Linklaters

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Occupational pension schemes:

Lump sum death benefits: Tax issues

Here we look at the main tax issues which arise in relation to lump sum death benefit payments. We shall start with tax-registered pension schemes.

In short:

Tax-registered pension schemes

Inheritance tax

It is often said that pension scheme rules must require lump sum death benefits to be payable at the trustees' discretion (rather than as the member directs), so as to avoid inheritance tax (**"IHT"**). This is not strictly correct.

To avoid IHT on lump sum death benefits from a registered pension scheme:

The true position is that a lump sum death benefit from a tax-registered scheme will not be chargeable to IHT, so long as two conditions are met:

> First, the lump sum must not <u>automatically</u> pass on death to the member's personal representatives (i.e. to his or her estate).

If it does automatically pass to the estate, then it will be treated as part of the estate for IHT purposes and so may give rise to an IHT charge.

But, so long as any payment to the estate is not automatic, there is no problem. If the trustees have discretion to pay it to the member's estate, the fact that the estate does not have an automatic right to the benefit means that there is no IHT charge – even if the trustees do in fact decide to pay the benefit to the estate.

Many of these schemes require the trustees to pay the benefit to the member's estate if it has not been paid out by the end of a two-year period. Even this will not trigger an IHT charge, as the estate's right to the lump sum still does not arise automatically on death.

(1) the lump sum must not pass <u>automatically</u> to the deceased's estate; and

> Secondly, the member must not have the power to direct payment to his or her estate.

It is not enough that the member *does not* direct payment to the estate: merely having the power to do so (whether the member exercises that power or not) will be enough to bring the benefit into the IHT net.

(2) the member must not have the power to direct payment to his or her estate.

However, the scheme rules may allow the member to direct payment to anyone except the estate (and the member may safely exercise that power) without this leading to an IHT charge.

So, where the trustees have a discretion as to who should receive the benefit, this should be seen as an integral part of the scheme's benefit design rather than as a means of avoiding IHT. We say this in particular because:

So where the scheme gives the trustees a discretion as to who should receive the benefit, this should be seen as an integral part of the scheme's benefit design rather than as an IHT planning issue.

> IHT could just as effectively be circumvented by making the lump sum automatically payable to whomever the member had nominated (other than the estate) before his death. However, this could give rise to some unfortunate results if the member died leaving an old nomination form that he or she had not kept up to date. The real advantage of having a trustee discretion is that it can be used to avoid outcomes like this.

> If the benefit were automatically payable to the estate, then that could give rise to an IHT charge – but only if it were to bring the estate over the IHT threshold of (currently) £325,000. IHT will only therefore be a concern for relatively well-off members. The more mainstream reason for avoiding automatic payment to the estate is that it could result in the money being used to pay the deceased's creditors – or being paid to beneficiaries named in an outdated will.

We mentioned earlier that many schemes require the benefit to be paid out by the end of a two-year period. We turn to the reason for this next.

Unauthorised payments

Any lump sum death benefit from a tax-registered scheme should be paid out within two years after the trustees became (or should have become) aware of the death. If it is paid out later than that, it will be an "unauthorised payment" under the pensions tax legislation, leading to adverse tax charges.

Other tax issues concerning lump sum death benefits from tax-registered schemes include the need to ensure that they are not "unauthorised payments" …

That is why many schemes require the trustees to pay the benefit to the member's estate if it has not been paid out by the end of a two-year period. This is not however the approach that will necessarily produce the most satisfactory result (particularly where payment to the estate would end up benefiting the member's creditors or individuals named by the member in an out-of-date will). It may also expose the trustees to claims from the people who might have expected to benefit if the trustees had acted sooner.

A better approach, if the trustees are still not in a position to make the payment to a beneficiary at the end of the two years, would be for them to pay the money into a separate trust outside of the scheme, whose class of potential beneficiaries is no wider than that under the scheme rules. Most occupational schemes' rules permit this.

