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THE RETIREMENT SPECIALIST

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TECHNICAL BULLETIN

INHERITANCE TAX ON PENSIONS

At her first budget as chancellor in October 2024, Rachel Reeves announced that most unspent pensions and pension death benefits would be included in the estate for inheritance tax (IHT) purposes from April 2027.

At the same time, HMRC launched a technical consultation into these proposals. It wasn't a consultation on whether the policy should go ahead, but rather on how it should be implemented.

HMRC have now published a response to the technical consultation, changing large parts of the proposed process, showing that they have listened to industry feedback. It has also clarified the scope somewhat.

Throughout all of this it's important to remember that any funds passed to a surviving spouse or civil partner are usually exempt from IHT, so the impact will be felt by unmarried couples and those leaving pension funds to their children. We have also included a summary of existing IHT gifting rules which customers may wish to consider.

AIM OF CHANGE

As well as raising more tax, the policy aims to restate pensions as a retirement savings vehicle, rather than an intergenerational wealth planning tool: pension contributions benefit from very generous tax relief. This is to encourage individuals to save for their retirement and is done under the understanding that the income from the pension will be taxed. Effectively tax is deferred.

Since pension freedoms in 2015, most unused funds and death benefits have been paid tax free provided the member dies before their 75th birthday. This has allowed pensions to be used as a way of passing wealth through the generations. This has been exacerbated by the abolition of the lifetime allowance. Under current rules, individuals could theoretically receive large amounts of pension tax relief and benefits can be paid out completely free of tax if they die before their 75th Birthday.

These proposals aim to bring pensions back to what they are intended for: to provide an income in retirement for the member and their spouse or partner.

The policy also brings parity between discretionary and non-discretionary schemes. Currently benefits paid at the discretion of the trustees or provider are not included in the estate. Benefits not subject to discretion are included in the estate.

SCOPE OF POLICY

There was some confusion in the initial consultation as to which payments would be caught by the change. Although the consultation didn't focus on the scope, the response does clarify the scope and granted an extra exemption.

The only pension death benefits which will not be included in the estate are:

- Death in service benefits paid by registered pension schemes: currently these lump sums are included in the estate where they are paid from non-discretionary schemes and initial proposals sought to bring all such benefits into scope for IHT. The consultation response acknowledges that including these in the IHT measure would lead to employers providing death in service benefits

through non-pensions group life policies in trust instead. This would not be possible for public sector schemes, leading to more inconsistency.
- Dependant's Scheme Pensions (as per original proposals)
- Joint life annuities: this is not a change in policy but a clarification from HMRC. Their view is that the rights of the survivor are separate to the rights of the annuitant and as such won't form part of the estate. Although joint life annuities are excluded from the IHT charge, note that guarantee periods and value protection lump sums will be included in the estate.

The consultation response also clarified a technical point regarding trivial commutation death benefits (the benefit being commuted is included for IHT, not the lump sum) and confirmed that any unauthorised payments are included in the estate for IHT purposes.

PROCESS

The initial consultation proposals placed most administrative responsibilities on pension scheme administrators, requiring them to deduct IHT before distributing death benefits. The pension scheme would have also been jointly liable for the tax and potentially subject to late payment penalties.

This drew significant criticism from the industry and HMRC have now redesigned the process so that the legal personal representatives (LPRs) will take on a bigger role:

Stage 1 – Information exchange

- LPRs will inform pension schemes of the member's death.
- The scheme will need to provide the LPRs with the value of the death benefits within 4 weeks and inform LPRs how the death benefits will be split between exempt beneficiaries (spouses/civil partners/charities) and non-exempt beneficiaries.

Stage 2 – LPRs value the estate

- LPRs work out whether an IHT account is needed.
- If an IHT account is needed, they will request relevant personal information on the beneficiaries.

Stage 3 – LPRs file IHT account and pay IHT (if needed)

- LPRs complete the IHT account if needed and settle IHT liability.
- LPRs to inform the scheme and beneficiaries how much (if any) IHT is due from the pension.

Stage 4 – Distribution of pension benefits

- Scheme identifies the beneficiaries (exercising discretion where relevant) and informs them what their options are.
- Scheme settles benefits and pays IHT where directed by beneficiary.

Stage 5 – Amendments

- LPRs are responsible for managing amendments.

Note that stage 4 is likely to overlap with stages 1-3, so pension schemes don't need to wait for the executors to sort out the tax before paying out benefits. Beneficiaries may ask administrators to hold onto all or part of the death benefits to settle the IHT bill once known.

PAYMENT OF TAX

The original proposals made pension scheme administrators jointly responsible for the tax, which caused concerns among the industry. The consultation response confirms that it will instead be beneficiaries and LPRs who will be jointly liable for the tax.

Nevertheless there will be different ways of paying the tax:

- the LPRs can pay the tax at the same time as the IHT due on the rest of the estate,
- the beneficiaries can pay the tax directly to HMRC, or
- the beneficiaries can direct the pension scheme to pay the tax on behalf of the beneficiaries.

To address concerns relating to double taxation of death benefits, it has been confirmed that the IHT payment will not be subject to income tax. Where the scheme pays the IHT, any income tax will apply to the remainder. Where the death benefit is paid without the deduction of any IHT, the beneficiaries can claim an income tax refund (this is only relevant to so much of the IHT bill as is attributed to the pension).

Even so, death benefits may be taxed twice, first at 40% IHT and the net amount will then be subject to income tax on the beneficiary. For example, a £10,000 lump sum death benefit subject to 40% IHT would result in a £6,000 payment subject to income tax. For an additional rate tax payer, this would result in a net payment of £3,300. So the effective tax rate would be 67%.

IHT GIFTING RULES

The change in tax treatment may result in individuals drawing more from their pension sooner and they may wish to gift some of their wealth during their life. So now is a good time to remind ourselves of the exemptions already available in the IHT regime:

Spouse's exemption

Transfers between spouses/civil partners are exempt from IHT, provided the spouse is a long-term UK resident. Any assets transferred to the spouse would then form part of the spouse’s estate, but they would also benefit from the transfer of any unused nil rate band.

Annual exemption

Individuals can give away gifts up to £3,000 a year without them being included in the estate. They can also carry forward the allowance for one tax year. By combining it with the spouse’s exemption, a married couple can give away £6,000 in total each year.

Gifts out of normal expenditure

If an individual makes regular gifts out of surplus income, these gifts are also deemed to be free of IHT. The conditions for these gifts are that they

- are made out of income,
- do not impact the donor’s standard of living, and
- form part of the normal expenditure, i.e. there is a pattern of these gifts.

Small gift allowance

Gifts of up to £250 are also exempt and there’s no limit of how many one person can make, but they can’t give more than £250 to one person under this exemption.

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Wedding/Civil partnership gifts

A special exemption exists for gifts made for a wedding or civil partnership. The limit is between £1,000 and £5,000 depending on the relationship with the recipient.

With all gift exemptions, it's important to keep accurate records to evidence to HMRC that a gift qualifies under these exemptions.

Any gifts outside of these are likely to be potentially exempt transfers (PETs) and subject to the 7 year rule.

NEXT STEPS

HMRC published draft legislation alongside the consultation response and have asked for comments on this by 15 September. It will then be included in a Finance Bill later in the year.

There is some more draft legislation to come and HMRC will work with the industry on some of the finer details of the process.

We're not expecting any major changes to the legislation, so now is a good time to review how this will impact various customer groups and what, if anything, can be done to mitigate against the increased tax liability.

FOR MORE INFORMATION

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