Death benefits: current issues and trends

In an earlier article exploring the mystery behind section 255 of the Pensions Act 2004 (Practical Pensions Law, November 2006), Christopher Berkeley explained the impact of the restriction imposed on occupational pension schemes limiting their activities to retirement-benefit activities.

Matthew Ambler examines how that restriction is affecting the provision of death benefits. He also considers how the legislation prohibiting age discrimination and anti-avoidance tax measures introduced in the latest budget are affecting life cover only schemes.

Life cover only schemes – a growing market

Before the recent legislative changes, life cover only schemes were mainly established by employers which only had group personal pension arrangements or stakeholder pension schemes, or for individuals whose death benefits exceeded the old Revenue death benefits cap (ie a lump sum of no more than 4 times final remuneration). However, section 255 of the Pensions Act 2004 restricts the activities of occupational pension schemes to “retirement benefit activities” only. For schemes which stray beyond this, for example by providing life cover to members who are not entitled to pension benefits from the scheme, there is now the risk of civil penalties. A growing number of employers with occupational pension arrangements, especially those with occupational pension arrangements closed to new members or new accrual or both, have therefore chosen to set up life cover only schemes to provide death in service benefits for employees.

Advantages of life cover only schemes

For employers, a separate trust-based life cover only scheme offers:

• the opportunity to offer valuable death in service benefits to employees free of inheritance tax while receiving tax relief on the cost of the insurance premium on the policy securing those benefits; and

• relatively few administrative burdens. Life cover only schemes are not occupational pension schemes, so avoid the administrative burdens imposed on the establishing employer and trustees of occupational pension schemes. However, to benefit from the employer tax relief, the life cover only scheme must be a registered pension scheme which does impose certain compliance burdens and restricts what the scheme can pay - registered pension schemes paying unauthorised payments risk tax charges and penalties. Nevertheless, these obligations are unlikely to be considered particularly onerous by pension managers and trustees.

For employees, a separate trust-based life cover only scheme offers:

• the security that if they die in service their closest relatives are likely to be provided for in the period immediately following their death. To enjoy the inheritance tax advantages, the recipient(s) cannot be conclusively determined before death, although in practice most life cover only schemes have nomination forms on which the employee expresses his or her wish as to who should benefit; and

• a benefit which would cost them more to purchase individually. (Most employers obtain a discounted premium because of the number of individuals covered and the tax relief available to employers is no longer available to employees - earlier this year the Government abolished tax relief on individual contributions to personal term policies.)

Disadvantages of life cover only schemes

Life cover only schemes work best when paying a lump sum death benefit. This means they are not always suitable replacements for replicating death benefits previously provided by an occupational pension scheme. Many occupational pension schemes offer a combination of lump sum payments (potentially including an element
representing a refund of member contributions) and spouse/civil partner or dependant pensions. These additional elements are not easily accommodated by most life cover only schemes.

When life cover only schemes were classified as occupational pension schemes, the benefits provided did not transfer to successor employers on a TUPE transfer. In certain circumstances having a life cover only scheme also excluded the employer from having to comply with the statutory stakeholder requirements. Unfortunately, the terms and conditions of a life cover only scheme may now form part of the employee’s terms and conditions which transfer on a TUPE transfer and must be replicated by the successor employer (although this will depend on how the benefit is conferred on the employee) and life cover only schemes no longer provide an exemption from compliance with the statutory stakeholder requirements. Rights which survive a TUPE transfer may have potential pricing implications for a transaction and statutory stakeholder requirements have compliance costs.

Problems resulting from age discrimination laws

The benefits provided by most life cover only schemes are secured by insurance policies which are the only assets of the scheme. However, regulatory restrictions currently prevent insurance companies from offering cover to individuals aged 70 or over. The recent age discrimination laws require older employees to be offered the same terms and conditions of employment as younger employees. Failing to offer employees in service after age 70 life cover benefits (which an employer would have to self insure if no insurance policy is available) gives rise to a potential discrimination claim.

In practice, there are very few employees in this age category and individual terms and conditions can probably be negotiated with such employees (although cost in itself cannot be used as justification for different treatment). The Association of British Insurers is lobbying for a change in the law which may remove the problem. However, even if the regulatory problems are removed, it is uncertain whether the premiums payable for those over 70 would be affordable.

Anti-avoidance

Among the anti-avoidance measures in the latest budget were provisions removing the tax relief on individual contributions to fund personal term assurance policies. Wealthy individuals have been purchasing these policies (taking advantage of the tax relief) to fund inheritance tax liabilities.

The change does not affect employer contributions towards death in service benefits which remain a legitimate tax-advantaged expense. Life cover only schemes that are established as registered pension schemes to provide payments to dependants of a deceased employee remain a useful and valuable employee benefit.

Conclusions

We are seeing a move towards life cover only schemes for the provision of lump sum death benefits. They offer tax advantages for employers and are a valued benefit for employees. There are relatively few problems associated with life cover only schemes, but it is always prudent to seek proper financial and legal advice before establishing any registered pension scheme.