Institute and Faculty of Actuaries

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IFoA response to Inheritance Tax on pensions: liability, reporting and payment

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Key points

- Our consultation response builds on our previous communication in December and largely focuses on the public interest aspects of the consultation proposals.
- We acknowledge the Government's objective to tax funds held within a pension scheme that could be used to transfer wealth in a way that would currently attract inheritance tax if those funds were not held in a pension scheme. However, we have concerns that the proposals go beyond this and start to erode the purposes for which governments intended pension schemes to be established, namely, to provide benefits for members upon retirement and protection for their dependants upon death. In particular, the proposals as they stand will delay, reduce and complicate benefits payable to dependants – who are financially reliant on the deceased member – in a wide range of situations.
- We also share the industry's concerns that the proposals are not workable in practice for pension schemes and other parties, particularly in terms of the timescales and reporting requirements.
- We make several recommendations that address these concerns without necessarily having a significant impact on the aggregate tax raised.

Introduction

Summary

Our consultation response builds on our previous communication in December.

We acknowledge the Government's objective to tax funds held within a pension scheme that could be used to transfer wealth in a way that would currently attract inheritance tax if those funds were not held in a pension scheme. However, we have concerns that the proposals go beyond this and start to erode the purposes for which governments intended pension schemes to be established, namely, to provide benefits for members upon retirement and protection for their dependants upon death. In particular, the proposals as they stand will delay, reduce and complicate benefits payable to dependants – who are financially reliant on the deceased member – in a wide range of situations.

We also share the industry's concerns that the proposals are not workable in practice for pension schemes and other parties, particularly in terms of the timescales and reporting requirements.

We provide a number of options for approaches that address these concerns.

Previous communication

We wrote to you in December seeking clarifications from the Government regarding its proposals. We were concerned there could be a serious risk of the Government being without the information it needs to avoid making changes which could have adverse and unintended impacts on deceased pension scheme members' dependant families following the consultation. We believe it is particularly important to avoid disrupting and delaying the payment of death benefits intended to protect dependants from the financial distress caused by the death of a loved one.

Briefly, we requested the Government clarify the following in relation to its proposals:

1. What is meant by "All life policy products purchased with pension funds… are not in scope"?

2. To what extent and how are the proposals intended to apply where a "reversionary" annuity (bought before the member's death) becomes payable to a non-spouse dependant only upon the member's death?

We also urged the Government to consider:

A. The distress to families of delaying the payment of death benefits, including cases where no inheritance tax (IHT) is due.

B. The different needs and types of death benefits for different age groups.

C. A distinction between "passing on" pension scheme *assets* and "*risk benefits*".

D. The equality and social impacts of the proposals.

E. Any effective reduction in a member's life cover arising from applying IHT to those benefits.

F. Consistency of IHT treatment with other life cover held outside a registered pension scheme.

This letter builds on that previous communication and now sets out the IFoA's formal response to the consultation.

Consultation response

We give a combined answer to questions 1-7 below, and then separately answer questions 8 and 9.

HMRC has already identified many of the difficulties of implementing its proposals, through its workshops and meetings with the pension industry. We are aware that attendees at these meetings have spelt out the manifold and varied difficulties of fully integrating pension scheme payments into the IHT regime in the way proposed. We anticipate that industry bodies and scheme administrators with relevant practical knowledge will set out the many practical difficulties and potential adverse consequences of the particular proposals. Therefore, rather than repeating similar points we will concentrate our response on the broader policy questions.

Question 1: Do you agree that PSAs should only be required to report unused pension funds or death benefits of scheme members to HMRC when there is an Inheritance Tax liability on those funds or death benefits?

Question 2: How are PSAs likely to respond if they have not received all the relevant information from the PR to pay any Inheritance Tax due on a pension by the 6-month payment deadline?

Question 3: What action, if any, could government take to ensure that PSAs can fulfil their Inheritance Tax liabilities before the Inheritance Tax payment deadline while also meeting their separate obligations to beneficiaries?

Question 4: Do you have any views on PSAs reporting and paying Inheritance Tax and late payment interest charges via the Accounting for Tax return?

Question 5: Do you agree that 12 months after end of the month in which the member died is the appropriate point for their beneficiaries to become jointly and severally liable for the payment of Inheritance Tax?

