SAUNDERSON HOUSE

Special Briefing

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Who will inherit your pension?

As we are often told, it is sensible to review Wills and estate planning on a regular basis. What can sometimes be overlooked in this regard is pension funds. This is particularly relevant since the Taxation of Pensions Act 2014 introduced some significant changes to pension death benefits (effective from 6 April 2015).

This note sets out the rules that now apply and the options available, together with a real-life case study. Having considered these, it may be appropriate to review the Expression of Wish you have in place or make one, if you have not already.

Strategic Planning

Pension death benefits are (in all but some exceptional circumstances) exempt from Inheritance Tax (IHT).

As set out below, pension assets can now be passed down the generations and need to be taken into account from an estate planning perspective. In many instances, it may be appropriate for individuals to draw down non-pension assets to fund expenditure, as this reduces the value of the estate subject to Inheritance Tax. There are many factors that interplay here and the correct approach will depend on individual circumstances and objectives. If you would like to discuss further, do please get in touch.

What are the options for pension funds?

Under new legislation, a pension fund can be inherited in three different ways (and by single or multiple beneficiaries):

- **lump sum** - the pension fund is paid out directly to chosen beneficiaries, or to Trustees to hold on behalf of the beneficiaries;
- **beneficiary's pension** - the pension fund is transferred into a pension in the name of chosen beneficiaries, from which unlimited withdrawals can be made at any time (including before age 55). Under previous rules this option was restricted to individuals, such as spouses or young children, who were designated a financial dependant (defined in the footnote below);
- **annuity -** the pension fund is used to purchase annuities in the name of the chosen beneficiaries. While annuities may be a suitable alternative, particularly for risk averse investors requiring a regular income for life, this note focuses on the lump sum and beneficiary's pension options.

The taxation of the lump sum or beneficiary's pension depends on the age of the pension scheme member at the date of death, as summarised below:

Age on death	Inheriting a lump sum	Inheriting a beneficiary's pension
Before 75	0%	0%
75 or over	Beneficiary's marginal income tax rate when the lump sum is paid	Beneficiary's marginal income tax rate as and when withdrawals are taken

Note: Different rules may apply if no action is taken within 2 years of the member's death.

We believe that the beneficiary's pension is the most attractive option for the following reasons:

- monies within a beneficiary's pension can continue to grow virtually tax-free (as with the original pension fund), and a beneficiary's pension is never tested against the beneficiary's own Lifetime Allowance;
- monies within a beneficiary's pension remain outside of the beneficiary's estate for IHT purposes and therefore any funds that the beneficiary does not require can be inherited by their own beneficiary (known as 'successor' under the new rules), and so on, subject to the same tax treatment as laid out in the table above. The tax rates that will apply depend on the successor's age at the time of their death (not the age of the original member). This process can continue indefinitely, allowing for pension funds to be passed down through several generations;
- on the death of the pension member after age 75, assuming a sizeable pension fund, withdrawals from a beneficiary's pension over multiple tax years (or simply as and when required) could result in a significantly smaller tax liability than taking the entire pension fund as a lump sum immediately (as lower rate tax bands may be available to the beneficiary);
- as unlimited withdrawals can be made from the beneficiary's pension at any time (including before age 55), the entire fund could still be drawn in a single payment (i.e. effectively as a lump sum).

A lump sum can be paid to anyone. Under the new rules, a beneficiary's pension can only be paid out to:

- a dependant (as classified in the footnote) – this is unchanged from the previous rules;
- any non-dependant beneficiary that you have specifically nominated in writing (this cannot be generic or a class of beneficiaries);
- another individual, nominated at the scheme administrator's discretion (only if neither of the above options exists).

If you wish for anyone besides a dependant to inherit your pension (or a proportion thereof), we recommend that you specifically nominate them in writing.

Additional points to consider

In some scenarios, you may deem control over assets to be more important than any potential taxation benefits of a beneficiary's pension. For example, if there are concerns over children's relationships. In this event, a lump sum payment to a Trust may be more appropriate, despite what may be significantly less favourable ongoing taxation. The rules applying to trusts are quite complex, though it is important to note that Trusts broadly incur tax at the 45% rate, with a tax credit available that may (or may not) reduce the income tax liability when distributions are subsequently made. Further details can be provided if this would be of interest.

For many, the default position has previously been to nominate the full death benefit to their spouse/civil partner. Deciding whether to nominate other beneficiaries (potentially alongside a spouse/civil partner) will depend on (i) your comfort that any spouse/civil partner will have sufficient other assets to fund their lifestyle should they outlive you and (ii) whether you are prepared for others to inherit your pension (and have access to this on their own terms).

If you are married or in a civil partnership and your spouse/civil partner outlives you, you can pass your non-pension assets to them without any IHT, whereas when passed to anyone else, these would be assessable to IHT. If you believe that any pension assets would also be required to support your spouse/civil partner (in addition to non-pension assets), you can still include them as a beneficiary of part (or all) of your pension.

Generic Expressions of Wish, such as 'refer to the executors of my will', which do not specifically nominate anyone, may still enable the distribution of death benefits as a lump sum or beneficiary's pension to a dependant. However, they may not enable the option of a beneficiary's pension to anyone not meeting the classification of a financial dependant.

For a number of occupational pension schemes, the treatment of death benefits is prescribed by the scheme rules and therefore the new flexibility may not be available through such schemes.

Typically, pension providers have their own 'expression of wish' forms, which can record this information, which may be sufficient for your needs. However, if your intentions for the pension fund are complex and cannot be adequately captured by your pension provider's standard form, you can draft a Letter of Wishes (with the assistance of a solicitor, if necessary) to clarify your intentions.

It is also important to be aware that the pension trustees retain discretion so there can be some flexibility to amend the distribution in the two years following death, particularly if all beneficiaries agree on a more appropriate strategy.

In light of the above, if you have not already done so, we believe it is appropriate to review your Expression of Wish regularly and bear in mind that any nomination should be based on how you would like benefits distributed assuming you were to pass away in the near future. Any Expression of Wish that you do make can be changed at any time, as your circumstances (or your views) change.

Case study

Consider the case of a client who passes away aged 70, with a SIPP worth £750,000 and Retirement Annuity Policies (RAPs) worth c£250,000.

The client had made an Expression of Wish for the SIPP to pass 1/3 to the surviving spouse and 1/3 to each of their two children. Each of these beneficiaries 'inherited' a pension fund worth £250,000 from which tax-free income can be drawn at any time, with funds growing free of any ongoing tax charge. There was no need to dispose of or repurchase any SIPP assets as these remained 'in the market'.

The surviving spouse has elected via her own expression of wish for the children to benefit from the inherited pension on her subsequent death.

The RAP proceeds were paid into a discretionary trust, with no immediate tax charge. However, income and capital gains will not be free of tax, with the trustees required to complete an annual tax return. Furthermore, there may be a tax charge at each 10 year anniversary and/or when subsequent capital gifts are made.

Conclusion

The new rules offer a simple and tax-efficient solution for the SIPP, with a more complicated and potentially administratively burdensome one via the trust, which will also have to contend with ongoing tax matters.

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An individual is classified as a financial dependant of the pension scheme member if they are:

1. the spouse or civil partner; or
2. a child that is still dependent. Specifically: (i) under the age of 23 (they will cease to be a dependant on attaining age 23) or (ii) dependent due to physical or mental impairment; or
3. anyone else who was deemed by the scheme administrator to be financially dependent on the member at the time of death (i.e. in most circumstances children aged 23 or more will not qualify).

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