The PENSIONS Advisory Service

Spotlight

Death and Pensions

This spotlight will cover what will happen to your pension when you pass away.

The Pensions Advisory Service is unable to give individual specific advice and you should seek regulated financial advice.

Introduction

Thinking about death is not easy, but it is important to understand what will happen to your pension if you pass away.

How your pension may be paid to your beneficiaries in the event of your death will depend on what type of pension you have.

A Defined Benefit (DB) pension is often known as a “final salary” pension which provides you with a guaranteed income in retirement for life based on a percentage of your **final salary** multiplied by the number of years you have been in the scheme.

A Defined Contribution (DC) pension is a type of pension which you, and perhaps your employer, has paid into. These contributions, along with tax relief and any investment growth, will form a pot of money which you can use to fund your pension at retirement.

Defined Benefit

If you have a Defined Benefit (DB) pension, any money paid to your beneficiaries will be as outlined in the relevant scheme’s rules. You should check with your pension administrator to find out what your beneficiaries may be entitled to if you pass away. You can even ask the trustees of the scheme to have a copy of the scheme’s rules applying to your period of service, to check this (at a small cost).

Pensions

Your administrator may pay a *dependant’s pension* to your spouse or civil partner, or your child providing they are under aged 23 and in full time education (or have passed age 23 if they are mentally or physically impaired). However, your pension administrator may also pay a pension to anyone who was financially dependent on (or interdependent with) you at the time of your death, including a partner to whom you were not married to or in a civil partnership with. The pension they will receive will be a percentage of the pension you are receiving or would have received if you die before your pension is in payment.

If your dependant receives a small pension, this can be taken as a lump sum providing the valuation is less than £30,000. This is known as a ‘trivial commutation lump sum death benefit’ and will mean that all your beneficiaries’ rights to benefits under the scheme, are no longer the responsibility of that scheme.

Any income paid to a dependant will be subject to income tax at their own marginal rate.

Defined Benefit - continued

Lump sums

Typically, there are 3 types of lump sums which may be paid to the beneficiaries of members of DB pension schemes who pass away:

Death in service lump sum: If you die whilst an active member of your DB pension scheme, then your beneficiaries may receive a lump sum which is often a multiple of your salary. This is known as a *defined benefit lump sum death benefit* and is paid tax free if you die before your 75th birthday as long as it is paid within two years of the earlier of the following dates:

- The date the pension scheme administrator first knew of your death, or,
- The date the scheme administrator could reasonably have been expected to know of your death.

If you die after your 75th birthday then any lump sum paid is subject to tax.

Pension protection lump sum: If your pension is in payment, quite often there is a guarantee period (usually 5-10 years). If you pass away within the guarantee period, a lump sum may be payable to your beneficiaries. This lump sum is usually the value of the pension payments which are due to be paid between your death and the end of the guarantee period. This is paid tax free if the member died before their 75th birthday, otherwise it is taxable on the person(s) receiving it. There might be inheritance tax liability (IHT) too as these payments form part of the estate of the deceased member.

Trivial commutation lump sum death benefit: This may be paid when the value of a dependants' pension or remaining guaranteed instalments of pension is no more than £30,000. This is usually an option if the dependant's pension is fairly small and is taxed at the recipient's marginal rate of income tax.

Defined Contribution

What happens if I die before I reach age 75?

If you die before you reach age 75, anyone who inherits your pension fund will not pay any tax (subject to payment within the two-year period above). Subject to the scheme's rules, the beneficiary can choose to take the pension in a variety of ways and the position on each is as follows:

- If no money has been taken from the pension fund at the time of death, your beneficiary can take the whole fund tax free. Alternatively, if they take out a drawdown policy or an annuity with the proceeds, they will not be taxed on any income received.
- If you are in drawdown at the time of death, then your beneficiary can take the remaining money left as a tax-free lump sum. Alternatively, they can continue to draw an income and will not be taxed on income received.
- If you had a joint life annuity, then the income your beneficiary receives after you die will not be subject to income tax. Note: if you opted for a single life annuity then the payments will cease on your death. There may be further payments if you had a guarantee period and passed away within the guarantee period.

If you die before age 75, any pension proceeds inherited will be tested against the lifetime allowance (LTA) if they have not been tested before. This is the maximum amount that an individual is permitted to save within a pension arrangement without incurring an additional (up to 55%) tax charge. The LTA is currently set at £1,073,100 (2021/22). However, any pension that a beneficiary inherits will not count towards their own lifetime allowance.

Defined Contribution - continued

What happens if I die after I reach age 75?

