most out of your pension after your death, it is important to ensure that you have a suitable and effective nomination in place with your pension scheme administrators. This nomination provides (non-binding) guidance to the pension scheme trustees when they come to make a decision about distributing your unused pension funds.

If you are in any doubt about your pension death benefit nominations then please contact your financial adviser.

**Summary**

A summary of the taxation of death benefits for pensions is outlined in the flow chart overleaf.

We believe that the changes introduced represent a significant development in the flexibility of pensions, and greatly improve the position for the member's beneficiaries upon death. The changes do however present a number of additional financial planning considerations and we continue to work closely with our clients to ensure that they are able to take advantage of these opportunities in order to meet their retirement objectives.

If you would like to discuss your pension provisions in more detail, please do not hesitate to get in contact with us.

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## Appendix - The taxation of pension death benefits