What happens when a member dies?

MEMBERS OF PERSONAL PENSION SCHEMES do not die only in retirement - they also die in service. Consequently, personal pension scheme rules have to deal with the use of the member's fund, as well as any life assurance benefits there may be. Most personal pension schemes use the Inland Revenue's Integrated Model Rules (the rules), which are seen as something of an industry standard, and these specify what death benefits can be provided. It is these rules that are considered in this article.

The situation has been complicated by the fact that the rules have changed. In August 1995 the Association of British Insurers (ABI) issued an amendment to deal with certain inheritance tax problems. Most personal pension scheme providers (such as insurers) amended their personal pension scheme rules over the months following the ABI announcement.

The change is most likely to affect members who took out their pension before the rules changed and proceeded on the basis of the old rules - but it could affect anyone. The two aspects that have altered are:

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2 how a trust of the benefits is set up; and

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2 how any life assurance benefits are assigned.
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Member dies before retiring

If members die before their normal retirement date, there are up to four steps that scheme administrators must take in dealing with the member's accumulated fund (note that life assurance benefits are dealt with separately below). Each step must be taken in turn, with the administrator moving on to the next only if the money could not have been paid out under the previous stage. The four steps can be found in rules 9. 1 and 9.1 5 of the Integrated Model Rules.

The steps the administrator must take are as follows:

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2 First, the administrator must check whether or not the member has requested that the money be used to buy an annuity for a spouse or a dependent. If so (and subject to the spouse's own options, which are set out below) an annuity should be bought. It is important that members actually make the request, as the administrator has no power to buy the

annuity if a request has not been received from a member. Unless the provider has a standard form, the member would normally simply make the request by letter.

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2 Second, if the member has not requested that an annuity be purchased the administrator must find out whether or not there was an irrevocable nomination in the contract (which is usually the application form). If so, the money must be paid to the person nominated on the form - this nomination is not limited to a spouse or dependent. This option is rarely used because there is no chance to review or change the nomination once it has been made.

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Although this nomination is likely to be made before any request for a spouse's pension has been made, it still has second place. The rules say that this nomination applies only if there is no spouse's pension payable when the member dies.

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2 Third, the administrator must check whether or not there is a valid trust to which the money can be paid.

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2 Finally, if none of the above options is available, the money must be paid under the administrator's discretionary power written into the scheme's rules: this power can be found at 9.15(3) of the Integrated Model Rules

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Nomination in contract

Any nomination in the contract is irrevocable, which means members cannot change their minds later, even if their circumstances have changed. They must also be careful with the way they make the nomination.

If, for example, the personal pension policyholder was a married man and he nominated his "wife" in the contract, then the payment must be made to his wife even if they were separated at the time of his death: it would be made to whoever was his wife at the time of his death. If, however, the man nominated the person (by name) who was his wife at the time the contract was taken out and he subsequently divorced and remarried, the payment would still be made to the named person.

A valid trust

Since August 1995, a valid trust is one that excludes the member and the member’s estate from benefiting. Prior to that, no such exclusion was necessary for the trust to be valid. The change was made when it emerged that there could be an inheritance tax liability under the gift with a reservation rule. If the trust did not exclude the member, it is not clear that the member’s estate must also be excluded, but it is considered good practice to do so. An advantage of these trusts over the discretionary power written into the scheme’s rules is their personal nature. In particular, the trustees ought to know the member and, therefore, be aware of the member’s plans and wishes.

Members who wish to set up a valid trust now should set up a trust that complies with the requirement to exclude themselves and their estate. Members who have already set up a trust will need to check that it is a valid one. To be valid it must comply with the rules that apply when they die and not when they set up die trust.

Trusts where the member or the member’s estate can benefit may still be valid if the trust was set up before the personal pension scheme changed its rules; and the rules were changed in the way recommended by the ABI. This introduced the necessary exclusion (protecting members who set up the new type of trust against a potential inheritance tax charge) but made an exception for pre-existing trusts. Members under these schemes (who had already set up a trust) have a valid trust, but may also have an Inheritance tax charge under the gift with a reservation rules.

If the trust cannot bring itself within this exception (either because the amendment did not exempt existing trusts or because the trust was set up after the amendment was made) it will need to be amended to exclude the member and the estate. Alternatively the member will have to rely on the administrator paying the fund value to the trustees under the discretionary power in rule 9.15(3) of the Integrated Model Rules.

This type of trust has nothing to do with any master trust under which the scheme may have been established. The member's own trust is designed to deal with the member's death benefits. A master trust is designed to regulate the relationship between the scheme provider (for example the insurer) and the member.

Discretionary power

The discretionary power found in the last of the four options requires the administrator to pay the money to:

(i) anyone nominated by the member; or

(ii) the member's surviving spouse, children or other relatives; or

(iii) the member's other dependents; or

(iv) anyone with an interest in the member's estate, or

(v) the member's legal personal representatives.

The advantage of such a discretionary power is that it avoids inheritance tax and similar discretionary powers are commonly written into occupational pension schemes. This power is a true fiduciary power. The members can suggest the names of people they would like to see receive the money but the final decision will rest with the administrator. If the scheme is set up under a master trust this will be a trustee power. Even if the scheme is set up under deed poll (an old-fashioned form of contract), it will still be a fiduciary power, in both cases imposing an obligation on the administrator to exercise it properly and in good truth.

