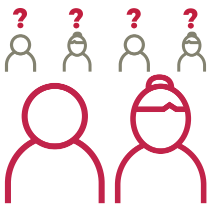
Death Benefits – Defined Contribution Schemes

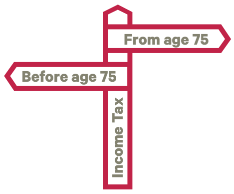
Tech-Bites

A look at how pension benefits can be distributed on death and their tax treatment.

Key Points

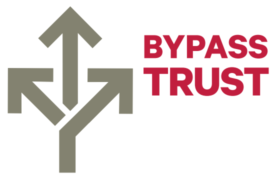


Individuals can nominate anyone to receive their pension death benefits.



The tax treatment of any death benefits is dependent on the age at death of the member.

A beneficiary's drawdown provides scope for passing benefits down the generations.



Using a discretionary trust to receive any lump sum death benefits can still be relevant where an element of control is the key driver.

How are death benefits treated for income tax purposes?

The taxation of death benefits is dependent on two FACTORS:

1. Whether the member's death occurred before age 75 or at age 75 and over; and
2. If the member's death occurred before age 75, whether those death benefits were paid out within the two-year window, from either:
   - uncrystallised benefits; or
   - lump sum death benefit paid out from crystallised benefits

The TWO-year window

- Is the timeframe the trustees of a pension scheme have to pay out any death benefit, from when the member died, or when they could reasonably have expected to know of the member's death
- Does not apply to members whose death occurred on or after age 75. There are no timescales on the payment of death benefits as all benefits are subject to income tax at the beneficiary's marginal rate of tax, or if not paid to an individual, for example, a trust or to the deceased's estate, 45% is deducted

Professional adviser use only

Charitable lump sum death benefit

Criteria to be treated as a charity lump sum death benefit:

- There are no dependants of the member; and
- The lump sum is paid in respect of either the member's drawdown pension fund or flexi-access drawdown fund at the date of the member's death; and
- It is paid to a charity nominated by the member (the scheme administrator cannot choose the charity receiving the payment)

Tax treatment:

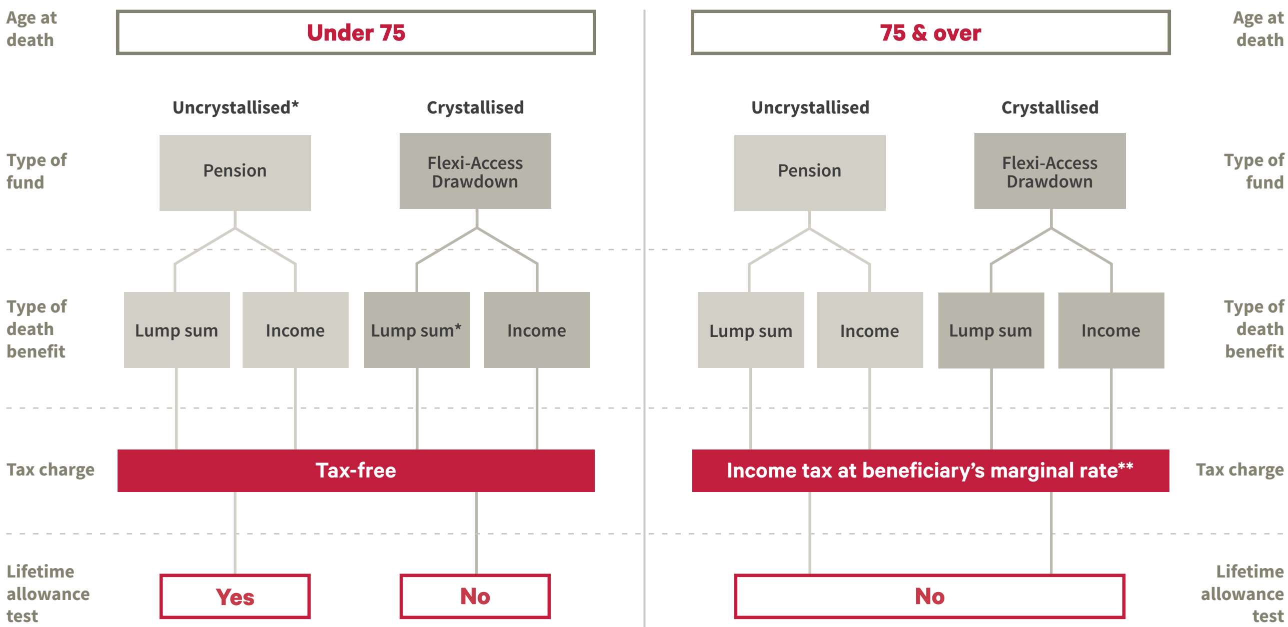
- There's no tax charge on the scheme administrator or the charity receiving the payment so long as it is used for charitable purposes

Lifetime allowance test

- A charity lump sum death benefit won't trigger a lifetime allowance test as it's not considered a benefit crystallisation event, so it doesn't use up the deceased member's lifetime allowance

Crystallised or uncrystallised – does it matter?

How pension death benefits are treated depends on the age at death and the timeframe with which any death benefits are paid out.



* If paid within the two-year period.

**If paid to an individual. If not paid to an individual, for example, a trust, 45% tax is deducted.

Death benefits and the Lifetime Allowance

A Lifetime Allowance charge may apply to benefits where:

- The member dies before age 75; and
- The benefits are uncrystallised and exceed the deceased member's lifetime allowance, or personal lifetime allowance, where some form of protection was in place; and
- The death benefit is paid out within the two-year period; either

  - As a lump sum death benefit; or

  - Designated into a beneficiary's flexi-access drawdown

A lifetime allowance charge applies on the excess at:

- 55% (if paid out as a lump sum)
- 25% (if designated to flexi-access drawdown or to purchase an annuity)

When are benefits not tested against the lifetime allowance?

