Pension Death Benefits for Vulnerable Beneficiaries

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The pension freedoms that were introduced in April 2015 improved the death benefits on pensions. For the first time it was possible for individuals to nominate that their pension fund would pass to anyone on death, rather than to dependants only which had chiefly been the case before 2015.

This creates a problem for vulnerable beneficiaries who may otherwise be independent; it may not be desirable for them to have access to the significant capital sums an inherited pension provides. In this piece I consider how the inherited fund might be protected from abuse, though another consideration not detailed here is the potential impact on state benefits – now or in the future the pension could be taken as an asset for the purpose of means testing.

How pension death benefits work

The first principle is that death benefits from any money purchase pension (as opposed to a defined benefit) can legislatively either be:

1. Annuity – a guaranteed income stream paid for the beneficiary or beneficiaries' lives
2. Inherited pension fund (known as flexi access drawdown)
3. Lump sum – cash paid directly to a beneficiary or beneficiaries

Taxation on the options above

Under 75
When the individual who held the pension dies under the age of 75 any of the above choices would ordinarily be paid tax free.

Over 75
Where the pension holder was 75 or over when they died the recipient will likely be subject to income tax.

For options 1. and 2. it is only the income output that is taxed, and this could be at 0 45% depending on the beneficiary's other income.

With a lump sum, the tax rates may well approach or even exceed 45% as tax allowances are used, depending on the fund left, but we regularly are advising on six or even seven figure pension funds.

Where the beneficiary is a trust
The age of the original pension holder is still relevant, with no tax paid on the receipt of the fund where the original pension holder was under 75. However, where they were over 75, the tax

rate would be 45%.

What is better a lump sum or a trust?

I have written about this on this blog on many occasions and very broadly speaking the differences (ignoring the tax charges post-75) are:

Pension fund:

• Under current rules enjoys income and capital gains tax free growth
• Accessible at any age
• No rules on control or access can be laid out (see trust below)
• No need for trust tax returns, trustees etc. – ongoing cost generally less
• Perceived to be more liable to future changes (pensions have seen more changes than trusts over the last few decades)

Trust:
• May incur periodic inheritance tax charges (broadly 6% on excess over £325,000 every 10 years)
• Can pay income and capital gains tax at higher rates than individuals (45%/20%) but legitimate methods can avoid or defer these taxes
• Generally, more complicated due to tax and legal considerations
• Requires on-going governance, investment advice, tax returns etc
• Gives flexibility with control as benefits cannot be accessed without the involvement of trustees

The general position

For most people the difference between the two from a tax perspective before 75 is negligible. This means those that do not wish to ensure control after their death, or those who want simplicity, the inherited pension from the fund is preferable.

For those small number of people who want control a trust doesn't have any significant disadvantages (other than the potential for some tax which can be often mitigated) before 75.

However, beyond 75 it is rare that any individual would want to leave money to a trust due to the 45% tax charge – an inherited pension fund, with good planning, should often be accessible at 0-20% income tax rates, and with no minimum age of accessibility there are interesting opportunities for planning (beyond the scope of this piece).

Therefore, it is only when control (i.e. preventing future access by beneficiaries) is of paramount importance that a trust would be used.

Strictly speaking, the 45% tax charge may be reclaimable but for most people, this is not practical as they would not have the supporting income to justify a tax reclaim (warning –

complex again not covered in this piece).

An example – background

We have clients where the dynamics of their children means acting in their mutual best interests may lead to different solutions. This is best explained through an example.

A widow (Jean) is the sole holder of a pension fund, she is currently aged 80, and in good health. She has two children; one she considers to be independent and there are no concerns over capacity. With this daughter (Alice), Jean is content to leave her pension to her, absolutely, were she die.

Her other daughter (Beatrice) has a history of substance abuse and an historic diagnosis of mental health issue. Jean explained that Beatrice's condition exhibits as her being overly trusting, as well as prone to dangerously impulsive behaviour.

Jean is aware Beatrice has more than one failed business behind her, as well as a bankruptcy and Beatrice has also been the victim of several online investment scams.

For these reasons Jean has already decided for a proportion of her main estate (not the pension) to be passed to a trust in the event of her death.

An example – potential solution

We discussed several solutions and agreed, with Jean's solicitors, the following solution. It is notable that this strategy could be changed in the future as circumstances evolve; this could be because Beatrice's' health improves, or even if legislation changed in the future, or if Jean's situation evolved.

With respect to the pension, we agreed an absolute gift (an inherited pension fund) was appropriate for Alice but only a trust, to give an element of control, would be appropriate for Beatrice.

Jean made a nomination such that the pension fund would go entirely to Alice. This meant Beatrice would have nothing from the fund; this was because Jean did not want Beatrice's half share going to a trust and incurring the 45% tax charge (as Jean was 80, and therefore already over 75), and Jean did not want to hand Beatrice control of the fund either.

Jean's solicitor said it was not necessary to update her will, as it already had an appropriate trust. Instead Jean wrote a letter of wishes to the executors of her estate (also the Trustees of the will trust) to take note of the pension nomination in allocating the rest of her estate.

The nomination gave some guidance (non-binding) that after inheritance tax and noting the pension fund would be subject to income tax over the years Alice drew it down (assumed to be 20%), that the total legacy would be equal for both children; Alice would have full control and Beatrice would have three trustees looking after her long-term best interests.

An example – benefits
The above solution saved significant tax, as now it looks likely the pension fund will only be taxed at 20% (as Alice draws it), rather than half of it paying 45% if either all the funds was left to a trust, or worse if it were left to Beatrice and she drew it all down in one year.

Both the letter of wishes / nomination to the executors (and trustees) are not binding but give them a sensible set of guidelines to ensure the fair treatment of both children. It is accepted that the final proceeds are unknown, but it is likely, in any case, Jean will live many more years.

It was also decided that it was not appropriate for Alice to be a trustee or executor – whilst Beatrice is the younger sister, Jean described that Beatrice had a history of 'bullying' Alice, Jean and Jean's late husband, when she needed funds. Despite the additional cost it was decided to elect professional trustees (in person, not a corporation) who were known to Jean.

Conclusion
The pension freedoms, and in particular the death benefit changes in 2015, are very attractive for many people. For this reason, where people can afford to do so we generally protect the pension at the expense of other (e.g. ISA) assets. However, the unrestricted nature of withdrawals on death benefits (but also other pension funds where pensionholders are over 55) have the potential for harm.

We specialise in this more complex, and sensitive, planning and I would be delighted to discuss any of the matters raised above, without obligation. It should be noted what is described is legislatively possible, but not all pension schemes will allow the functionality detailed above, and due to the range of complicating factors you should consider any action or inaction without seeking appropriate financial and legal advice.

NB: Our clients value our discretion, so names and specifics of the situation detailed above have been changed.