Question 6: What is the most appropriate means of identifying or contacting beneficiaries if either the PR or HMRC realises that an amendment is needed after Inheritance Tax has been paid? Should PSAs be required to retain the details of beneficiaries for a certain period?

Question 7: What are your views on the process and information sharing requirements set out above?

A1-7

In our view:

- The timescales envisaged (before interest and penalties apply) will often be unworkable for pension schemes, where deaths are frequently notified months and occasionally years after the time of the event.
- The proposals will delay the payment of death benefits, and we are particularly concerned that any such delays would adversely impact the deceased’s financial dependants.
- The proposals will reduce the effective value of death benefits. We are concerned about reductions where those payments would have been intended to provide a long-term income for the surviving dependants, such as young children or those impaired by mental or physical disability. It might be that “risk benefits” are not included in the scope of the consultation but this is not clear (see our answer to question 8).

- The payment reductions, delay and uncertainty will add to the distress (financial and otherwise) of the bereaved dependants whereas those benefits would currently be able to be settled outside the IHT process.

- Making Pension Scheme Administrators (PSAs) responsible for calculating and administering IHT payments risks a move (whether by practice or amendments to a scheme) to trustees paying death benefits to the estate rather than actively considering to which potential beneficiaries to make payments. In our view this would remove a valuable social protection where there is at present an entity capable of exercising judgment to achieve an appropriate outcome "judged in the round", having been able to consider all the evidence available to them, irrespective of whether the deceased member has an up-to-date will or death benefits nomination form. In particular, we fear this would remove protection for unmarried partners that is not otherwise provided for under current inheritance or intestacy laws.

- The detrimental impact of the proposals will fall disproportionately across different social groups. The consultation suggests that the impact is limited to the wealthiest estates and – by implication – those already likely to be well provided for. However, in our view, the impact (delay, reduction, exclusion, and uncertainty) may fall particularly heavily on those in a much less secure financial position, including:

    - Unmarried partners.
    - Unadopted children of partners.
    - Those in religious or overseas marriages not legally recognized in the UK.
    - Adult children dependant by reason of physical or mental impairment.
    - Children cared for by a family member other than a parent.

These family types are not evenly spread across the population by income groups. We know, for example, that those in higher paid and/or managerial roles are more likely to be married than those in other jobs[1]. Therefore, the impacts of the family types listed above will interact with existing wealth, income, and health inequalities, in perhaps unexpected ways.

In making these points we are thinking particularly of working-age deaths where:

- The death is unexpected or notably early.
- The deceased is more likely to have young children.
- The deceased is more likely to have financially dependent partners with a lower or no independent income of their own (e.g., those looking after children).
- The death benefit will often disproportionately derive from a "risk protection" benefit as opposed to an investment held for the member at the time of their death (but see our answer to Q8 below – this might not be the intention).

[1] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/adhocs/002214ct01142011censussexbyagebylivingarrangementsbyoccupationbynssecenglandandwales

- The proposals would put PSAs in a position of relying and waiting on Personal Representatives (PRs) to provide information before they can fully settle death benefits. Equally, the PRs would be in a position of waiting on the PSAs before they can finalise the IHT. There will inevitably be much "back and forth" in some cases, and even circularity if the trustees decide to exercise their discretion in a way that takes account of the IHT payable. We are not IHT experts but we are aware the existing process for PRs, obtaining probate, and settling IHT are already complicated and frequently take many months and sometimes years to complete. At present PSAs do not need to establish contact with the PRs before the benefits are paid – there are disclosures that should be made afterwards but if the PRs cannot be contacted (and sometimes there are none) the payments are not delayed by that fact. In many death cases the trustees are able to pay out benefits before probate is obtained (if it ever is). Incorporating pension death benefits into that process will only add to the burden of settling estates, even if ultimately no IHT is due. These processes will be even more complex and take significantly longer where the deceased has benefits in multiple schemes.

