

Be Careful When You Die

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April 6th 2006, or 'A-Day' as it was known to those in the pension world, saw the introduction of a new tax regime to govern pensions. By sweeping away previous legislation, the Government's aim was to introduce a single 'simplified' set of pension rules. These new rules fundamentally changed the way in which pension funds are taxed, both during our lifetime and on death. This article examines how pension funds are taxed in the event of death.

Uncrystallised Funds

Individuals have a Lifetime Allowance (£1.65m in 2008/09 tax year) on their pension savings.

In the event of death before pension 'crystallisation' (i.e. before it comes into payment), 'uncrystallised' funds can be paid to nominated beneficiaries as a lump sum and, as long as the value of the pension pot does not exceed the Lifetime Allowance of the deceased, there is no tax to pay. If the pension pot exceeds the deceased's Lifetime Allowance, then the excess amount can still be paid as a lump sum, albeit subject to a 55% tax charge. Alternatively the excess amount could avoid this tax charge if it is used to provide a pension for a spouse, civil partner or dependant.

The rules are slightly different for 'Protected Rights' funds. These funds must be used to provide a pension for a surviving spouse or civil partner and, if no spouse or civil partner exists, the payment of a lump sum can be made but will count toward the deceased's Lifetime Allowance.

Crystallised Funds before age 75

Tax treatment on death changes dramatically once pensions come into payment.

If an annuity is purchased with an insurance company, the fund value is forgone in exchange for a guaranteed income for life. If capital protection is selected (the return of the original capital less annuity income paid before death) the resulting lump sum will be subject to a 35% tax charge.

Alternatively the pension fund could provide an 'Unsecured Pension', where an income is drawn directly from the pension fund by disinvesting an amount equivalent to the income needed. The advantages are that there is much greater control over the amount and timing of income payments, control over how funds are invested and greater flexibility in determining how the fund will be paid out in the event of death. However, Unsecured Pension does not offer the guarantees of an annuity and also exposes the individual to investment risk which an annuity would not.

Rather than having to make the irrevocable decisions required when purchasing an annuity, an Unsecured Pension fund can be used to provide payments most suited to the need of the spouse, civil partner or dependant at that time. The crystallised funds can be used to provide them with an income, either by purchasing an annuity or providing an unsecured pension, or a lump sum payment can be made subject to a 35% tax charge.

Again with Protected Rights, a lump sum can only be paid if there is no spouse, civil partner or dependant.

Crystallised Funds after Age 75

The Government is very keen to remind us that the tax reliefs granted to pension funds are supposed to encourage us to provide an income in our old age and not enable pension funds to be passed to future generations.

We therefore have the situation where the tax treatment of a pension fund on death changes at the arbitrary age of 75. Whilst it is no longer compulsory to purchase an annuity at age 75, the opportunity for sensible succession planning is limited.

Instead of an annuity one can receive what is called an 'Alternatively Secured Pension', which is broadly similar in concept to an Unsecured Pension, whereby income is drawn direct from the fund. However, the position on death is very different.

In the first instance, the fund **MUST** be used to provide a pension for a spouse, civil partner or dependant, if there is one. Only if there isn't any pension to be paid in this way, or on the death of the recipient, can the funds then be left to a nominated charity, free from tax.

Any attempt to pay the remaining fund as a lump sum (other than when it is paid to a charity, as outlined above) will trigger what is known as an 'Unauthorised Payment' tax charge. The rules surrounding the taxation of 'Unauthorised Payments' are complex but in general will lead to a tax bill equivalent to approximately 70% of the lump sum payment.

Following this tax charge, the remaining funds will be treated as forming part of the deceased estate and therefore, where this exceeds their nil rate band, will also incur a charge to inheritance tax at 40%. The composite effect of these tax charges is a staggering 82% of the lump sum.

Conclusion

While there may have been good intentions around the pension legislation changes enacted on A-Day, the options available to individuals are far from simplified. There are a range of options available where the benefits and tax treatment can vary significantly. For such a complicated subject, and without the knowledge of when they are going to die, it is imperative that private individuals, particularly those with significant pension funds, take professional pensions advice.



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