

This article was published in *Trusts and Estates Tax Journal*, June 2002, Number 27.

Taxing Benefits

By Matthew Coggins, Solicitor

Matthew Coggins of Sacker & Partners provides a summary of lump sum death benefits arising under occupational pension schemes.

Occupational pension schemes invariably provide benefits which arise on the death of their members, whether in the form of an entitlement to a pension payment or a lump sum benefit. The provision of these benefits gives rise to significant technical questions for pensions lawyers. But when distributing lump sum benefits, trustees are rarely in a position to consider the tax consequences for the recipient. Given the size of some lump sum benefits, those advising the family of a deceased scheme member would be wise to draw these sorts of issues to the trustees' attention.

A lump sum benefit may arise on the death of:

- an active member of the scheme (somebody who was still in employment at the time of his death);
- a deferred member, who had left service while retaining benefits in the scheme;
- in limited circumstances, a pensioner.

Whilst lump sum benefits for active members are extremely common, schemes are much less likely to provide such benefits for deferred members and pensioners. The amount of such benefits (if any), the circumstances in which they will arise, and the identity of the people to whom the benefits are payable, will depend on the wording of the scheme's governing documentation, normally a trust deed and a set of rules.

But the bulk of occupational pension schemes in the United Kingdom are "exempt approved" schemes which obtain significant tax advantages provided that they conform to the Inland Revenue's requirements. The most basic of these is that the Scheme must only provide what are called "relevant benefits", as defined in the Taxes Act. Approved schemes are allowed to provide lump sum benefits on death because they are within the definition of relevant benefits. However the definition in the Act excludes benefits which would only arise on death by accident occurring during the member's service. Similarly, "key man" insurance, whereby a lump sum becomes payable to the employer on the death of an employee (or a partner or director) is not a relevant benefit.

If a Scheme is to obtain or retain exempt approved status it must follow the guidance issued by the office of the Inland Revenue now known as IR (Savings, Pensions, Share Schemes), previously the Pension Schemes Office, which sets out the Revenue's requirements for the approval and continued approval of Schemes. This guidance is principally contained in the *Practice Notes on Approval of Occupational Pension Schemes*, known as IR12. A lot of what follows describes the Inland Revenue's practice, and needless to say, is in various respects a necessarily severe simplification.

Death in Service

It is quite typical for a scheme to provide a lump sum benefit arising on the death of a member whilst in the employer's service. For Inland Revenue purposes, the death need not arise out of the person's actual performance of his job. Death in service benefits cover deaths occurring at any time or place while employed by the employer. Clearly, if a person dies while in employment, the needs of his family or dependants are likely to be such that this benefit will be extremely valuable to them. For this reason, the Inland Revenue permits lump sum benefits to be significantly greater than the similar benefits available to deferred or pensioner members of the Scheme.

The Revenue allows a lump sum benefit of up to £5,000 or if greater, 4 times the deceased's final remuneration. It is typical nowadays for a scheme to provide death benefits of around 3 times salary. For these purposes, final remuneration is given a more liberal definition than that used when calculating Revenue limits on pension benefits. The provision of this sort of benefit is generally secured by an insurance policy, usually with relatively low premiums. Thus not only is the benefit potentially very valuable, and obviously attractive to employees, it is relatively cheap to provide compared to the cost of funding pension benefits (particularly in a final salary arrangement). For this reason it is unusual for a pension scheme not to provide lump sum death in service benefits.

Distribution of Death Benefits

The Inland Revenue permits death benefits to be distributed in one of three ways:

- payment to the member's legal personal representatives;
- payment to a beneficiary nominated by the member during his life;
- payment at the discretion of the trustees of the scheme or the employer.

If a Scheme allows a member to nominate a beneficiary, the member may nominate anybody he likes, including a corporate body or a society or club. Perhaps surprisingly the Revenue does not require that the beneficiary should have been financially dependent on the deceased at the time of his death. However, the first two of these options have adverse consequences for the member for inheritance tax purposes. If the scheme provides that the benefits are to be paid to the member's personal representatives or to his nominee, the benefit will form part of his inheritance tax estate unless it is paid to the member's surviving spouse.

