Death where is thy sting?

Simon Nicol outlines changes to death benefits.

To the everlasting joy and sorrow of the pensions industry there is barely a year that goes by that does not see changes to pension rules, but 2014 seemed extraordinary even for us seasoned industry professionals.

The March 2014 Budget saw the announcement of plans to introduce a degree of pension flexibility and access to pension funds not before seen in a century of modern pension provision. The Budget also referred to a review of the tax position for pension funds on death. When the announcement about death benefits came at the Conservative Party conference in September 2014, this proved almost as dramatic. The new death benefit provisions are without doubt a game changer; they significantly alter the equation for many when considering the transfer of wealth between generations.

Taxation of Pensions Act 2014

The death benefit provisions in the Taxation of Pensions Act 2014 have been overshadowed by the pension flexibility rules, but the effect on many people or their descendants will be dramatic. For the most part the new death benefit rules affect death payments made on and after 6 April 2015, but they will apply even where death occurred before that date if payment is deferred until after 5 April 2015. In the event of a death before 6 April 2015 deferring payment will be an attractive option for most. Therefore the new rules need to be considered now.

Current regime

The current tax regime distinguishes between pensions that are in payment, ie “crystallised”, and those that are not, ie “uncrystallised”.

Crystallised pension funds will be largely those in drawdown plans from which tax free cash has been taken. Uncrystallised funds will be those from which no tax free cash or income has yet been taken. It is common to have a mixture of crystallised and uncrystallised funds in the same plan if pension income has been phased in.

The second major distinction is whether death occurs before or after age 75. Table 1 summarises the tax charges applicable to each of these designations.

Under the old regime there was an incentive to defer crystallising benefits to preserve the tax free status of funds on death, and to take income from a crystallised pension to reduce the amount subject to 55% tax on death. The new rules will no doubt make some people reverse this approach.

New rules

The new regime radically alters the tax position, very much to the benefit of pension holders and their beneficiaries. Many of the latter will find themselves in an enviable tax position.

Death tax abolished

All pension funds, regardless of status, crystallised or not, or age on death, can be passed on tax free with no 55% death tax, and outside the estate for IHT purposes, *as a pension fund*.

Death under age 75

If the pension holder dies under age 75 the beneficiary could choose to take the benefit as a tax free lump sum, or perhaps more efficiently leave the pension fund in a drawdown plan known as a “flexi access drawdown” (FAD) and draw cash as and when required still tax free. This leaves the fund in the tax favoured environment of pensions and outside the beneficiaries’ estate. Further income can be drawn from the fund at any age with no tax charges.

It is also possible for a *dependant* to buy an annuity with income paid tax free.

Death at 75 or over

The FAD is still tax free at point of setup, but income tax at the beneficiary’s marginal rate is paid on any withdrawals. The option to take a lump sum at the outset exists but tax will be paid as a “special lump sum death benefit charge”, which will be 45% for payments during 2015/16, but is expected to revert to a marginal income tax charge on the beneficiary from 2016/17. Again it is hard to see why the lump sum option would be taken.

Successive generations

Any individual or individuals can be named as the original pension holders “nominee” and they in turn can nominate “successors” to receive the remaining fund. What’s more the tax position is reset for each succeeding

Table 1

Old rules	Pre-age 75	Post-age 75
Lump sum	Uncrystallised funds – tax free Crystallised funds – 55% tax	Subject to 55% tax
Income	Taxed as income Option only available to dependants	Taxed as income Option only available to dependants

beneficiary depending on the age at death of the preceding holder. Thus the income tax status on withdrawals can change from taxed to not taxed if the previous holder dies before age 75.

The ramifications of this will take some consideration. It is possible that large pension funds will build up over generations, and there is no limit to how many pension funds any one individual can accumulate. When income is taken and how pension funds are passed on will no doubt be the subject of some angst for wealthy families.

Lifetime Allowance (LTA)

An LTA test will take place on some funds upon death. These will be primarily uncrystallised funds for pre-age 75 deaths. In most other cases the LTA test will already have taken place at crystallisation or upon reaching age 75.

If the member's benefits exceed £1.25m, or such higher personal LTA as may have been gained through LTA protection, then the excess will be subject to the standard 55% LTA excess tax charge.

An LTA test would only possibly take place on the death of the original pension holder. Inherited pension funds will always have been tested and will not be further tested when passed on again. Inherited pension funds also do not count towards the recipients personal LTA.

Two-year rule

A two-year clock starts from the earlier of the pension scheme administrator being informed of the death and when they should have known. Payments not made within this window are subject to the "special lump sum death benefit charge" of 45% for 2015/16 (expected although not yet confirmed to be marginal income tax rate from 2016/17). However, interestingly, payments outside this two-year window are not also tested against the LTA. Unlike the existing regime there may be occasions when waiting for the two-year period to elapse may prove advantageous.

The new rules are summarised in Table 2.

It is important to note these new rules apply only to defined contribution (DC) schemes, defined benefit (DB) schemes are excluded and remain unaffected, e.g. spouse's pensions will still be taxable in any circumstances. This may encourage some to transfer from DB to DC schemes.

Implications for advisers

As an estate planning vehicle it is difficult to see how pensions could be much better. Tax relief on contributions, no seven-year wait, tax free growth, access to the funds if you need them (with 25% back tax free!), and no IHT considerations for successive generations. Anyone who does not reconsider their pension contribution position will surely be missing a trick.

It is a pity that pension contributions are limited to the annual and lifetime allowances, but with carry forward there will be plenty of scope for contributions for many people.

For those already in retirement a review of strategy is essential. For many retirees a phased retirement approach has been used, designed to minimise the amount of pension fund crystallised and subject to tax on death. With that distinction now gone, the pension holder may be well advised to minimise their own tax position by greater use of the remaining tax free cash available.

A rethink will also be in order regarding which income sources are used. Perhaps pension funds are best left and other sources of funds and capital that may be subject to IHT, used in preference. Again, flexible pension access means funds will always be available if needed.

It will also be wise for pension members to look at their pension nominations forms. Is the spouse still the best option as the named beneficiary? For those with no nomination the administrator's choices may be restricted.

It is also important to understand that just as with the new flexible pension access, the pension provider does not have to offer all the new options. If the pension provider does not have a flexi access drawdown account then a lump sum death benefit may be the only option. This will particularly apply to older policies and to company DC schemes. In the latter case there will be little incentive for companies to keep administering pensions for long deceased employees.

Summary

Rarely have we seen a tax change that carries such potential benefit for those affected. There will be many families saving many thousands of pounds as a result.

As a final note of caution I would direct readers to my first sentence and this thought. Before too long some lucky beneficiaries will have inherited pension funds of several million pounds upon which they paid no IHT, and indeed upon which no tax has ever been paid. Further, the beneficiary can invest the funds tax free and receive a healthy tax free income. In other words no tax at all is paid on this wealth and this could carry on for generations. How long will a future Chancellor leave that lowest of hanging fruit untouched? **TPT**

Table 2

New Rules	Pre-age 75	Post-age 75
Lump sum	Tax free	Subject to 45% tax (marginal rate from 2016/17)
Income	Tax free Option available to any beneficiary	Taxed as income Option available to any beneficiary

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