- The proposals would make some PSAs jointly responsible for IHT adjustments after they have settled benefits in good faith. We think this is unfair to pension scheme members (including the surviving members of the scheme or sponsors who might bear the costs) and unworkable, as the PSAs would then no longer hold the assets from which to make the IHT payment, or the ability to retrieve funds from the beneficiaries. We also note that since it may take far longer to determine an estate's final IHT position than it might take a pension scheme to pay death benefits there is potential in the meantime for beneficiaries to die or for the scheme responsibilities to have been transferred to another party (noting the trend for scheme and pot consolidation underway at present and encouraged by the Government, and also the large number of schemes working to buy-out their liabilities or transfer them to another scheme/provider before winding-up). We assume that PSAs would be discharged of responsibility to make the adjustments in these circumstances, but it would be more straightforward if their responsibilities were clearly terminated on discharging the death benefits – that would avoid the need for them to justify/apply for exceptions etc.

Question 8: Are there any scenarios which would not fit neatly into the typical process outlined above? How might we address these?

A8

In our December letter we drew attention to two particular areas of uncertainty where it was not clear if the benefits would be in scope of IHT nor, if they were, how IHT would operate for them. These were:

- "**Risk benefits**" where the benefit is contingent on the member's death, i.e. specifically payable only on the death of the member – usually within a particular timeframe and under specific circumstances – and was not an asset the member holder could have made use of themselves even if they had survived to an older age. Examples include a lump sum payment of "5 times salary on death" etc.

- **Reversionary annuities** purchased by the member prior to their death from their own pension assets but payable only to their dependant if the member dies before the dependant. Examples include a "50% dependant's income" purchased alongside the member's own annuity (or as a package). We refer to these as "reversionary annuities" because they only become payable to the second party upon the first's death. Sometimes they are referred to as "joint life annuities" though the income is typically reduced on the member's death. Importantly, no asset is payable if the dependant pre-deceases the member.

We emphasise that both these benefits are *contingent* on the member's death under particular circumstances – there is *not* an income stream/lump sum that is payable in any event where it is only the recipient that is uncertain (in contrast, for example, where the member has assets in their own pension they are able to drawdown during their retirement, or where an individual has purchased an income stream that will always be paid but just to nominated beneficiaries if there are outstanding instalments at the time of their death). The death benefits we are talking about here are *not* "unused pension funds" but akin to an insurance option (whether or not reinsured by the pension provider with an insurer or "self-insured" by meeting from the scheme's own resources).

The consultation focuses on "unused pension funds" and it seems likely these "risk benefits" are not in scope, and not what the Government has in mind in relation to the proposals announced in the Budget. However, the references to "and death benefits" and the content of Annex B have made this less than certain. Annex B is not clear on what is meant by the "life products" out of scope. Neither does the Annex elaborate on the particular forms of death benefit listed – for example, it does not distinguish between dependant's annuities purchased prior to and after death, and nor does it explain whether and why a trivial commutation lump sum death benefit would be in scope if that benefit was a commuted dependant's scheme pension (which is not within scope of IHT).

The proposals appear designed to capture the assets a member might have held prior to their death and would have been able to make use of themselves (either immediately or at a later date), and that are to be distributed to their beneficiaries if they remained unaccessed at the time of death. If this is a correct reading, the proposals would not relate to either risk benefits or reversionary annuities – we would be grateful if you could clarify this as soon as possible.

If, however, the Government *does* intend to bring "risk benefits" into scope of IHT (or is exploring doing so) then they are very different benefits to "unused pension funds", and different considerations would apply. For example, lump sum cover would then be treated differently to life cover held under other trusts, and there would be important actuarial questions to explore about how to value and adjust reversionary annuities. There would also be a question about why IHT would fall on reversionary annuities but not dependants' scheme pensions. As we said in our December letter, it is not possible to respond to the consultation questions meaningfully in respect of these benefits until the proposals are clarified. In our view, if the intention is to bring either contingent risk benefits or reversionary annuities into scope of IHT, this should be the subject of a separate consultation.

Question 9: Do you have any other views on the proposal to make PSAs liable for reporting details of unused pension funds and death benefits directly to HMRC and paying any Inheritance Tax due on those benefits? Are there any feasible alternatives to this model?

A9

In general, pension schemes were set up to provide for the retirement of individuals and for the protection of their financial dependants on those individual's deaths. This is true whether the scheme was set up by an employer for their employees or by individual savers using a private pension account. We agree with the Government that pension schemes should not be used "as a tax-planning vehicle for wealth transfer after death".

However, considering our comments above, our strong view is that PSAs should not be involved in the IHT process.

