Inheritance tax on pension funds and death benefits

Changes proposed in Autumn Budget 2024

This document was accurate based on published information as at 20 November 2024 and is subject to change.

“We will close the loophole created by the previous government… made even bigger when the Lifetime Allowance was abolished… by bringing inherited pensions into inheritance tax from April 2027”

Rachel Reeves, Chancellor of the Exchequer

Autumn Budget 2024

Delivered on 30 October 2024

Introduction

While there had been speculation about changes to the taxation of pension death benefits ahead of the Budget, the Chancellor has gone further than many people expected.

From 6 April 2027, unused pension funds and most death benefits will be included within the value of a person's estate for inheritance tax (IHT) purposes.

This is a significant change from the current regime where many death benefits are not assessed for inheritance tax through the discretion that trustees/managers of registered pension schemes apply when distributing death benefits.

There are only limited death benefits that will be excluded from this measure, with dependants' scheme pensions being the main exception. The existing overriding IHT exemption for transfers between spouses and civil partners on death will also continue to apply.

A consultation has been published on the government's proposed (very detailed) reporting and payment requirements, which runs until 22 January 2025.

This document was accurate based on published information as at 20 November 2024 and is subject to change.
This is a highly complex and evolving area and so this information should be considered for general background only.

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Agenda

1 **Background**
Discretionary vs non-discretionary pension schemes and inheritance tax – the current position

2 **Summary of the proposals**
What does the technical consultation cover?

3 **Pensions tax rules following death**
What is the current position when someone dies?

4 **Analysis of the changes**
How will the position change from April 2027?

5 **Trustee considerations**
Unintended consequences and thoughts on current actions

1

Background

Discretionary vs non-discretionary pension schemes and inheritance tax – the current position

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Inheritance tax – the essentials

Inheritance tax is a tax on the estate (the property, money and possessions) of someone who has died.

Inheritance tax is paid on the value of the estate at death, and any gifts made in the 7 years before death, above a threshold known as the nil-rate band.

The nil-rate band is currently set at £325,000 and has been frozen at this rate since 2009.

There are several further thresholds and exemptions which may be available, including the residence nil-rate band (which increases the thresholds when a main residence is inherited by direct descendants) and exemptions for transfers between legal spouses and registered civil partners. This means that for a couple with a house the combined nil-rate band can effectively be up to £1 million.

Personal representatives (PRs) are legally responsible for the estate during the administration period.

PRs are required to gather information and seek advice as necessary to settle the deceased's estate. The PRs for the estate usually pay any inheritance tax due before passing the remaining inheritance to the beneficiaries.

Source: https://www.gov.uk/government/consultations/inheritance-tax-on-pensions-liability-reporting-and-payment/technical-consultation-inheritance-tax-on-pensions-liability-reporting-and-payment

Discretionary schemes and inheritance tax

Most UK registered pension schemes (including standalone group life assurance schemes) are discretionary when it comes to paying benefits on death.

Lump sums (DB)

Pension scheme rules contain provisions about discretionary benefits on death.

The following may be payable:

- Death of an active member - a lump sum death benefit of a multiple of salary
- Death of a deferred member – a lump sum equal to the member contributions
- Death of a pensioner within five years – a lump sum equal to the sum of the payments due

Pensions (DB)

Pension scheme rules usually provide that a pension is payable on the death of an active, deferred or pensioner member to the member's legal spouse or civil partner.

Where the member does not have a spouse or civil partner, the trustees have a discretion to pay the pension to a person who satisfies the financial dependency provisions under tax law.

Some rules provide that the trustees have a discretion to pay to someone other than a spouse or civil partner, even where there is one (subject to the contracted-out benefits going to the spouse or civil partner). Some rules provide for children's pensions to be paid.

Unused (uncrystallised) DC pension savings

Pension scheme rules contain provisions about discretionary benefits on death (and may set out the options for using the unused DC pension savings – so, the beneficiaries may be able to use the unused savings to purchase an annuity outside the scheme).

Death of an active or a deferred member (the following may be payable):

- an uncrystallised funds lump sum death benefit or
- dependants' annuities or nominees' annuities or
- dependants' drawdown pensions or nominees' drawdown pensions or
- dependants' scheme pensions

Most trustees pay a lump sum death benefit of unused DC pension savings or give the beneficiaries the option of having an annuity outside the pension scheme.

The trustees decide to whom to make the payment. The member may have completed an expression of wish form. They may have drawn up a will.

The trustees have a duty to look at the potential beneficiaries in line with the wording about discretionary benefits and then make the payment.

