# PENSION DEATH BENEFITS: THE BASIC RULES

## (MONEY PURCHASE)

APRIL 2025

Although pensions are primarily used as a tax efficient way to save towards income once you stop work, not everyone will use all their pension fund before they die. **The way in which the death benefits for money purchase pensions are treated currently offers a very tax efficient method of passing wealth through generations. However, Inheritance Tax is now expected to be applied to pension death benefits from April 2027, and so existing plans may require reviewing once full details are known.**

**Not all pensions will offer the full range of death benefit options**, and you should check your current policy to make sure it is right for you. It is also very important that you **keep your nominated beneficiaries (expression of wishes) up to date**, so the funds are passed as you intend, with minimal delay and maximum tax efficiency.

You should be aware that, as ever, **legislation may change in future**. This note gives a summary of the choices available on death for funds within money purchase pensions, and how these are taxed.

# SUMMARY

While most individuals will need to use most or all of their pension funds to support their lifetime income, some will not. Here, the pension can instead be used to pass funds onto the next generations, or to other selected beneficiaries. For those in a scheme which allows drawdown, this can currently be a particularly tax efficient way of passing on benefits. However, from April 2027, we expect Inheritance Tax to be applied to all pension death benefits, and so some existing plans may need to be reviewed once full details are known.

The ability to pass on pension wealth to a beneficiary also does not stop after the original member's death. A beneficiary can, in turn, nominate their own successor who can take over the drawdown fund following their death. This can currently allow accumulated pension wealth to potentially cascade down the generations in perpetuity, whilst continuing to enjoy the tax benefits that the pension wrapper provides.

We cover below the main death benefit options for money purchases schemes, and accompanying tax considerations:

- Lump sum
- Flexi-access drawdown
- Beneficiary's lifetime annuity

The choice is not necessarily all or nothing – the same pension pot may provide benefits in different ways.

It is important to **check that your current pension plan can offer all the options you may want**, and that your '**nomination of beneficiaries**' or '**expression of wishes**' form is completed and reflects your wishes, as otherwise your preferred death benefit option may not be available.

**Those who have either taken some pension benefits before 6 April 2024, or who have Pension Protection in place, need to be aware of the rules applying to their particular situation**. Please see our note on Pensions post April 2024: Transitional Rules and Protections for more details if this might apply to you. This note assumes that neither of these apply. Scheme pensions and the special rules which dictate the death benefits available from contracted out rights (that is, GMP or Section 9(2B)) are also not covered in this Note.

# LUMP SUM

Any funds remaining on the death of the original member (or a beneficiary who had inherited a pension fund), may be paid out as a **lump sum**. This can include both **crystallised funds** (funds that have moved into drawdown or been used to buy an annuity) and **uncrystallised funds** (funds that have had no pension income drawn from them yet).

Lump sum death benefits can be paid to any individual, a trust or charity (if there are no surviving dependants).

Once lump sum death benefits have been paid, the funds are **outside the pension wrapper** and will form part of the beneficiary's estate for Inheritance Tax (of course, with the imposition of IHT on pension death benefits from April 2027, this distinction may cease). Any growth and income on the fund will be subject to the normal regime of income and capital gains taxes.

Some death in service (life assurance) contracts may be classed as 'pension' lump sums. For higher earners and/or those with a large multiple of death in service (e.g. 10x), it may be beneficial to consider discussing with your employer whether your death in service could be written under an 'excepted life' basis (see tax below).


# INCOME DRAWDOWN

Where a pension fund is uncrystallised, or already in drawdown, then **beneficiary's drawdown** is one of the ways a beneficiary can use an inherited fund. If chosen (and available, see below), it will allow funds to remain in the pension scheme under an arrangement set up for the beneficiary.

The beneficiary may then draw from this pot at will, or leave the funds undrawn until required in the future. The funds remaining undrawn continue to benefit from the largely income and capital gains **tax free growth environment** provided within a pension. They also continue to remain outside the taxable estate for Inheritance Tax purposes, at present, but this looks likely to cease from April 2027.

Drawdown arrangements can be provided for any individual (not just a dependant), but not for bodies such as charities or trusts.

The beneficiary may also nominate who they would like to benefit from any remaining funds when they die, with the taxation position on death depending on the beneficiary's own age at death. In this way it is currently possible for pension savings to pass down through generations.

# BENEFICIARY'S LIFETIME ANNUITY

A lifetime annuity may be an attractive option for a beneficiary who needs a secure level of income.

An annuity can be used to provide a pension income for any individual (not just dependants), irrespective of their age. It can be purchased together with a lifetime annuity by the original member in their lifetime (as a joint annuity) or purchased after the member's death by the beneficiary (as a dependant's, nominee's or successor's annuity).

A lifetime annuity cannot be set up to pay to a charity or trust.

