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INHERITANCE TAX ON PENSION DEATH BENEFITS: FURTHER DETAILS ANNOUNCED

Unused pension funds and death benefits under registered pension schemes will come within scope of inheritance tax (IHT) from 6 April 2027.

The Government has published (on 21 July) draft legislation and announced further details on what payments will be caught, who will be liable to pay the tax and the mechanics of paying any IHT due.

The good news is that the Government confirmed that death in service benefits under registered pension schemes will not be caught by the changes and this will be the case regardless of whether the benefit is paid on a discretionary or non-discretionary basis. Benefits under certain public sector schemes, such as the NHS Pension Scheme, will therefore be out of scope of IHT from 6 April 2027. Other lump sum death benefits remain in scope of IHT.

The Government also announced that, where the IHT changes do apply, it has changed tack on requiring scheme administrators to calculate and pay the IHT due on death benefit payments. It now proposes that the deceased's personal representatives (PRs), who are responsible for dealing with IHT on the remainder of the deceased's estate, will take on this role. Beneficiaries of death benefit payments will be jointly liable with the PRs for any IHT due and can

also ask the scheme to deduct and pay the tax due before paying out the benefit (a new form of 'scheme pays').

There will also be new reporting and information sharing requirements on scheme administrators to assist the PRs in calculating the IHT due and to know who is liable for the tax.

Schemes will need to be ready to implement these processes from 6 April 2027, including updating member communications, webpages and member booklets ahead of April 2027. A key concern for members will be to understand when IHT does not arise (i.e., for a spouse or civil partner as exempt beneficiaries) and where a death benefit may be subject to IHT and income tax on the remainder, such as for benefits payable on death after age 75.

SOME HELPFUL CLARIFICATIONS

Alongside the new draft legislation, the Government published a response to its technical consultation held over several months following the announcements in the 2024 Autumn Budget.

The consultation response provided helpful clarification on various points, including that:



- + any person exempt from IHT under normal rules (i.e. spouses and civil partners) will be exempt in relation to pension benefits also, whereas non-exempt persons will be jointly and severally liable with the PRs for any IHT due on pension benefits if they are the recipient of those benefits.
- + there will be no change to the current rules that IHT must be paid within 6 months of the date of death and that interest on late payment will accrue from 6 months, and
- + even where IHT is payable on a death benefit payment, income tax may also be payable (e.g. on benefits payable on a death after age 75).

Finally, to address concerns expressed in the consultation around liquidity (in the sense of having sufficient funds in the estate to pay the IHT due on pension death benefits before those benefits are distributed), HMRC proposes three options: (i) PRs pay the IHT due from other funds in the deceased's free estate, (ii) the death benefit beneficiary asks the scheme to deduct the IHT due before paying out the benefit, under a new form of scheme pays, or (iii) the death benefit beneficiary pays the IHT due on the benefit from their own funds.

HOW WILL IHT ON PENSIONS OPERATE IN PRACTICE?

The consultation response also included a helpful summary of how information will be shared to ensure the IHT due on the pensions component of a member's estate is calculated and accounted for correctly. Briefly, the process is expected to be as follows:

Stage 1: Information exchange to establish pension value

Once PRs have notified the scheme of the member's death, the scheme administrators will have 4 weeks to provide details of the value of the member's unused pension funds and death benefits at the date of death. They must also, once the scheme administrator has identified the recipients of the benefit, notify the PRs of the split between beneficiaries who are exempt from IHT and those who are not.

Stage 2: PRs value the estate (including the pensions component)

The PRs will collate all information relating to the estate including from all relevant pension arrangements. If an IHT account is due, the PRs

will provide the IHT reference number to the scheme administrators and request details of the individual beneficiaries.

Stage 3: PRs to file IHT return and pay IHT (if needed)

If no IHT account is due (or if an account must be made but no IHT is payable), each beneficiary and scheme administrator will be informed, and the administrators can pay the death benefits due.

If an account is due and IHT payable, then the PRs will calculate the tax due from each beneficiary and submit that information on the account to HMRC. The IHT due in respect of the pension benefits can then be paid in one of the ways referred to above.

Stage 4: Distribution of pension death benefits

It will be the scheme administrator who will communicate with beneficiaries about this process and the options for paying any IHT due, including the new scheme pays option. They will also need to confirm to the PRs when the benefits are paid out, and their value so that the PRs can calculate if the member's lump sum allowances have been exceeded.

OUR VIEW

Regardless of your opinion on whether pension death benefits should be subject to IHT, we think that the Government's response is overall to be welcomed: it is positive that responsibility for accounting for, and paying, the IHT will fall on PRs and that death in service benefits will be carved out. It is, however, disappointing that in most cases (because death generally happens after age 75) pension death benefits will be subject to IHT and income tax, giving an effective rate of tax of up to 67%.

From a scheme trustee and administrator perspective, there will be work to do to prepare for the April 2027 changes. HMRC will be publishing further guidance and tools in due course, and we will also be providing regular updates.

Please contact your usual Stephenson Harwood representative for specific advice on how this will affect you or your scheme.



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