- Benefits already crystallised; or
- Benefits paid outside of the two-year period; or
- Any benefits where the member was 75 or over when they died

Beneficiary's drawdown–dependant, nominee and successor

There are three types of beneficiary to whom a death benefit can be left:

Beneficiary nominated by the member

Individuals now have the ability to nominate anyone as a beneficiary. Nominations for death benefits are no longer restricted to a dependant.

1) Dependant:

- Any individual married to, or in a civil partnership with the member at the date of their death
- Any child (including a legally adopted child) of the member who has not reached the age of 23; or
- Any child of the member who, in the opinion of the scheme administrator, is dependent on the member because of physical or mental impairment at the date of the member's death
- Any person who was not one of the above but in the opinion of the scheme administrator at the date of the member's death was financially dependent on the member, or the person's financial relationship with the member was one of mutual dependence, or the person was dependent on the member because of physical or mental impairment.

2) Nominee:

- Any individual that is not a dependant, who is nominated by the member; or
- Any individual nominated by the scheme administrator, (where there is no dependant, no individual or charity nominated by the member)

Beneficiary nominated by the dependant or nominee (or successor)

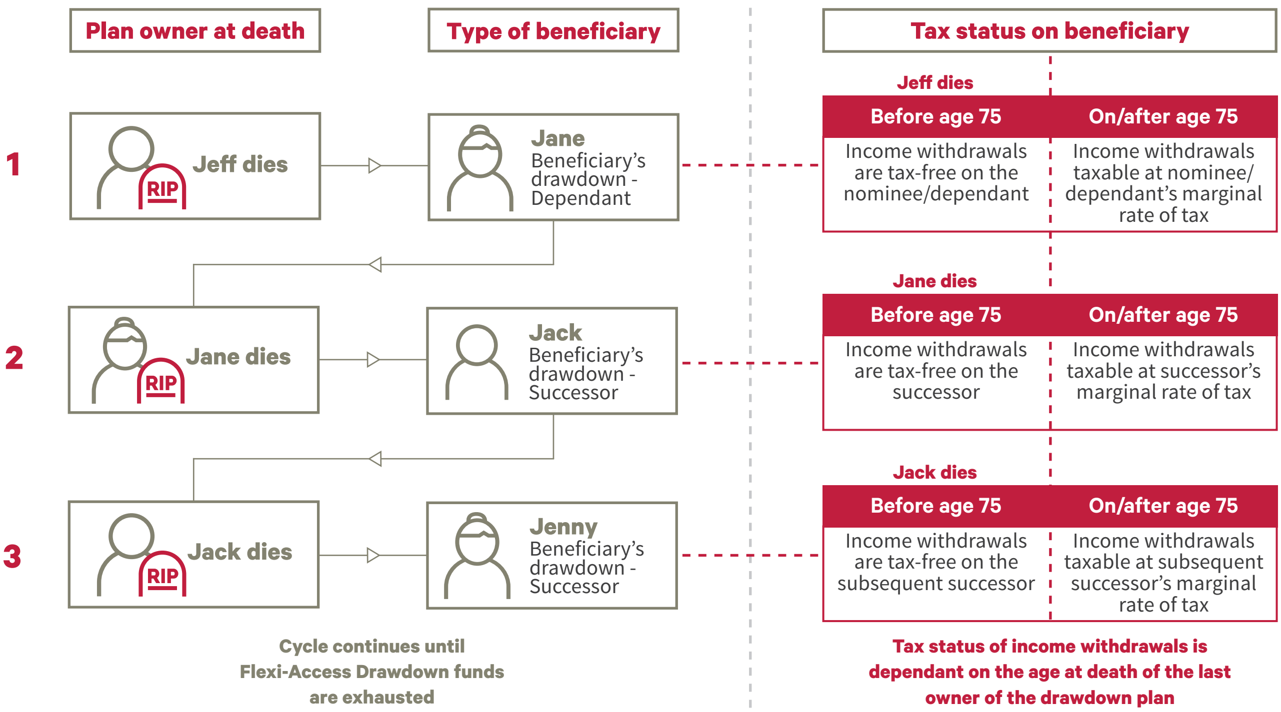
Those dependants or nominees in receipt of a beneficiary's flexi-access drawdown can also leave any remaining benefits to a successor on their subsequent death.

3) Successor:

- Any individual nominated by a dependant, nominee or successor
- There is no limit on how many times benefits can pass from successor to successor

Example–beneficiary's drawdown passing through the generations

1. Jeff is in flexi-access drawdown, and nominates his wife Jane to receive a beneficiary's drawdown, on his death.
2. Jane now has a beneficiary's drawdown, and she nominates their son Jack to receive her beneficiary's drawdown on her death.
3. Jack now has a beneficiary's drawdown, and he's nominated his daughter Jenny to receive a beneficiary's drawdown, on his death.



Planning considerations

Pension tax planning can help clients:

- Use existing wealth to build retirement benefits for other family members, for example using pension contributions
- Run down other non-pension assets to provide income in retirement, in the most tax efficient manner
- Looking to protect benefits above the current lifetime allowance, where they meet the existing criteria for either Fixed or Individual Protection 2016

Pension estate planning can help clients:

- Structure pension death benefits to pass on wealth to the next generation in the most tax efficient fashion
- Where discretion is an issue, to use a discretionary trust to receive any lump sum death benefits.

This document is based on Canada Life's understanding of applicable UK tax legislation and current HM Revenue & Custom's practice, as at March 2020 and could be subject to change in the future. It is provided for professional advisers only. Any recommendations are the adviser's sole responsibility.

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