

Pension death benefits payable under defined benefit schemes

Although death benefits under defined benefit schemes have largely remained unchanged as part of the pension freedom rules, introduced in April 2015, there have been some key changes in how they are taxed. Below we look at the type of death benefits payable and the tax implications under the defined benefits schemes.

1. Types of benefit

Lump sums

- A defined benefits lump sum death benefit is typically (but not necessarily) a multiple of salary for those in employment. Member contributions may also be returned on death.
- A pension protection lump sum death benefit may be available when a scheme pension is being paid (see section 4).
- A trivial commutation lump sum death benefit may be paid when the value of a dependants' pension or remaining guaranteed instalments of the pension is no more than £30,000.

Pension

- Dependants' scheme pensions can be paid on the death of a scheme member before or after retirement. Depending on scheme rules they can be deferred for a period, payable for a limited time, reduce in payment or be paid less frequently than annually. However, upon the dependants' death they cannot have a guaranteed period, pension protection, be accompanied by a pension commencement lump sum or have a further pension payable.

2. Death in service

Often the lump sum death benefit is a multiple of salary (for example, 4 times). In addition, a pension may be payable to a spouse, civil partner or (depending on scheme rules) another dependant, which is normally a fraction (for example, half or two-thirds) of the member's pension based on potential service to normal retirement date. Many schemes offer a smaller pension for dependent children in addition.

However, there is no legislative maximum for either the lump sum or pension.

3. Death in deferment

A lump sum death benefit is unlikely to be available to those who no longer work for the sponsoring company (or cease to be a member of the pension scheme), but pensions for dependants are likely to be on the same basis as for active members.

4. Death in retirement

Dependants' pensions may be payable when a member dies after starting to receive their pension. There is no maximum level of such pensions under age 75, but on death after age 75 the total of dependants' pensions must not exceed the pension payable to the member at the time of death.

Alternatively, or in addition, the pension may be guaranteed to be paid for a period of up to 10 years, even if the member dies in that period, or a pension protection lump sum may be paid with a maximum of 20 times the initial level of pension, minus the total of pension paid before death.

Dependants' pensions and pensions paid during guaranteed periods cannot be commuted except on the grounds of triviality (if the value is under £30,000).

It is possible, but not common, for a defined benefits lump sum death benefit to be paid when a pension is in payment.

5. Potential beneficiaries

There are no legislative restrictions on recipients of lump sum death benefits, though scheme rules may contain restrictions. Recipients are at the discretion of the scheme trustees, but the member may make a non-binding expression of wish. This could be that benefits are paid into a trust set up by the member, but the trustees are not bound to follow that wish.

Dependants' pensions can be paid to spouses and registered civil partners, and also to those who were financially dependent on or inter-dependent with the member at the time of death, or were dependent because of physical or mental impairment. Children under age 23 also qualify as dependants. What dependants' pensions are available will be specified in the scheme rules.

6. Taxation – member's death before age 75

Assuming that the scheme trustees have discretion over beneficiaries, all benefits payable should be free of inheritance tax regardless of the age of the member on death. However, they may be subject to income tax.

Lump sums

Defined benefits lump sum death benefits payable following the member's death under age 75 are free of tax, as long as they are within the lifetime allowance and are paid within two years of the date when the scheme administrator first knew of the member's death (or could reasonably be expected to have known).

Where the two year period is exceeded the lump sum is treated as taxable income by the recipient. From April 2023, if the lump sum exceeds the lifetime allowance, the excess will also be taxed at the recipient's marginal rate.

The two year limit does not apply to a pension protection lump sum, which is taxed as income for the recipient.

Trivial commutation lump sum death benefits are taxable as income for the recipient.

Pension

Dependants' scheme pensions are taxable as income for the recipient.

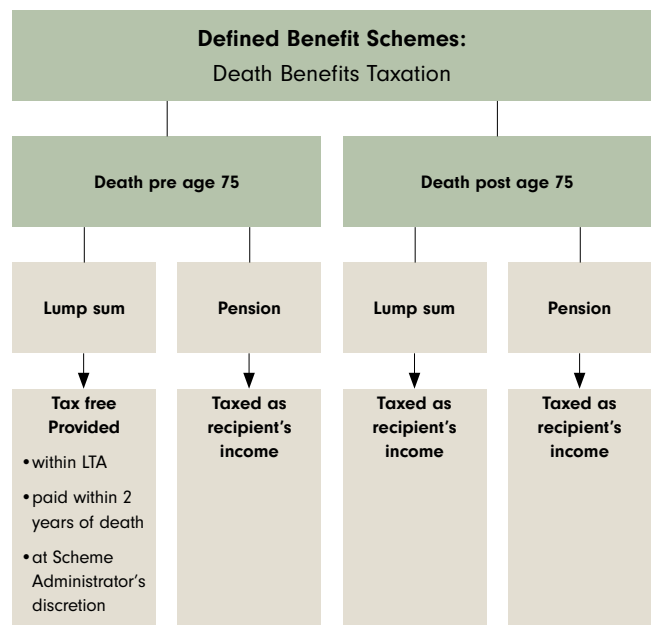
7. Taxation – member's death age 75 or older

Lump sums

Defined benefit lump sum death benefits and pension protection lump sum death benefits are taxable as income for the recipient. Trivial commutation lump sum death benefits are taxable as income for the recipient.

Pension

Dependants' scheme pensions are taxable as income for the recipient.



8. Pension freedom rules and defined benefit pension death benefits

The pension freedom rules implemented in April 2015 mean that most death benefits (regardless of the form of the benefit paid) from money purchase arrangements are tax-free where the member dies under age 75 and funds do not exceed the lifetime allowance. However, this was not extended to defined benefit schemes meaning dependants' pensions remain taxable regardless of the age on death.

The main changes for defined benefit pensions were:

- Pension protection lump sum death benefits are no longer taxable under age 75 (previously there was a 55% charge); and
- Lump sum death benefits paid on a member's death age 75 or over and when the two year limit is exceeded in respect of benefits payable following a member's death under age 75 are treated as taxable income for the recipient.

Please note that many death in service lump sum death benefits will be set up using an 'excepted group life policy'. Excepted group life policies are not subject to the pension legislation outlined in this document.

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Information is correct as at April 2023.

