Removal of the 55% tax on passing on pensions at death

This document provides further detail on the removal of 55% tax rate on pensions at death, following the Chancellor's announcement on 29 September 2014. HM Treasury and HMRC plan to discuss the technical detail further with industry stakeholders prior to final legislation.

Current system

	Crystallised	Uncrystallised
Below Age 75	55% charge if paid as lump sum or dependant can draw down at marginal rate	Can pass on as a lump sum completely tax free to any beneficiary up to the deceased's lifetime allowance
Above Age 75	55% charge if paid as lump sum or dependant can draw down at marginal rate	55% charge if paid as lump sum or dependant can draw down at marginal rate

A 55% tax rate on pensions applies when an individual dies and a lump sum is paid out of their pension to somebody else, and where the pension money is:

- crystallised (regardless of the individual's age at death), or
- uncrystallised and the individual is 75 or over at death

Currently an individual can pass their defined contribution pension to their dependant (spouse, civil partner, child under 23 or other financial dependant), who can then draw it down at their marginal rate of tax.

Where the individual dies under the age of 75 and there are uncrystallised pension funds, it can be paid out as a lump sum completely tax-free (up to the lifetime allowance).

New system

	Crystallised	Uncrystallised
Below Age 75	Can pass on completely tax free to any beneficiary as a lump sum or as a drawdown pension	Can pass on completely tax free as a lump sum to any beneficiary (up to the lifetime allowance)
Above Age 75	Any beneficiary can draw down on it at their marginal rate or 45% charge if paid as a lump sum (marginal rate from 2016-17)	Any beneficiary can draw down on it at their marginal rate or 45% charge if paid as a lump sum (marginal rate from 2016-17)

Under the new system, the 55% tax rate will no longer exist. Anyone who dies below age 75 who hasn't yet started their pension, or is taking a drawdown pension, will be able to give their remaining defined contribution pension to

anyone as a lump sum death benefit or as flexi-access drawdown completely tax-free. This does not apply to income from annuities or scheme pensions. Income from these sources will be taxed at the beneficiary's marginal rate.

Those aged 75 and over who haven't yet started their pension, or are taking a drawdown pension will be able to pass on their remaining defined contribution pension to any beneficiary who will then be able to take it as a drawdown pension at their marginal rate of income tax, or as a lump sum taxed at 45% (taxed at marginal rate from 2016-17).

To confirm, from April 2015 the following lump sum death benefits will be tax-free where the individual dies before age 75, and taxed at 45% (taxed at marginal rate from 2016-17) where the individual dies age of 75 or older:

- pension protection lump sum death benefit
- annuity protection lump sum death benefit
- drawdown pension fund lump sum death benefit
- defined benefits lump sum death benefit
- uncrystallised funds lump sum death benefit

Key Points

Deaths before April 2015

- The reforms will apply to payments made on or after 6 April 2015, rather than deaths on or after 6 April 2015.

- The beneficiaries of people who die before April 2015 (including the beneficiaries of people who died before the 29 September 2014 announcement) will be able to ask the scheme administrator to delay the payments in order to benefit from this change

- However, tax-free lump sum payments (where the individual died under 75) must be made within two years of the scheme administrator being notified of the death of the individual.

[Example: if X died aged 72 in July 2014, and the scheme was notified in August 2014, then the payment would have to be made by August 2016.]

Lump sums taxed at 45% versus drawdown pensions at marginal rate

- An individual might choose to take a lump sum if they wanted to avoid the hassle of setting up a drawdown account, or if their marginal rate is 45% (same rate as applied to the lump sum). However, drawdown would continue to be the best option for most individuals from a tax perspective.

Version: 1 October 2014. Subject to final legislation and guidance.

- The Government is aware that in some cases, a pension provider may choose not to offer drawdown. The Government will engage with industry on the detailed operation of these rules to minimise this risk and to ensure that lump sum payments are also taxed at marginal rates from 2016-17.

How this applies to other lump sum death benefits

- The change to the tax rate also applies to lump sum death benefits, which can be paid from some annuities.