The purpose of the discretion is that the benefits payable are NOT treated as part of the member's estate and are NOT liable for inheritance tax, even if the trustees decide to pay the benefit to the member's estate.

Pensions paid to the member's legal spouse or civil partner are NOT treated as part of the member's estate and are NOT liable for inheritance tax.

Non-discretionary schemes and inheritance tax

Some pension schemes – like the NHS Pension Scheme – are non-discretionary when it comes to paying benefits on death. The following applies to the NHS Pension Scheme but is common to other non-discretionary schemes.

Lump sums (DB)

The lump sum death benefit is paid according to the rules of the scheme and the member's nominations, rather than at the discretion of the NHS Pension Board.

This means it's payable to the legal spouse, registered civil partner or qualifying scheme partner, unless the member has nominated someone else on the lump sum on death benefit nomination form.

It is not included in an inheritance tax assessment if it is paid to the member's spouse or registered civil partner.

Otherwise, if it's paid to someone else – if there isn't a spouse, for example - then it's paid to the member's estate and included for inheritance tax purposes.

Pensions (DB)

Pensions are payable to a spouse, registered civil partner, qualifying scheme partner or dependent child.

These pensions are not included in the member's estate and, therefore, are not included in an inheritance tax assessment, where they are paid to a legal spouse, registered civil partner or dependent child. (This may be different for pensions paid to others.)

Sources: https://www.nhsbsa.nhs.uk/information-about-nhs-pensions/about-nhs-pension-scheme *and* https://www.nhsbsa.nhs.uk/sites/default/files/2024-08/Survivors%20Guide%20%28V12A%29%2004.2024.pdf

2

Summary of the proposals

What does the technical consultation cover?

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Summary of the proposals

In her Budget speech, Rachel Reeves, announced "we will close the loophole created by the previous government … made even bigger when the Lifetime Allowance was abolished … by bringing inherited pensions into inheritance tax from April 2027".

From 6 April 2027, most unused pension funds and death benefits will be included within the value of a person's estate for inheritance tax purposes.

- The current distinction in treatment between discretionary and non-discretionary schemes will be removed
- The change will apply to both DC and DB UK registered pension schemes
- A small number of specified pension benefits will remain outside scope for inheritance tax, including where funds can only be used to provide a dependants' scheme pension

From 6 April 2027, pension scheme administrators will become liable for reporting and paying any inheritance tax due on unused pension funds and death benefits.

- Personal representatives will have to inform pension scheme administrators of a member's death
- Pension scheme administrators will need to share details of unused pension funds and death benefits
- Personal representatives will have to calculate and share how much inheritance tax nil-rate band is apportioned to the relevant pension
- Pension scheme administrators will be required to use this information to calculate the amount of inheritance tax due on the unused pension funds and death benefits and report and pay this to HMRC

'Pension scheme administrators' means the person or persons appointed in accordance with the pension scheme rules to be responsible for the discharge of the functions conferred or imposed on the scheme administrator of the pension scheme by and under Part 4 of Finance Act 2004. Usually this is the trustees of the pension scheme.

The pension scheme administrator must send pension scheme reports and pay tax charges to HMRC. Often the pension scheme administrator appoints an authorised practitioner (such as the third-party provider of administration services) to act on their behalf. They must be registered on HMRC's online service – Managing pension schemes.

3

Pensions tax rules following death

What is the current position when someone dies?

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Pensions tax rules following death

The current position depends on the type of payment, whether the registered pension scheme's benefit is a DB pension or a DC pension (or even a lump sum death benefit), and the age of the member when they die.

Payment type	DB or DC benefit?	Age of member on death	Type of tax payable
Most lump sums (e.g. defined benefits lump sum death benefit, uncrystallised funds lump sum death benefit)	DB or DC	Under 75	Free from income tax unless the lump sum is above the lump sum and death benefit allowance NOT INCLUDED IN ESTATE FOR IHT
Most lump sums (e.g. defined benefits lump sum death benefit, uncrystallised funds lump sum death benefit)	DB or DC	75 or over	Income tax deducted by the trustees/managers NOT INCLUDED IN ESTATE FOR IHT
Trivial commutation lump sum death benefit	DB or DC	Any age	Income tax deducted by the trustees/managers NOT INCLUDED IN ESTATE FOR IHT
Dependants' scheme pension	DB or DC	Any age	Income tax deducted by the trustees/managers NOT INCLUDED IN ESTATE FOR IHT
Annuity or money from a new drawdown fund (set up or converted and first accessed from 6 April 2015)	DC	Under 75	Free from income tax NOT INCLUDED IN ESTATE FOR IHT
Annuity or money from a drawdown fund	DC	75 or over	Income tax deducted by the trustees/managers NOT INCLUDED IN ESTATE FOR IHT
Money from an old drawdown fund (a capped fund or a fund first accessed before 6 April 2015)	DC	Under 75	Income tax deducted by the trustees/managers NOT INCLUDED IN ESTATE FOR IHT

