background

1 Mostly death in service (DIS) benefits are treated as just insurance for employees, which one can pass to the employer's insurance broker before moving to this or that legal issue. DIS schemes come in different flavours and have their share of legal traps.

legal framework

2 The Finance Act 2004 defines a pension scheme in s150 as a scheme to provide benefits (a) on retirement, (b) on death, (c) on having reached a particular age, (d) on the onset of serious ill-health or incapacity, or (e) in similar circumstances.

3 The authorised member payments defined in s164 of the FA 2004, that are relevant to DIS schemes are those permitted by the pensions death benefit rules in s167 and the lump sum death benefit rules in s168.

4 Section 167 permits pensions to be paid the member's dependants (defined in schedule 28 para 15) and, added by the Taxation of Pensions Act 2014 s3 with effect from 17 December 2014, his nominees (as defined in schedule 28 paragraph 27A) if paid as nominees' annuity (ib para 27AA). NB A pension for successors (as defined in schedule 28 paragraph 27F) may be paid only if purchased using undrawn flexi-access funds (ib para 27FA(1)(e)) so cannot be paid from a DIS scheme.

5 Section 168 lists nine lump sum death benefits, which are authorised member payments for the purpose of s164. Of these the relevant benefit in this note is a defined benefits lump sum benefit (FA 2004 s168(1)(a): a defined benefit is a benefit which is not a money purchase benefits (FA 2004 s152(7)), so a lump sum, that is a multiple of an employee's earning or a specified amount, is a defined benefit even if provided by what is otherwise a money purchase scheme.

6 The classic occupational final or average salary (defined benefit – DB) pension scheme provides all the benefits in para 2 above or perhaps (a) or (c), (b) and (d). Typically, two kinds of DIS benefits are provided, first a lump sum and secondly a pension. The lump sum is usually funded by an insurance policy, although large schemes might carry the risks and fund all or part of the lump sums out of their own resources. Pensions for dependants' in DB schemes are normally funded out of the scheme's own resources in the same way as members' pensions. If a money purchase or other defined contributions (DC) scheme provides dependants' pensions other than what the member provides out of the member's account, which is not common except in large schemes, they are likely to be funded by insurance.

7 A different kind of arrangement is made where the employer has a smaller occupational DC scheme or provides pensions by a master trust occupational or a grouped or other personal pension scheme. Here DIS benefits, commonly lump sums only, are provided by stand-alone schemes funded by an insurance policy using trust documents provided by the insurer.

benefits – employment contract or insurance policy

8 The members of an occupational pension scheme are entitled to the DIS benefit described in the scheme's trust deed and rules. If there is a difference between

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that and what the insurer (if any) provides, the scheme (and ultimately the employer) must fund the difference to ensure that the full benefit is provided.

9 This is not usually so under a typical stand-alone scheme. Here the insurance company's model trust deed and rules provide that matters such as eligibility for membership, the amount of the benefits and the conditions on which they paid are governed by the insurance policy or subject to the insurer's agreement. The member's entitlement under the scheme is therefore limited to what the insurer pays, which can be less that the member's expectation.

10 Employers need to have this difference drawn to their attention and should decide whether the benefits of an insured stand-alone DIS scheme are to be those stipulated by the insurer or by the employer. If the former the employment contract terms, handbooks etc must make it clear that any benefit that appears to be promised is subject to the insurer's terms. If the latter, the employer should alter the insurer's standard documents to avoid ambiguity and be aware that it might have a funding risk if a benefits is promised that is not by covered or fully covered by insurance.

TUPE

11 Regulation 10 of the Transfer of Undertakings (Protection of Employment) Regulations 2006 exempts from the transfer rights in an occupational pension scheme to benefits for old age, invalidity or survivors. DIS benefits are benefits for survivors. Therefore, if they are provided by an occupational pension scheme, the right to them does not pass to the transferee. The transferring employees, who were members of the transferor's occupational scheme of the have instead a right to pension protection under ss257 and 258 of the Pension Act 2004. Pension protection is access to a scheme to which the transferee employer pays contributions to provide a pension, but does not include DIS benefits.

12 Rights to personal pension schemes do transfer under TUPE and so, possibly as an unintended consequence of s255 of the Pensions Act 2005, do rights to DIS benefits under a stand-alone DIS scheme. If the transferring employees were members of the transferor's stand-alone DIS scheme, the transferee employer risks the "grieving widow syndrome", which is that an employee will die just after completion, and the transferee will arrive at the works or office on the following morning to be met by the grieving widow with a babe in arms wanting to know 'ow much she will get. The transferee will have to pay the DIS benefit out of its own resources, unless, before completion, it had either arranged insurance or agreed to participate in the transferor's scheme.

age discrimination

13 Ordinary pension schemes and DIS schemes are inherently discriminatory on the grounds of age and therefore there are numerous exemptions from the age discrimination provisions of the Equality Act 2010.

14 It is not discriminatory for an employer to cease to provide insurance after age 65 or the state pension age if greater, so it is permissible to cease to provide death in service insurance at that age (EA 2010, sch 9 para 14). This paragraph does not mention trustees. BIS has stated its opinion that, because pension schemes are part of an employer's pay and benefits package, the exemption for employers extends to trustees, but it is not clear that they are exempt.