- Some annuity contracts allow for a lump sum to be paid to a beneficiary after the individual's death (an annuity protection lump sum death benefit). If the individual dies before 75 the beneficiary may receive this lump sum tax free. If the individual is 75 or older when they die the lump sum will be taxable at 45% (marginal rate for payments from 2016-17).

- Payment of dependants' annuity from joint life annuities will, as now, be taxed at the recipient's marginal rate, regardless of the age of the member when they died. There is also no change on the rules on who may receive a dependant's annuity.

- The government is clear that annuities will remain the right choice for many at some point during their retirement, and believes that many people will still value the security of an annuity.

- The Government has taken a number of steps to make annuities a significantly more flexible product, including:

    - allowing annuities to decrease
    - allowing lump sums to be taken from lifetime annuities in certain specified circumstances – for example if care needs arise –
    - changing the rules regarding payments from annuities after death by extending the maximum guarantee period for guaranteed annuities.

How this applies to defined benefit (DB) pensions

The change to the tax rate for defined contribution (DC) savings taken as a lump sum also applies to DB pensions.

- Under 75: pension not yet in payment - If the individual dies before 75 and hasn't started to take their pension then (depending on the scheme rules) the beneficiaries can receive a lump sum tax-free. This lump sum will, as now, be tested against the member's lifetime allowance. The scheme rules may also provide for the payment of a dependant's pension taxable at the dependant's

marginal rate of tax. There is no change in who may receive a dependant's pension.

- Under 75: pension in payment - the scheme rules may provide for the payment of a pension protection lump sum death benefit. If the individual dies before 75 the beneficiary may receive this lump sum tax free. The scheme rules may also provide for the payment of a dependant's pension taxable at the dependant' marginal rate of tax. There is no change in who may receive a dependant's pension.

- Over 75: Any DB lump sum death benefits or pension protection lump sum death benefits paid to beneficiaries will be treated the same as lump sum death benefits from DC pensions and taxed at 45% (marginal rate of tax from 2016-17). The scheme rules may also provide for the payment of a dependant's pension taxable at the dependant' marginal rate of tax. There is no change in who may receive a dependant's pension.

- The difference between the treatment of DB and DC under the new system will be where the beneficiary receives an income from a DB pension, where the deceased has died before age 75. In this case the income will be taxed at the recipient's marginal rate, whereas income from a beneficiary's drawdown pension would be tax-free.

- The options that individuals and beneficiaries have (i.e. to choose between a pension and a lump sum payment) will be dependent on scheme rules.

Investment growth within inherited drawdown products

- The drawdown accounts inherited by beneficiaries ("pension beneficiary drawdown accounts") will be treated exactly the same as normal drawdown accounts with respect to investment growth. Investment growth will continue to be tax-free, regardless of whether the person who died was over or under 75.

Interactions with the Lifetime Allowance (LTA)

- The LTA (currently £1.25m) still applies. If an individual's pension has not already been tested against the LTA when that individual dies, it will be before being passed on as a lump sum.

- However, any pension wealth that a person inherits will not count towards their own LTA.

[Example: Person A dies at 65, without having touched his pension. His pension savings were £1.5m. £250k is taxed at 55% (the LTA charge), leaving the

beneficiary (£112,500 + £1.25m) = £1,365,000, which is then not taxed further if it is taken as a lump sum.

If the deceased is over 75 OR is under 75 but has begun taking their pension, then their savings will have been tested against the LTA and charged when they turned 75/started taking their pension.]

When the deceased has not made a nomination

- Scheme sponsors or trustees have the discretion to pass the funds to the beneficiary who they feel is most deserving. In a case where there is no nomination, we would expect them to exercise this discretion.

- There may be some cases where no nomination is made and scheme administrators choose to pay the pension into the deceased's estate as a lump sum. In this case, if the individual who died was aged 75 or over, the fund will be subject to a 45% tax charge before being paid to the estate. If the individual was under the age of 75, it will be paid to the estate tax-free. In either case it may then become liable to IHT as part of the estate.

- We would encourage individuals to contact their pension scheme to nominate a beneficiary and ensure that their nomination is kept up to date