Notes:
The lump sum and death benefit allowance is £1,073,100 unless the member had a protected right to a higher lump sum.
Lump sums payable on death under age 75 (other than the trivial commutation lump sum death benefit) are subject to a 'two-year rule' where the benefits must be paid within two years of the trustees/managers first being aware of the death of the member.

Sources: https://www.gov.uk/tax-on-pension-death-benefits and https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm070000

4

Analysis of the changes

How will the position change from April 2027?

Pensions tax rules following death – from 6 April 2027

Apart from a dependants' scheme pension and a charity lump sum death benefit, the position will be changed and the benefit (whether paid as income or lump sum to the beneficiary) will be included in the value of an individual's estate for IHT.

Payment type	DB or DC benefit?	Age of member on death	Type of tax payable
Most lump sums (e.g. defined benefits lump sum death benefit, uncrystallised funds lump sum death benefit)	DB or DC	Under 75	Free from income tax unless the lump sum is above the lump sum and death benefit allowance INCLUDED IN ESTATE FOR IHT
Most lump sums (e.g. defined benefits lump sum death benefit, uncrystallised funds lump sum death benefit)	DB or DC	75 or over	Income tax deducted by the trustees/managers AND INCLUDED IN ESTATE FOR IHT
Trivial commutation lump sum death benefit	DB or DC	Any age	Income tax deducted by the trustees/managers AND INCLUDED IN ESTATE FOR IHT
Dependants' scheme pension	DB or DC	Any age	Income tax deducted by the trustees/managers NO CHANGE- NOT INCLUDED IN ESTATE FOR IHT
Annuity or money from a new drawdown fund (set up or converted and first accessed from 6 April 2015)	DC	Under 75	Free from income tax INCLUDED IN ESTATE FOR IHT
Annuity or money from a drawdown fund	DC	75 or over	Income tax deducted by the trustees/managers AND INCLUDED IN ESTATE FOR IHT
Money from an old drawdown fund (a capped fund or a fund first accessed before 6 April 2015)	DC	Under 75	Income tax deducted by the trustees/managers AND INCLUDED IN ESTATE FOR IHT

Notes:
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Sources: https://www.gov.uk/tax-on-pension-death-benefits *and* https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm070000

5

Trustee considerations

Unintended consequences and thoughts on current actions

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Trustee considerations

Consideration	Questions	Action
Impact on member engagement Some members will perceive this negatively, potentially in cases where they will not be impacted. It may lead to confusion and negatively influence their view of the savings they have made and their approach to future savings.	How should employers and trustees communicate with members between now and April 2027? It is difficult to communicate in the absence of full proposals, but staying silent may result in concern from employees/members.	**Action:** Consider communications strategy
Scheme design changes Some employers (and trustees) may want to reconsider some aspects of scheme design and how they operate discretion.	For example, where the pension scheme continues to provide DB benefits for active members, is the life assurance benefit provided in a standalone scheme or an excepted group life arrangement? Should trustees continue to operate their current policy on discretion, given the impact of the proposals?	**Action:** Consider when the proposals are further advanced
Impact on trustees and administrators The technical consultation proposes that pension scheme administrators (e.g. the trustees working with their administrators) will be responsible for paying IHT before they pay any benefits to the beneficiaries.	The steps required include the passing of information between the deceased member's personal representatives and the scheme. IHT has to be paid within six months of the end of the month in which death occurred. We expect industry to push back on the additional requirements.	**Action:** Keep an eye on the responses to the consultation
Buy-in and buy-out considerations When trustees purchase a buy-in policy, scheme rules still apply. Trustees usually retain the same discretions, meaning that the considerations covered here apply.	When benefits are bought out and the pension scheme is wound up, it's usually the case that the insurance company responsible for each policy in the member's name, no longer operates on a discretionary basis. The death benefits may automatically count towards the deceased member's estate (with the exemption for those provided to a legal spouse or civil partner).	**Action:** Consider as part of any buy-in feasibility discussions and consider for projects in progress

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