Quilter

Change in Death Benefit Legislation - Case Study

Charles, 64, has been semi-retired for the last four years

He is in good health and works with his wife in a bed and breakfast business they set up when he retired from full time employment in the petro-chemical industry. Charles took the benefits from the final salary pension scheme at 60. After taking the pension commencement lump sum, his pension is now worth £25,000 a year and the scheme provides for a pension for his wife of 50% of his pension on death.

The income from their business is supplementing their current retirement needs and this allows their other investments to continue to grow for later life.

Charles has built up money purchase pension savings alongside his final salary scheme, partly during an earlier period of self-employment, and latterly to benefit from the annual allowance entitlements since April 2006. The total value of those savings is around £300,000 and is held in a retirement annuity contract and stakeholder personal pension.

The couple have also built up reasonable ISA savings as part of their retirement portfolio.

They have two adult children and three grandchildren.

Wider choice of retirement income

After learning of the wider choice of retirement income solutions available they asked their financial adviser to review their current position from a retirement perspective, and also to look at the plans they currently have in place to pass on some of those savings after death. The key information from the adviser's review is:

- The maturity age of the retirement annuity contract is 75, at which time Charles would have to buy a lifetime annuity.
- Charles's current pension savings do not offer any form of income drawdown facility, but provide an open market option to secure a lifetime annuity.
- The provider holding the retirement annuity contract investment has indicated that they provide an Uncrystallised Pension Funds Lump Sum facility but only in relation to a total encashment of the plan. This does not look appropriate, given that Charles would be liable to income tax at his highest marginal rate on 75% of the plan value.

If Charles wants to pass on any of the remaining value of his pension savings to his children, the only option currently available to him is by payment of lump sum death benefits. The capital would then form part of their estate.

If Charles's pension savings were restructured into a Collective Retirement Account, it would provide:

- more flexible retirement income solutions through flexi-access drawdown
- a number of alternative options as to how any pension savings remaining on his death can be passed down to other generations of his family.

His financial adviser explains that the 'new world' will provide the options below, which could benefit his family.

If Charles were to die before his 75th birthday:

- The option to pay a lump sum tax-free to his children would still be available on the value of his pension savings within his Lifetime Allowance. Any amount exceed his lifetime allowance will be taxable as income.
- However, it will now be possible for Charles to request that the remaining savings be applied in the form of beneficiary drawdown for his adult children. They will be free to draw capital and/or income from those savings tax-free, for their lifetimes regardless of their age and pay no income tax on any withdrawals they make. In addition, the fund will remain invested in a pension environment and hence outside of their estate for inheritance tax purposes.
- The value of the savings received as beneficiary drawdown will not affect the children's personal Lifetime Allowances for pension savings of currently £1.0731 million (for the 2023/24 tax year).
- In the event of the subsequent death of any of the children, any remaining value of their savings could be passed on by them as they see fit.

If Charles were to die after his 75th birthday:

- Any lump sum death benefit or beneficiary drawdown payments would be subject to each recipient's marginal rate(s) of income tax.
- However, with young grandchildren (and possibly more in the future), Charles might consider making the drawdown facility available to different beneficiaries. So part (or all) of any remaining savings from his drawdown arrangement could be applied for the benefit of his grandchildren. This could allow each of them to take tax-free income up to their remaining personal allowance limit. Any amount taken above that limit would be taxable at their marginal income tax rate(s).

The ability to provide this flexibility is something that appeals to Charles. He and his financial adviser agree that they need to talk to the children to discuss the additional flexibility that the new pension world will provide for passing on his pension savings and for creating a generational financial planning path in respect of these savings.

To make this happen Charles will need a contract, such as the Collective Retirement Account, that can provide:

- multiple income options under flexi-access drawdown to meet Charles's retirement income requirements
- the option for Charles's beneficiaries to receive any residual pension savings on his death via a beneficiary drawdown arrangement.

Wider choice of retirement income

The following flowcharts show:

- the tax treatment and Lifetime Allowance issues of any death benefit payment from residual money purchase pension savings; and
- the range of options available in terms of how death benefits can be paid and to whom.

Tax treatments of death benefit payments

Death of member/ dependant/ nominee/ successor***

Death under 75

- Lump sum paid within 2 years is tax-free. LTA test on the lump sum only where it originates from uncrystallised funds. Amount exceeding LTA is taxed as income.
- Lump sum paid after 2 years is subject to income tax under the PAYE system. If paid to someone other than an individual, such as a trust or company, the tax charge will be 45%. No test against LTA.
- Flexi-access account set up within 2 years is paid tax free. LTA test only if it originates from uncrystallised funds.
- Flexi-access account set up after 2 years that originates from uncrystallised funds is subject to income tax. No test against the LTA.
- Flexi-access account that originates from crystallised funds is paid tax free. No test against the LTA. No 2 year rule.
- Annuities-tax free if set up within 2 years. LTA test if from uncrystallised funds.

Death over 75

- Lump sum is subject to income tax. If paid to someone other than an individual, such as a trust or company, the tax charge will be at rate of 45%. No test against the LTA.
- Flexi-access account is subject to income tax. No test against the LTA.
- Annuities are subject to income tax. No tests against the LTA

It is important to note that if the deceased member's remaining fund was tested against the LTA whilst alive, it won't be tested after death. Any pension wealth a person inherits won't count towards their own LTA.

* *A nominee is anyone nominated by the member or by the scheme administrator (but a nomination by the scheme administrator cannot overrule a nomination made by the member or take precedence over a dependant if one exists).*

** *A successor is a person nominated by the dependant or nominee to receive flexi access drawdown. When the successor dies their remaining drawdown fund can be passed onto another successor that they choose. Where no nomination is made by the time the beneficiary dies, a scheme administrator may nominate a successor.*

The range of options available since 6 April 2015

Who can receive benefits on member's death?

1. *Lump Sum*

- A dependant (such as a spouse/civil partner, a child of the deceased under 23, a child of the deceased over 22 who was dependent on the member because of physical or mental impairment, or someone who was financially inter-dependent with the member).
- Any other beneficiary nominated by the member
- Any other beneficiary chosen at the discretion of the scheme administrator from the potential recipient(s) allowable under the scheme's rules (but only if there is no dependant of the deceased and no other nomination has been made).

2. *Annuity*

- A dependant (such as a spouse/civil partner, a child of the deceased under 23, a child of the deceased over 22 who was dependent on the member because of physical or mental impairment, or someone who was financially inter-dependent with the member).

3. *Flexi-Access Drawdown*

- A dependant (such as a spouse/civil partner, a child of the deceased under 23, a child of the deceased over 22 who was dependent on the member because of physical or mental impairment, or someone who was financially inter-dependent with the member).
- Anyone nominated by the member on their expression of wish
- If a member does not make a nomination, the scheme administrator cannot use their discretion to provide flexi-access drawdown to anyone other than a "dependant" if a dependant exists. If no nomination has been made and no dependant exists, the scheme administrator can use their discretion to nominate any potential recipient(s) allowable under the scheme's rules.

Your clients' investments may fall or rise in value and they may not get back what they put in.

The tax treatment and efficiency of these options will depend on the individual circumstances of each customer. Tax rules and their application may change in the future.

Full details of the CRA can be obtained from your Quilter consultant.

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