# INCOME TAX CHARGES ON DEATH

The income tax treatment of pension death benefits depends upon whether the pension scheme member dies before or after age 75, and whether the pension benefits are paid as a lump sum or as income. **Please note that it is the immediately preceding member's age which is relevant, not the original member if the pension fund has already been inherited. Please also note that from April 2027, IHT is also likely to be applied to all pension death benefits.**

| Income Tax on Withdrawals | Pension Lump Sum | Pension Income |
|---|---|---|
| **On death before age 75** | Income tax-free within available [1] LSDBA<br>Income tax on the excess | Income tax free [2] |
| **On death after age 75** | Income tax<br>(on all payments made) | |

**Notes:**

1 LSDBA=Lump Sum Death Benefits Allowance. See below for amounts which reduce your available allowance.

2 Assuming settled within 2 years of notification of death

 

# INCOME TAX CHARGES ON DEATH

## DEATH AFTER AGE 75

For death after age 75, all benefit payments, whether lump sum or income, are taxed at the **beneficiary's highest marginal income tax rate**. Where funds are paid from beneficiary's drawdown, the amount and timing of withdrawals may be able to be varied to maximise tax-efficiency.

## DEATH BEFORE AGE 75: PENSION INCOME

For death before age 75, any **pension income death benefits are paid free from income tax**. This includes the spouse's pension benefit for a joint annuity in payment at death, the purchase of a beneficiary annuity, or using beneficiary drawdown.

If using drawdown, the income does not have to be paid out immediately. The fund can be held within the pension wrapper for future tax-efficient growth, whilst maintaining the income tax free access when required.  It is therefore currently important to ensure that nominations of beneficiaries are up to date, to ensure that the funds do not pass into your estate (and would then be potentially subject to Inheritance Tax – of course, from April 2027 IHT is likely to apply and so nominations may need to be reviewed in any case). Where trust planning has already taken place (for example with spousal bypass trusts), it is essential to review these arrangements to ensure that they still give the required outcome, in terms of control over the destination of the funds and tax efficiency.

## DEATH BEFORE AGE 75: PENSION LUMP SUMS

The situation is a little more nuanced for lump sum pension death benefits. Where the pension fund is within the available Lump Sum and Death Benefits Allowance (LSDBA), lump sum can be paid free from income tax

However, where the pension fund is over the LSDBA, the excess funds are subject to income tax at the beneficiaries' marginal rate of income tax. For large lump sums, the effective rate of income tax on this lump sum may be high, with little scope for tax planning to reduce it. Careful consideration to the available options should therefore be given before payment, as beneficiary drawdown may often be more suitable and will allow for large payments (even the whole fund in one withdrawal if required).

Death in service (life assurance) benefits written under pension rules would be classed within this lump sum category; however, those written under excepted life rules are outside this regime and would not be tested against the LSDBA.


 

# INCOME TAX CHARGES ON DEATH

## LUMP SUM AND DEATH BENEFIT ALLOWANCE (LSDBA)

- **The standard LSDBA is £1,073,100** unless you have existing LTA protection

- **Your available LSDBA is reduced by relevant BCEs.** Broadly, these include tax-free lump sums taken in your lifetime, together with any serious ill-health lump sums and authorised lump sum death benefits
    - Where a Pension Commencement Lump Sum (tax-free cash) was taken during lifetime, the actual amount paid tax-free is deducted from the LSA in £ terms
    - However, if scheme specific protection applied, or for a stand-alone lump sum, then 100% of the crystallised fund is deducted from the LSDBA
    - Where an Uncrystallised Fund Pension Lump Sum was taken in lifetime, then the tax-free element is deducted in £ terms
    - Pre-April 2024 tax-free lump sums are calculated as standard using 25% of the LTA used at the time. However, they may be calculated based on the alternative method using the actual £ amount if a certificate has been obtained

- **Your available LSDBA is not reduced by** the tax-free elements of trivial commutation lump sums, winding up lump sums, and small pots payments received. It is also not reduced by charity and trivial commutation lump sum death benefits

- **Your available LSDBA is not reduced by** death benefits from crystallised rights already tested under the LTA (e.g. death benefits from drawdown funds crystallised prior to 6.4.24).

**Those who have either taken some pension benefits before 6 April 2024, or who have Pension Protection in place, need to be aware of the rules applying to their particular situation.**
Please see our note on Pensions post April 2024: Transitional Rules and Protections for more details if this might apply to you. This note assumes that neither of these apply.

### Who pays the tax?

The order in which death benefits are paid is relevant. The personal representatives will be able to decide in what order the beneficiaries can 'use' the LSDBA, and hence which beneficiaries may or may not suffer income tax on their inheritance. For those where the lump sum received is not covered by the LSDBA, the deemed date of payment for income tax purposes will be the date of death of the member.

# PENSION DEATH BENEFIT NOMINATIONS

Being in a scheme which offers lump sum and pension income death benefit options doesn't necessarily mean that all beneficiaries will have all the options available to them – this can also depend on the death benefit nominations made by the deceased member.

A death benefit nomination helps to guide the trustees or pension provider when exercising their discretion over where and how to pay death benefits.

Nominated individuals may have the choice of a lump sum or a pension (via income drawdown or a lifetime annuity) whereas nominated charities and trusts can only receive lump sums.

Having an up to date nomination in place can speed up the payment of death benefits.

An anomaly in the legislation also means that in some cases, the full range of death benefits won't be available. This is because income death benefit payments, for example via Flexi-Access Drawdown (which will generally be the most tax efficient), cannot be provided to non-dependant beneficiaries, such as adult children, if:

- they haven't been nominated to receive benefits, and
- there is a surviving dependant (usually a spouse).

It is therefore extremely important to review nominations and keep them up to date.