Members who are relying on the discretionary power would be well advised to notify the administrator of the people they would like to see receive the money.

Retirement annuity contracts

Retirement annuity contracts were the forerunners of personal pension schemes. They ceased to be available when personal pension schemes were introduced in 1987. Unlike personal pension schemes (and occupational pension schemes) they had no discretionary power written into the rules. This meant that the death benefits had to be paid to the member's personal representatives, with the consequential inheritance tax liabilities.

The only way to avoid this was to put the policy into trust. This was often known as "writing the policy under trust". For this reason it is important that administrators should distinguish between a retirement annuity contract and a personal pension scheme when paying out death benefits. Often insurers do not consider all the people who could benefit under the discretionary powers of personal pensions but simply pay the personal representative by default. This could be a breach of their trustee or fiduciary powers.

Payment of life assurance benefits

If life assurance benefits are included in the personal pension plan (not all schemes include these as an option), they will be paid if the member dies while still insured (usually if he or she dies before buying an annuity). The way the money will be paid is very similar to the way the accumulated fund is paid. If the Integrated Model Rules are used, rule 10 will apply.

There are two main differences in the way the accumulated fund and life assurance benefits are treated. The first is that there is no option for the member to require the money to be spent on buying a survivor's annuity (so the first step of the four steps is omitted).

The second is that, after considering whether or not there is a valid trust (the same rules apply to a valid trust of life assurance benefit as apply to a valid trust of an accumulated fund), the administrator must see whether or not there has been a valid assignment of the life assurance benefits. (Assignments are most often used as security for a mortgage or equivalent debt.)

Valid assignment

Since August 1995, a valid assignment is one that has been expressly included in the contract (which is usually the application form). The rules of the scheme itself must prohibit an assignment unless the power has been included in the contract. Prior to August 1995, the Inland Revenue Integrated Model Rules allowed members an open-ended right to assign. However, this created a general power and therefore an inheritance tax liability that remained until such time as an irrevocable choice was made.

Members who wish to assign the life assurance benefits now must have reserved this power to themselves when they took out the policy. To reserve the power of assignment, to the policyholder, the contract must contain a clause to this effect.

Members who wish to assign their life assurance benefits must check that they have the necessary powers. Members who have already assigned their life assurance benefits will need to check that it is a valid assignment. The assignment will be valid only if there was a power to make an assignment at the time the payment is to be made.

Assignments made under a power in the rules (rather than a power in the contract) will be valid if-.

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2 the assignment was made before the personal pension scheme changed its rules; and
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2 the personal pension scheme adopted the amendment recommended by the ABI. This introduced the necessary exclusion into the rules (and allows members to reserve the necessary power for themselves in the contract) but made an exception for pre-existing assignments.
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If the assignment cannot bring itself within this exception it will be invalid. Members in this position will have to rely on the administrator paying the assignee under the discretionary power written into the rules. They should therefore inform the administrator of the assignee as soon as possible.

Member dies in a deferral period

A deferral period occurs when, on retirement, a member chooses to defer buying the annuity with the accumulated fund, and instead draws down income. Not all personal pension schemes offer this option, but many do.

If a member dies during a deferral period, the administrator must follow the same steps as set out above for death in service. The administrator must first find out whether or not the member required the fund to be used to buy a spouse's or dependant's pension. If so (and subject to the spouse's own options, which are set out below), such a pension should be bought. If not, the money must be paid out under rule 9.15. In other words, the administrator then has to consider questions 2 to 4 in order.

Spouse's and dependant's options

The options available to a spouse or dependent arise whenever the member has required the administrator to provide them with a pension. The options apply only to the accumulated fund (not the life assurance held), and only if the member died before the normal retirement date for the scheme or while deferring the purchase of an annuity. The nature of the spouse's options will depend on when the member dies.

If the member dies before the normal retirement date in the scheme's rules, the survivor has a right to choose to defer the purchase of an annuity and draw down income.

If the member dies during a deferral period, the survivor can defer the purchase of an annuity and draw down income. Alternatively (even if income drawdown is initially chosen), the survivor may, within the first two years after the death, choose to take the capital sum.

If a spouse or dependent dies while the purchase of the annuity is being deferred and income is being drawn down, the outstanding accumulated fund must be dealt with under the discretionary power written into the rules. Payments under this power are free of tax.

Death in retirement

If members die in retirement, in other words after their annuity has been bought, the only benefits available will be those contained in the annuity itself. Thus, if it was an annuity with a spouse's or dependant's pension, such a pension would be paid.

There will be no accumulated fund available, as this will have been used to buy die annuity. Nor will there be any life assurance, as cover usually ends when the member retires.

Protected rights

Protected rights arise if members have used their personal pension scheme to contract out of the state earnings related pension scheme. These rights are subject to more stringent rules than those set out above. For example a pension *must* be paid to any surviving spouse and can only be commuted for triviality.

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Here is information on how to order *Drafting Trusts and Will Trusts* and other books by James Kessler QC.

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