For this reason, by far the majority of schemes provide that the benefit is to be distributed at the discretion generally of the trustees rather than the employer. Schemes tend to have wide class of potential beneficiaries. They will typically include the member's family and dependants, and also enable the member to name a potential beneficiary during his lifetime by using an "expression of wish form". An expression of wish by the member does not, of course, bind the Trustees in any way. The class of beneficiaries may also include charities, clubs, corporate bodies and so on and there is no need for the beneficiary to be financially dependent on the member in any way.

In exercising their discretion the trustees will have regard to the usual principles governing the exercise of trustee discretion. They will consider any relevant matters, disregard any irrelevant matters and direct themselves properly as to their powers properly as to their powers (see for example *Edge v Pensions Ombudsman* and *Wild v Smith* [1998] Ch 512). It is never easy, however, to say what the relevant matters are that the trustees should

consider. Where the member is survived by a spouse or children, the trustees may well look no further. The position becomes more difficult where the member was separated from his spouse or has “complicated” personal circumstances. The trustees will tend to look at the relationship between the deceased and the various potential beneficiaries and the financial circumstances of those beneficiaries. The “expression of wish” form is a relevant factor but it should not be, and generally is not, the only matter that the trustees will consider. Trustees may also want to consider the terms of the deceased’s will. Where an appointment is made in favour of children, the pension scheme trustees will almost invariably establish an accumulation and maintenance trust with separate trustees. Otherwise, the money will generally be paid to the beneficiary absolutely.

Where the lump sum benefit is large, tax treatment in the hands of the ultimate beneficiary could become an issue. Similarly, a relatively small amount could have an adverse effect on means-tested social security benefits. But though trustees will often enquire into the financial circumstances of the possible beneficiaries, they will rarely be properly aware of these issues when they exist. If they are aware of them, they may not be in a position (even if properly advised) to come to an informed decision on the best way to mitigate adverse tax or social security consequences. Those advising the families of deceased pension scheme members should be aware that they should alert the scheme trustees to these sorts of issues at the earliest opportunity. If trustees are aware that an appointment to a beneficiary in a particular manner will have adverse consequences, they will be bound to at least consider it when deciding how to exercise their discretion (see *Abacus Trust Company v NSPCC*).

It may be that from either a tax or a social security perspective a properly advised beneficiary will want the money to be settled on a discretionary trust. Pension scheme trustees will normally only be able to exercise their discretion among a restricted class of persons. The question will arise whether a power to “pay or apply the money to or for the benefit of X, Y or Z on such terms as they decide” allows them to settle money on trustees with beneficiaries X and various others outside that class. By analogy with section 32 of the Trustee Act 1925, and following *Pilkington v IRC* (which said that the power of advancement in that section was wide enough to permit a resettlement on discretionary trusts) the answer may be that it does. But before the scheme trustees can properly make such an advancement they will have to be satisfied, and reasonably satisfied, that that would be for the benefit of a member of the permitted class. The scheme trustees should be aware that a consequence will be that the entire benefit could be appointed away from the intended beneficiary. They arguably should guard against this by being careful about their choice of trustees, but only in unusual circumstances will scheme trustees themselves consent to have an on-going role in a death benefit trust (they have responsibilities enough of their own).

Because of the tax reliefs which the lump sum benefit will attract whilst it remains in the hands of the scheme trustees, the Revenue requires the trustees to make a distribution within two years of the member's death. The Revenue guidance states that if the distribution cannot be made within two years, the money must be withdrawn from the scheme and held under separate trusts or paid to the deceased member's personal representatives. Generally the latter approach is taken, although some schemes provide that the benefit terminates if the distribution is not made within that timescale, and the money is then treated as an accretion to the scheme's general funds. Where there is a delay in payment, the scheme trustees may pay interest on the benefit from the date of death until the money leaves the scheme provided that the limit on total lump sum benefits is not thereby exceeded. This is not true income for income tax purposes. Obviously if the money leaves

the scheme to be held under separate trusts, any interest arising is chargeable to income tax in the hands of the trustee in the usual way.

