J05 Pension Income Options 2020/2021
Part 6 Death benefits

This section will look in detail at the options when the member dies.

The milestones are to be able to understand:

- The options open to a nominated person
- The importance of the member making a nomination
- The taxation of the death benefits
- The conditions for making a charitable lump sum death benefit

Death benefits overview

A deceased member could have had:

- Been in receipt of a DB pension
- Been in receipt of lifetime annuity
- An uncrystallised fund
- A Flexi Access or Capped Drawdown fund

A DB pension may be inherited by another person on the member's death. The scheme rules may only allow it to be paid to a legal spouse or civil partner. If there are children under 18 or in full time education the rules may allow a pension to additional pension on their behalf. The pension cannot be paid to anyone else when the dependent dies.

With a lifetime annuity, all the death options would have been selected at the outset so no further action is required.

Raj bought a single life annuity with no guarantees. He died six years later, the income ceases and no one else can benefit Vera bought a joint life annuity with her husband Roger as the second life. She died before Roger so he continued to receive an income until he died. Frank had a single life annuity with a 10 year guarantee. He died seven years after purchase so the income is paid for another three years. Ian bought a single lifetime annuity for £200,000 with a 50% capital guarantee. When he died he had received a gross income of £70,000 do a capital guarantee payment of £30,000 was made

A wider range of options is available if the member dies with either an uncrystallised or a FAD fund. These funds will not be part of the deceased's estate and cannot be passed on by will or intestacy.

Who gets to decide?

Most plans will be written under trust so ultimately the scheme administrator can decide who is going to benefit. However, the member would normally have made a nomination naming the person or persons who get the right to choose what to do with these funds. This is not binding and the administrator can override the nomination.

If the member wanted absolute certainty that the money would be paid to a specific person, then a binding instruction would be made but this would probably mean that HMRC would treat the funds as part of the deceased's estate.

The member can nominate anyone as there is no minimum age to receive the benefits but HMRC will class them either as:

- A dependant
- A nominee

A dependant is defined as a spouse/civil partner, a child under 23 at the date of the member's death or a child over 23 who is financially dependent on the member.

Anyone else will be a nominee

The nominated person has three options:

- Take the fund as a cash payment
- Use the fund to buy a dependant's or nominee's lifetime annuity
- Designate the fund as a dependant's or nominees FAD

These are not either/or options and the fund could be split to take all three if required. If the deceased had nominated two individuals, each could select a different option.

The options in more detail

Cash lump sum

The nominated person takes all or part of the lump sum and can do whatever they like with it. The money is now outside the pension regime.

Lifetime annuity

This would be a dependant's or nominee's lifetime annuity and would cease on their death. There can be no other beneficiary and no guarantees. The rate would be calculated on the nominated person's age.

Designate the fund as a FAD

This would be described as a **dependant's/nominee's flexi access drawdown fund**. The nominee or dependant could take as much or as little as they wished from the FAD. The nominee or dependant cannot make contributions into this nor transfer an uncrystallised fund into it.

The fund remains in the pensions regime so growth is tax free and it is outside the dependant's or nominee's estate

The dependant or nominee can nominate someone to receive any remaining fund on their death. That person is a successor and they will have the same options:

- A lump sum payment
- A successor FAD
- A successor annuity

Again, the lump sum payment will take the money outside the pension regime whereas the FAD means that it is still within it.

If the FAD option is chosen the successor can nominate a further successor who will have the same options.

If a dependent or successor annuity is purchased this cannot be passed on after death.

Note that the member cannot nominate a successor which could raise issues with second marriages.

Alan and Suzanne are married and each have children from previous marriages. Suzanne would ultimately like her children to benefit from the drawdown fund.

She dies and nominates Alan to receive the fund who can nominate his children to receive the benefits on his death. To avoid this Suzanne should nominate her children bypassing Alan.

Alternatively, she could consider having the remaining fund placed into a trust on her death. This would take the money outside the pension regime

No Nomination made

If at any stage a nomination hasn't been made the administrator has the power to nominate. In most cases the nominated person(s) will have all three options but there can be a restriction if the **member dies** and no nomination has been made.

To understand this restriction let's consider three scenarios.

1. Administrator nominates one or more persons who are all dependants.
2. Administrator nominates one or more persons, all of whom are non-dependants

3. Administrator nominates two or more persons, but some are dependants and some are non- dependants

In the first two cases the people who the administrator nominates can be given all three options.

In the third a non-dependant can only be given the cash option.

When Kelly died, she was a widow and had two children Alan aged 26 and Peggy aged 22. She had made no nomination for her uncrystallised fund.