*Lifetime allowance (**"LTA"**)*

… the possibility of a lifetime allowance charge arising ...

Additionally, some lump sum benefits from tax-registered schemes payable on death before age 75 are tested against the deceased's available LTA (so potentially leading to an LTA charge).

Broadly speaking, this applies to the main types of defined benefit lump sums on death (but not a "pension protection lump sum"[1]) and to those money purchase lump sums where the member dies before starting to draw his or her pension.

The lifetime allowance charge is then calculated as 55% of the amount by which the lump sum exceeds the member's available LTA.

Special tax charge

… and, in certain other instances, the possible imposition of a 55% special tax charge.

Other lump sum death benefits are subject instead to a 55% "special lump sum death benefits charge".

This is payable by the scheme administrator (which generally means the trustees, in the case of an occupational pension scheme). Usually the scheme rules will allow the trustees to deduct the tax charge from the lump sum giving rise to it.

Subject to narrow exceptions[2], the 55% charge is incurred on any lump sum death benefit which does not have to be tested against the LTA (either because it does not fall into one of the categories of benefit mentioned above or because the member died after reaching age 75).

Both the LTA charge and the special tax charge are more material now than they were until relatively recently: the special tax charge rose from 35% to 55% in 2011, while the lifetime allowance (reduced from £1.8m to £1.5m from 6 April 2012) is to be lowered again from 6 April 2014 to £1.25m.

The LTA reduction in 2014 is of particular concern here. This is likely to affect more people than did the last LTA decrease in 2012, and many members whose retirement pensions would not normally be expected to bring them over the LTA may find that the lump sum payable were they to die in service would be enough to trigger an LTA charge.

1 This is a benefit that arises where a member dies having become entitled to his or her pension and the member had previously specified that the lump sum death benefit be treated as a "pension protection lump sum death benefit". The main purpose and effect of specifying that the lump sum be treated in this way is the difference in tax treatment outlined on this page.

2 These exceptions are: trivial commutation lump sum death benefits; certain other types of lump sum benefits permitted by the legislation not exceeding £2,000; winding-up lump sum death benefits; and charity lump sum death benefits.

Non-registered schemes: "Relevant life policies"

The LTA charge will not apply if the benefit is provided from a non-registered scheme.

The LTA charge (as well as the special tax charge and any unauthorised payment charges) can be avoided by instead providing these lump sum death benefits through a trust *outside* of the tax-registered framework.

However, this does need to be structured carefully. *The IHT treatment of schemes that are not tax-registered is potentially stricter than it is for those that are, and income tax can also arise on both the death benefit and on the employer's contributions (as a benefit in kind) where it would not do so under a tax-registered scheme.*

To address these tax issues, a number of requirements should be met:

To minimise the income tax and IHT consequences of the scheme not being tax-registered, the policy should be a "relevant life policy" and the scheme should meet certain requirements.

Lump sum death benefits provided through a non-registered trust

Key steps for minimising income tax and inheritance tax charges

The benefits should be secured through what is called a **"relevant life policy"**. Some of the key features of this type of policy are that:

> the benefit may only be payable on death before a specified age not exceeding 75;

> there are limits on the surrender value that the policy may have at any given time;

> all lump sum death benefits are payable at the direction of (in this context) a trustee who will secure payment to an individual or charity;

> there are tight restrictions on the other types of benefits that the policy may provide; and

> in the case of a group policy (an **"excepted group life policy"**):
  - the benefit must be payable in the same circumstances for each person covered by it and must be calculated in the same way for each of them; and
  - no other benefits may be paid under the policy.

The only assets transferred to the trust should be the policy (or policies). The employer should pay the premiums for these and should <u>not</u> put the trustees in funds to pay the premiums themselves.

The range of potential recipients of the lump sum is much narrower than would be possible under a tax-registered pension scheme.

The trust must come to an end within three years of its creation. This may mean periodically having to terminate the trust and replace it with a new one.

We shall be taking a closer look at this type of arrangement in a separate newsletter.

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