Finally, in the 1970's many pension arrangements were established to provide lump sum benefits for directors of private companies who had *life appointments*. The main purpose of these arrangements was to take advantage of the IHT exemption on the discretionary distribution of the lump sum. The attraction of these arrangements was removed by Revenue rules which restrict the manner in which benefits arising on the death of a controlling director can be distributed and which restrict death in service benefits generally to deaths occurring before the age of 75.

Deferred Members

Under the pensions legislation, where a member of a pension scheme with more than a minimum period of service (not more than two years) leaves the employment to which the scheme relates, he will retain deferred pension benefits within the scheme unless he transfers them elsewhere. However, whilst employers are willing to provide death benefits to their own employees, few will be willing to extend this to scheme members who leave their service to take up employment elsewhere, not least because they will generally have death in service benefits from their new job. Similarly, there is no legislative requirement to provide a continued lump sum death benefits after a member has left employment. However, some schemes will provide for a refund of an employee's own contributions which he has paid to the pension scheme (with or without interest) if he dies having left service. If there is such a refund, it will generally be distributed as a lump sum form in the same way as death in service benefits.

Death After Retirement

The Inland Revenue takes the view that by the time a person reaches retirement, he will have reduced financial commitments and his main needs will be met by the security of a continuing income during his old age. For this reason, they do not generally permit schemes to provide lump sum benefits on death after retirement. This is subject to certain exceptions.

It is permissible for a pension scheme to guarantee that pension installments will continue to be paid for a certain number of years after the retirement of a member, even if he dies during that period. This is a means of ensuring that a member receives reasonable value for the contributions that he and his employer have paid into the scheme. Most schemes provide such guarantees for a period of five years (though Revenue practice permits them to last for up to 10 years). If the guarantee does not exceed 5 years, an immediate lump sum may be paid as an alternative to continuing payment of the member's pension.

Payments under a pension guarantee are normally paid at the Trustee's discretion in the same way as for death in service benefits.

The second exception relates to the very limited circumstances in which the Revenue will allow firms to continue to provide lump sum life assurance after retirement. The Revenue requires however, that the disposal of policy proceeds following a retired member's death must not be subject to discretionary trusts and so escape charge to inheritance tax. If the policy is issued to the member personally, or the employer acts as a nominee or bare trustee, the policy will be the member's personal property and hence form part of his inheritance tax estate. However, where the cover is provided through policies held by the

scheme trustee, the Revenue requires that the disposal of the lump sum benefit must not be subject to the trustee's discretion except where:

- it is less than £2,500; or
- the continued life cover is in respect of a period between early retirement on the grounds of incapacity and the member's normal retirement date.

If these exceptions do not apply, the Scheme rules must provide for the death benefits to be distributed to either:

- the surviving spouse (if there is one); or
- the deceased's legal personal representatives.

Conclusions

- Occupational pension schemes can provide significant lump sum benefits on death.
- Most such payments are subject to a highly favourable inheritance tax treatment.
- Pension scheme trustees will not be able to consider the tax treatment in the hands of the recipient unless they are properly advised by the beneficiary. Trustees will not consider it incumbent on themselves to look into these matters on their own initiative.
- Depending on the scope of the trustees' express powers, they may be able to settle a sum on discretionary trusts provided that it is *proper* for them to do so. The trustees will have to consider the interests of the beneficiary including the potential tax advantages and weigh this against the risk that the entire income and capital may be appointed to a person who could not otherwise have benefited from the pension scheme.

Case references

Abacus Trust Company (Isle of Man) Ltd and anor v NSPCC [2001] STC 1344

Edge v Pensions Ombudsman [1998] Ch 512

Pilkington v IRC [1964] AC 612

Wild v Smith [1996] PLR 275