As Peggy is a dependant (under 23) the administrator can nominate Peggy to have an income or lump sum but Alan as a non-dependant can only receive a lump sum.

However if Alan and Peggy were both over 23 when their mother died neither would be a dependent and could be offered both the income and lump sum options.

This restriction does not apply on the death of a beneficiary or successor.

Taxation of death benefits

The good news is that this is very simple as all the following death benefits from a money purchase arrangement are taxed in the same way:

- Dependant's nominee's pension from a joint life annuity
- Income or capital guarantee from a lifetime annuity
- Lump sum death benefit from an uncrystallised fund
- Flexible Access Lump Sum
- Income from a dependant's/nominee's annuity
- Income from a dependant's/nominee's/successor's FAD

For a death occurring after 5 April 2015 all benefits are tax free provided the **deceased was under 75** when death occurred and the scheme/provider was notified within two years of death.

For deaths that occurred before 6 April 2015 the key factor is whether any income or withdrawal was taken.

Ben's wife died in 2012 and he received 50% of her pension immediately following her death. This income will be taxable and will remain so for the rest of Ben's life.

Eve designated her late husband's uncrystallised fund as a dependant's FAD in September 2014. She made the first withdrawal in May 2015 so all future withdrawals are tax free.

If Eve had taken a withdrawal in February 2015 then all future withdrawals would be taxable.

If the member or owner of the FAD was over 75 or under 75 but the scheme or provider wasn't notified within two years of death, then the benefits will be taxable as the recipient's non-savings income.

It is the age of the deceased person that is significant as illustrated in the following examples.

Alistair had designated his pension fund as a FAD and nominated his wife Hazel as his dependant. Alistair died age 74 when Hazel was 78 so all benefits would be tax free.

Hazel decided to take a dependant's FAD and nominated her son Donald as the successor. Hazel died aged 82 when Donald was 52. All benefits would be taxable.

From a purely tax efficiency point of view it would be better if Donald designated a successor FAD than take a lump sum. Let's say the value of the fund was £100,000 taking this as a lump sum would mean that it would all be taxable in the tax year it was taken. By designating it a FAD Donald can control the amount of income that is taken each year.

Donald designates it as a FAD and takes no withdrawals. He dies aged 64 and his two children are the nominated successors. All benefits would be tax free

Here is another example to illustrate the under/over 75 rule.

Claire had designated her late husband's capped drawdown fund a dependant's drawdown fund when he died in 2013. She had taken regular withdrawals since the date of his death so these would be taxable.

Claire died in 2016 aged 73 with £100,000 remaining in the fund. She nominated her son Andy as the beneficiary, He instructs the administrator to designate it a successor's FAD. All withdrawals are tax free.

Paying death benefits into a trust

An individual may nominate a trust rather than an individual to receive the death benefits This will take the money out of the pension regime and may have an adverse tax effect.

If the deceased was over 75, the transfer will be taxed at 45% rather than at the recipient's personal tax rate. This is because a trust is not a person. If the trustees pay out the whole or part of this immediately to a beneficiary it will be paid with a 45% tax credit which can be reclaimed by the beneficiary. The same rule applies if the deceased was under 75 and the money was not paid into the trust within two years of death.

Mary died aged 78 and she nominated a discretionary trust to receive her FAD fund of £100,000. This would be a subject to a tax charge of £45,000. The trustees decide to pay this to her granddaughter.

She receives £55,000 with a tax credit of £45,000. Assuming she is a higher rate tax payer she has a liability of £40,000 and can offset the tax credit so can claim a £5,000 refund.

If the deceased was under 75 there is no tax charge.

Charitable Lump Sum

There is a final option open to the member and dependant which is to use an uncrystallised fund or a Drawdown fund to make a gift to a charity lump sum. The rules for the member are:

- There must be no dependants of the member
- It is paid to a charity nominated by the member.

Antonia had a husband when she died she could not make a charitable gift from either an uncrystallised or a drawdown fund.

For a dependant or successor, the rules are broadly the same but there must be no dependants of the original member. There are no age restrictions but benefits can only come from a drawdown fund.

Jeremy and Zoe were married at the time of his death and Zoe designated Jeremy's uncrystallised fund as a dependant's FAD. Jeremy had no children but Zoe had one child under 23 from a previous marriage

On Zoe's death a charitable lump sum can be made because Jeremy had no dependants even though Zoe does have a dependant

Zoe could select a charity of her choice but if Jeremy had made a nomination before he died then Zoe could not override this.

In the absence of any nomination the scheme administrator does not have the power to make a charitable donation.

That concludes this part so you should now understand:

- The options open to a nominated person
- The importance of the member making a nomination
- The taxation of the death benefits
- The conditions to make a charitable lump sum