UK Pensions - Tax Simplification.

Death and Survivors’ Benefits

Our earlier newsletter, “UK Pensions - Tax Simplification”, summarises the Revenue’s simplification proposals and so provides the background to this note. A copy of that newsletter is available from julie.west@linklaters.com.

This newsletter and attached schedule considers issues relating to death and survivors’ benefits in light of the proposed tax changes.

Possible changes in benefit structures/scheme rules

– Schemes will need to review death benefit trusts, if the current proposals that lump sums will be payable only to dependants or legal representatives are enacted.

– Five year guarantee lump sums may have to be withdrawn in certain circumstances. It is to be hoped that if Section 67 of the Pensions Act 1995 (or replacement legislation) makes this difficult, the legislation will provide for an exclusion.

– Larger lump sums on death after retirement may, in spite of the 35% tax, become a more attractive proposition to many members, as giving value for the capital invested.

– Schemes may want to consider giving an option for members to cap lump sum death-in-service benefits (or death-in-deferment benefits) so that amounts in excess of £1.4 million are taken as dependants’ pensions.

– The proposed conversion factor of £20 capital for £1 pension when valuing benefits against the lifetime limit assumes dependants’ pensions equal in total to the member’s pension. Schemes may want to consider providing options to increase dependants’ benefits up to that level to assist members to stay within the lifetime allowance. Schemes may want to review their surrender provisions and related administration.

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The proposals raise the possibility of minimising tax liability through use of partial vesting, by taking advantage of the fact that lump sums from unvested pension funds are tax free up to the lifetime limit, whereas lump sums from vested pension funds are subject to tax at 35% (see example below). Schemes will need to factor this into discussions on flexible vesting.

Example
At age 55, Joe Bloggs has benefits valued at £1.2 million – i.e. below the lifetime limit.

He decides to vest benefits worth £200,000 and starts receiving a secured pension of £10,000 per annum. Unfortunately, he dies within one year. A lump sum of £190,000 could be paid from his vested benefit fund, subject to tax at 35%. His residual unvested fund of £1 million could be paid tax free.

Had he vested his total fund of £1.2 million (receiving, say, a pension of £60,000 per annum for the year before his death) a lump sum of £1.14 million would have been payable, all subject to 35% tax.
<table>
<thead>
<tr>
<th>Current type of benefit</th>
<th>New type of benefit</th>
<th>What will be permitted?</th>
<th>Proposed tax treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependants’ pensions on death in service and death in deferment</td>
<td>Dependants’ pensions before vesting.</td>
<td>Any amount. Payment terms similar to current regime. May not carry income guarantees or be value protected.</td>
<td>Subject to income tax in the recipient’s hands. Does not generally count towards member’s or recipient’s lifetime allowance.</td>
</tr>
<tr>
<td>Lump sums on death in service and death in deferment.</td>
<td>Lump sum before vesting.</td>
<td>Unlimited lump sum payable (only) to dependants or member’s legal representatives.</td>
<td>Amounts in excess of lifetime allowance will be subject to a 55% recovery charge.</td>
</tr>
<tr>
<td>Dependants’ pensions on death after retirement.</td>
<td>Dependants’ pensions after vesting.</td>
<td>Any amount. May be taken as unsecured benefits until dependant reaches 75. Payment terms similar to current regime. May not carry income guarantees or be value protected.</td>
<td>Subject to income tax in the recipient’s hands. Does not count towards recipient’s lifetime allowance.</td>
</tr>
<tr>
<td>Lump sums on death after retirement e.g. a 5 year guarantee lump sum.</td>
<td>Lump sum after vesting but before age 75.</td>
<td>Where a member is drawing unsecured benefits (i.e. drawdown), a capital sum equal to the undrawn funds.</td>
<td>Subject to tax at 35%.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Where a member is drawing secured benefits, the initial capital value of the pension less pension instalments already paid (“value protection”).</td>
<td>Subject to tax at 35%.</td>
</tr>
<tr>
<td>5 - 10 year pension guarantees on death after retirement</td>
<td>Pension guarantee.</td>
<td>Secured pension may continue for up to 10 years from the date of vesting. Value protection and guaranteed pension payments are mutually exclusive. Can seemingly apply even if member was aged over 75. Dependant can defer any dependant’s pension until the guarantee pension expires.</td>
<td>Subject to income tax in the hands of the recipient.</td>
</tr>
</tbody>
</table>
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