15 What is clear is that an uninsured benefit is not within the exemption. Therefore the withdrawal of an uninsured DIS benefit at any age is discriminatory unless the discriminatory treatment is "a proportionate means of achieving a legitimate

aim" (EA 2010, s13(2) if the discriminating is direct and s19(2) if it is indirect). The provision of a tax favourable benefit scheme as a means of attracting and retaining employees is probably a legitimate aim and the fact that the age limit for favourable tax treatment is 75 years (see para 18) probably protects an employer from a claim of discrimination for failing to provide cover as an uninsured benefit from age 75. A grey area here is the distinction between insurance and a benefit the funding of which is underwritten by insurance.

trusteeship

16 The normal insurance company's stand-alone DIS deed and rules provides for the employer or principal employer to be the scheme's sole trustee with power to appoint the trustees. Lump sum benefits are almost always held by the trustee on discretionary trusts to be paid to some or all of a wide class of beneficiaries. Members are usually encouraged to sign and deposit with the trustee a statement of her or his wishes who should benefit and to what extent or in what proportions. The trustee must have regard to expressions of wishes and are entitled but cannot be required apply the benefits in accordance with it. Employers need to be made aware of their duty to exercise this discretion (rather than leaving it to the HR department to apply the expression of wishes automatically) and to consider whether this is a duty that the employer can and wishes to perform or whether to appoint trustees. The requirement for member nominated trustees or directors applies only to occupational pension schemes.

taxation

17 DIS benefits paid as pensions are subject to income tax.

18 There is no limit on the amount that can be paid as a DIS lump sum, which is tax free if:

(a) it is paid on the death of a member who has not reached age 75;

(b) it is paid to a person who is not a non-qualifying person;

(c) and to extent that it does not exceed the unused amount of the deceased member's lifetime allowance (LTA); and

(d) it is paid before the expiry of the period of two years beginning with the earlier of the day on which the scheme administrator first knew of the member's death and the day on which the scheme administrator could first reasonably be expected to have known of it.

19 A non-qualifying person is a person who is not an individual or, if an individual, receives the payment in his capacity as a trustee or personal representative, director of a company, partner of a firm or member of an LLP (FA 2004 s206(9) inserted by the Finance (No 2) Act 2015 s21(1),(5).

20 The conditions in para 18 apply to lump sums paid on and after 6 April 2016 (FA 2004 s206(1A), (1B) inserted by the FA 2011, s65 and the Taxation of Pensions Act 2014 s3 and sch 2, para 17) and are broadly similar to the present definition of a defined benefits lump sum death benefit in the FA 2004 sch 29, para 13.

21 If these conditions are not satisfied, a special lump sum death benefits charge arises on the payment of the defined benefits lump sum death benefit (FA 2004 s206(1A),(1B). The rate of the charge is 45% of the lump sum (FA 2004 s206(4), reduced from 55% in respect of payments on and after 6 April 2015 by the Taxation of Pensions Act 2014, s2(5)).

22 Inheritance tax is payable if (amongst other circumstances) the trustees are bound to make a lump sum death payment to a person nominated by the

member or if they have no discretions how the lump sum is to be applied and must pay it to the deceased's estate. Money held on discretionary trusts for a class of beneficiaries cannot form part of the estate for IHT.

lifetime allowance (LTA) and DIS lump sums

23 The amount of an individual's LTA on 6 April 2006, when the present tax regime was introduced, was £1.5m, which was increased until it reached £1.8m in 2010, since when it has been reduced until from 6 April 2016 it will be £1m.

24 A member's LTA is tested on each benefit crystallisation event (BCE) (FA 2004, s216), and amounts crystallised in excess of his LTA are subject to a charge to income tax known as a lifetime allowance charge (ib s214). The charge is 55% of the amount of the excess taken as a lump sum or 25% on the amount retained in the scheme and paid as pension (ib s215).

25 If, as an illustration:

(a) an employee with an annual salary of £200,000 dies in service on or after 6 April 2016 and before drawing any benefits, so that the whole of his LTA is available,

(i) with an account worth £750,000 in a money purchase scheme, and

(ii) DIS lump sum benefit of £800,000 (four times his annual salary): and

(b) his money purchase account is disposed of first and is disposed of as a single designation, after which his DIS lump sum is paid as a single lump sum, the consequences would be that

(i) the first BCE, the designation of his money purchase account will be tax free and leave £250,000 of his LTA available, so that

(ii) on the second BCE, the payment of the DIS lump sum, £250,000 will be free of tax and £550,000 will be subject to tax.

26 One response to that situation would be for the DIS scheme's trustee to assess not only who is to benefit and for how much (para 16 above) but also how the tax will affect each prospective beneficiary and in what order and how the distributions are to be made.

27 Another response, which could be made in anticipation of this situation, is for the employer to investigate and decide whether or not to exclude its higher and prospectively higher paid employees from its registered DIS scheme and to provide for them an unregistered scheme with either or both of two kinds of life assurance policy, which are (a) a relevant life policy under s393B(4)(b) of the Income Tax (Earnings and Pensions) Act 2003, which is for a single person and it transferrable to a new employer, and (b) an excepted group life policy under the s480(3) of the Income Tax (Trading and Other Income) Act 2005, which is for two or more employees. to provide death in service benefits, on terms which can be broadly similar to those of the registered scheme

28 The significant feature of unregistered schemes with either relevant or excepted group policies is that they are not subject to the FA 2004 and the benefits under them do not affect and are not affected by the member's LTA.

29 The costs (premiums to the insurance policies) are paid solely by the employer and there is no tax liability on the employee in respect of either the premiums paid by the employer or the lump sum benefit, unless the schemes and the policies are used for tax avoidance.

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