Case Study - Exploring Pension Options

One of the most important decisions a client will make is how to access their pension.

This document is based on London & Colonial Assurance PCC Plc's understanding of applicable UK tax legislation and current HM Revenue & Customs practice, as of December 2024, which could be subject to change in the future.

Joe:

- aged 66
- lives in England
- with his partner Susan

Joe decides to take his defined contribution pension fund, withdrawing the maximum Pension Commencement Lump Sum ('PCLS'). Below we compare Joe accessing his pension via pension drawdown versus purchasing London & Colonial Assurance PCC Plc's ('LCA') Flexible Pension Annuity ('FPA').

Pension Drawdown

During Joe's lifetime, the income received is treated as pension income and taxed accordingly. But what happens on Joe's death? Let's look at two examples where Susan decides to take the death benefit as a lump sum.

Example 1 — Joe dies aged 72

Currently and up to 05 April 2027, any lump sum payable to Susan needs to be tested against the Lump Sum and Death Benefit Allowance ('LSDBA'), with any excess being subject to UK income tax at Susan's marginal rate of UK income tax.

On death under age 75, the maximum lump sum that can be paid tax free is limited by the available LSDBA. The standard LSDBA is £1,073,100, however, if the member took tax-free lump sums in their lifetime, they may have used up some of this allowance.

If the death benefits are paid from funds that were put into drawdown prior to 6 April 2024, these would not be tested against the LSDBA, but any other funds will be.

Any lump sum death benefits paid out above the available LSDBA will be subject to income tax for the beneficiary receiving the payment.

Two-year rule

To remain tax free, the death benefit lump sum must be paid out to the beneficiary within two years of the date the scheme administrator knew, or should reasonably have known, of the member's death. If the payment is made after this two-year window, then there is no test against the LSDBA, but the entire lump sum will be subject to income tax.

Example 2 — Joe dies aged 80

Under current legislation (and up to 05 April 2027), if Joe died after age 75, the death benefit paid to Susan will be taxed as income at her marginal rate of UK income tax.

On Joe's death there is a death benefit of £100,000. Currently Susan's taxable income is £40,000 so her taxation is:

- Personal Allowance £12,570 @ 0%
- Remaining £27,430 @ 20% = £5,486
- Marginal rate of tax is therefore 13.72% (£5,486/£40,000)

If Susan decides to take the entire £100,000 death benefit in a single payment her taxable income would be £140,000. This would affect her personal allowance (for every £2 over £100,000 the personal allowance is reduced by £1). This means that for this tax year she will have no personal allowance resulting in more of her other income being taxed at a higher rate.

Example 2 — Joe dies aged 80 (continued)

If Susan takes the entire fund as a lump sum her taxation would be:

- £37,700 @20% = £7,540
- 87,440 @ 40% = £34,976
- £14,860 @ 45% = £6,687
- Total tax = £49,203 meaning her marginal rate is now 35.15% (£49,203/£140,000)

An alternative would be for Susan to take the benefits as an income, for example setting the income at £10,270 would mean that her income stays under the higher tax rate band of £50,270.

NB Pensions Death Benefits and IHT (effective 06 April 2027).

- Married couples and civil partners will continue to inherit each other's assets, including pensions, free of IHT. However, cohabiting couples will not. Joe will need to factor this into his planning.
- Income tax will continue to be payable on lump sum death benefits if the member dies aged 75 or over or their LSDBA is exceeded, in addition to any IHT payable (double taxation).

Flexible Pension Annuity

Most lifetime annuities provide an income based on a guaranteed annual growth-rate and whilst they provide a guaranteed income, they are less flexible than a drawdown.

The Flexible Pension Annuity ('FPA') is a unit-linked lifetime annuity which, like drawdown, ensures that the investments chosen by Joe match his attitude to risk. However, being a Gibraltar based company, LCA can offer full open architecture allowing Joe to choose from a wider range of permitted investments.

During his lifetime, the annuity payments from the FPA are treated as pension income and taxed at Joe's marginal rate of UK income tax. The FPA has built-in flexibility that allows Joe to vary the amount and frequency of his annuity payments. But what happens on Joe's death?

On Joe's death the FPA ceases, and no further annuity payments are made from the FPA. When Joe purchased his FPA, he also had the option to purchase a Preference Share in London & Colonial Assurance PCC Plc, a Protected Cell Company. The purchase of the Preference Share was totally separate to the purchase of the FPA. As Joe decided to purchase the Preference Share, the Share is linked to the Cell which holds all the assets that back his FPA.

Whether Joe dies aged 72 or 80, the ownership of his Preference Share passes to his legal personal representatives. Joe's legal personal representative must value all of his estate, which includes the value of the Preference Share (the value of the remaining investments held within the Cell) for inheritance tax ('IHT') purposes.

Under current IHT legislation, there are reliefs and exemptions that allow assets to be passed on to a deceased's beneficiaries tax-free. One such relief is Business Relief. Currently (and up to 05 April 2026), where the asset is a share in an unlisted trading company, 100% Business Relief is available, provided the asset was owned by the deceased person for at least two years before they died and continued to be held on death. LCA is an unlisted trading company so the Preference Share can potentially continue to benefit from 100% Business Relief.

However, with effect from 06 April 2026, the rules around Business Relief will change. Shares in unlisted trading companies will continue to benefit from 100% Business Relief, but only on the first £1m of qualifying assets/shares and 50% on the value of shares exceeding the £1m allowance. The Preference Share in LCA still needs to have been owned for at least two years before death.

Therefore, irrespective of whether Joe dies aged 72 or 80, Susan as beneficiary of his estate, could potentially receive the remaining value of the assets held in the Cell without being subject to income tax or IHT.

Susan can then choose how to invest or spend her inheritance.

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The Flexible Pension Annuity offers:

- Flexibility to vary the amount and frequency of the annuity payments.
- Gross roll-up, which means that any income or growth made on the underlying investment is not subject to tax at source – apart from an element of withholding tax.
- The ability to consolidate multiple pension plans.
- The potential to pass on a death benefit free of IHT (up to £1m from 06 April 2026) irrespective of when death occurs (provided a Preference Share has been bought and on death the Share has been held for at least two years).

Summary

Taxation	Pension Drawdown	Flexible Pension Annuity (FPA)
Income during lifetime	Taxed as pension income	Taxed as pension income
Taxation of Death Benefits before age 75	Only tax-free up to the available LSDBA*	Currently, and up to 05 April 2026): the proceeds from the Preference Share are IHT exempt after two years of owning the LCA Preference Share and continues to be held on death. From 06 April 2026, the proceeds of the Preference Share, up to £1m, are 100% exempt from IHT. Any proceeds that exceed the £1m allowance will benefit from 50% Business Relief and IHT will be payable on the excess.
Taxation of Death Benefits after 75	Taxed as income in the hands of the beneficiary at their marginal rate of income tax	As above.
Inheritance tax	Currently, and up to 05 April 2027: Tax-free provided Scheme is established under discretionary trust* From 06 April 2027: All death benefits and unused DC pension pots will form part of the deceased member's estate and will be liable for inheritance tax.	As above.

*Please note that on death if the death benefit was paid out more than two years after death (or the date the scheme administrator became aware of his death) income tax would be payable.

Want to know more?

If you would like further details on our Flexible Pension Annuity or any other product we offer, please contact your dedicated business development manager or email sales@stmgroup.online.

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