The beneficiary can choose to take the pension in a variety of ways and the position on each is as follows:

- If no money has been taken from the pension fund at the time of death, your beneficiary will be taxed at their marginal rate on all money received. Alternatively, if they take out a drawdown policy or an annuity with the proceeds, they will be taxed on any income received at their marginal tax rate.
- If you are in drawdown at the time of death, then your beneficiary can take the remaining money left as a lump sum with a tax charge at their marginal rate. Alternatively, they can continue to draw an income and they will be taxed at their marginal rate on income received.
- If you had a joint life annuity, then the income your beneficiary receives after you die will be taxed at their marginal rate. Note: if you opted to a single life annuity then the payments will cease on your death. There may be further payments if you had a guarantee period and passed away within the guarantee period.

As mentioned, as there is a test at 75 against the lifetime allowance, there will be no further tests against the lifetime allowance at death.

How do my beneficiaries qualify for this tax treatment?

In order to benefit from the favourable tax treatment, it is necessary to designate funds to a beneficiary within two years of death. In practice, this period of two years starts from the date on which the pension administrator is notified of the death of an individual. This means that if your beneficiary wishes to take the benefits in the form of a lump sum, they need to take the money within two years. However, if they decide to draw down pension, they don’t need to take the first payment within the two years, but they do need to notify the administrator of their intentions to draw an income.

What about Inheritance Tax (IHT)?

Unless you have cashed in your entire pension, any funds left in your pension fund at death will not usually form part of your estate for IHT purposes. Bear in mind that any assets left (such as cash or savings, even if they were originally part of your pension fund) will be part of your estate for IHT purposes. Notable exceptions to this rule are funds within a Retirement Annuity Contract (RAC), a product which normally does not have a discretionary trust arrangement. It is important to remember that choosing whom the beneficiary, or beneficiaries are, can either involve the scheme administrator, etc, using their discretion, or you directing the choice before passing away. The way this choice is made – of whom the beneficiaries are - can affect the IHT payable on the benefits.

State Pension

Generally, when you pass away your State Pension will stop being paid. There are a few situations where your spouse or civil partner may inherit some of your State Pension.

The rules on inheriting the State Pension through a partner are complex and beyond the scope of this Spotlight. They can depend both on what each of you have built up and when each of you reached State Pension Age. The easiest way to test whether you are eligible to inherit extra State Pension entitlement is to use the government’s tool available at: https://www.gov.uk/state-pension-through-partner. Note: it is not possible for anyone other than a spouse or civil partner to inherit State Pension.

Nominating dependents

Many pension schemes will ask you to nominate a beneficiary (often using what is called an Expression of Wish or Nomination form) so it is important to advise them of whom you want to leave your pension to, and to update this if circumstances change.

Defined Benefit Schemes (DB)

If you have a DB scheme, then any benefits will be paid according to scheme rules. It is important you keep your nomination up to date, particularly following and significant life events such as marriage, divorce, loss of a partner, birth of a child, etc, so that the trustees of the scheme are aware of whom you would like to receive any death benefits payable. It is important to note that, although the trustees will take your expression of wishes into account, they have the discretion on who to pay the benefits to. As stated earlier, any pension death benefits paid under the trustee's discretionary powers, will normally not be included in your estate and consequently should not have any IHT liability.

Any dependant's pensions which are due are usually paid to the member's legal spouse or registered civil partner. Some schemes may pay the pension to a partner, with whom the deceased member was living when they passed away, who was financially dependent on the member, but other schemes will not do so. it is important you check with your scheme to find out what happens on your death.

Defined Contribution Schemes (DC)

You can nominate whoever you want to receive your pension fund in the event of your death, however, it is up to the discretion of the provider or trustees who look after the pension as to who it can be paid to. If you have completed an Expression of Wish/Nomination form, they will take this into account, so it is important you keep your nominations up to date.

If you have already bought an annuity with your pension fund, then the annuity is usually only payable to the person you named when you set the annuity up as a Joint Life annuity. This is because the annuity would have been calculated based on your circumstances including whom you have nominated to receive the annuity in the event of your death.

Again, if providers of the DC scheme you are a member of, have discretion over who to pay death benefits to, the benefits are normally free from IHT. If there is no such discretion, the benefits could be liable to IHT, as these will then have to be paid to your estate.

About Us

The Pensions Advisory Service (TPAS) works to make pensions accessible and understandable for everyone. We provide independent and impartial information and guidance about pensions, free of charge, to members of the public.

We help with all pension matters covering workplace, personal and stakeholder schemes and also the State Pension. We answer general questions, help with specific queries and offer guidance for people with complaints about their private pension scheme.

The Pensions Advisory Service is provided by Money & Pensions Service

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