Under the current regime HMRC has accepted the view and allowed that pension schemes should be able to pay death benefits (on a death before age 75 where no income tax is otherwise due) gross to beneficiaries. Any tax due in the minority of cases where a member's lump sum and death benefit allowance (LSDBA) is exceeded is then directly settled between the beneficiaries and HMRC. The PSA's role is to tell the PRs what amounts have been paid, with the PRs then passing relevant information to HMRC, and then HMRC

liaising with the PSAs if it needs further information about the beneficiaries. A very similar model operated prior to 6 April 2024 where death benefits were paid in excess of the lifetime allowance and a lifetime allowance charge was due from the beneficiaries.

We think that this model has worked, and continues to work, well for bereaved families and ensures that a tax charge due in a minority of cases does not delay the payments to the majority.

In our view it would be entirely reasonable and far more appropriate if PSAs could continue to be able to pay out death benefits gross to beneficiaries without needing to establish, calculate, withhold, deduct or remit IHT.

Nevertheless, we recognise the Government's concerns that the current tax treatment of pension schemes allows them to be used by a minority of members to deliberately leave assets in their pension scheme that would otherwise (if withdrawn from the pension scheme) fall into scope for IHT. We also recognise that where IHT is due on pension death benefits then there are some advantages to the Government of having it withheld by the pension scheme and for a net payment to be made to beneficiaries. With this in mind, it seems to us that the Government is chiefly concerned with assets held prior to the member's death, and where those assets are intended to be "handed on" to younger generations in a way that avoids the IHT that would apply if the same assets were held outside a trust. These will typically be invested in income drawdown type products, where the member has considerable choice over the rate at which income is withdrawn from the pension asset. We do not believe it is fair to include risk benefits put in place by employers to protect employees' families on their early death and hope that the Government is able to clarify that it does not intend to do so. Similarly, we hope that the Government does not intend to penalise (the chiefly female) surviving dependants where a member has secured a reversionary income for them in conjunction with purchasing their own annuity. We make the following suggestions:

1. That **risk benefits be clarified as out of scope of the consultation**, whether or not trustees have reinsured those benefits with an insurer.

2. That **reversionary annuities purchased prior to the member's death be clarified as out of scope**.

3. That **PSAs have no involvement with IHT** other than information sharing along the pre-2024 lines.

4. That **death benefits paid to dependants** (we suggest using the definition of "dependants" in Finance Act 2004 for dependants' scheme pensions) **continue to be outside the scope of IHT**. (As a minimum this should cover children under 23 or above that age but physically or mentally impaired – but we think it would be fair and consistent with dependants' scheme pensions to extend it to adult unimpaired financial dependants as well). This would preserve the existing protection for financial dependants of the member, while removing the tax advantage where assets are being passed to those who were not dependant on the member at the time of their death. We note the precedent of existing IHT exemptions for disposals for the maintenance of family, but that these are much more limited than would apply to dependants' scheme pensions.

5. That where payments are paid to individuals who were not dependants of the member (e.g. adult children, or grandchildren who might be dependent on their parents but were not dependent on the deceased), the PSA should withhold and remit to HMRC **a charge based on the payment amount, without any regard to the member's wider estate or their IHT position**. For example, a fixed percentage "inherited pension charge" might be applied – perhaps above a certain level – where a lump sum is paid to or transferred to a non-dependant. The appropriate percentage and tax-free portion would be for the Government to decide. In setting those parameters it might want to consider what the alternative IHT charge would typically be, and the potential for some estates to pay more than they would have done in IHT.

In point 5 there would be a question of whether the charge is "final" or a "downpayment" on the true IHT liability once the benefits have been brought into scope and the final IHT position in relation to them established.

The "downpayment" approach (as currently applies in the case of some death benefits paid to a trust that are later paid on to particular individuals[2]) would achieve eventual but full consistency of IHT treatment between assets held inside a pension scheme and other assets held by the member immediately before death. However, there might then be inconsistency between assets held within a pension trust and assets held in other types of trust. If pension assets are brought within the IHT and a downpayment approach is followed, there would still be a lot of additional work for PSAs, PRs, HMRC and the beneficiaries themselves. Thinking foremost of the beneficiaries, although it would expedite prompt payments to them, it would leave ongoing doubt as to how much of the payment they might eventually have to give up – this seems far from ideal.

The "final" approach might therefore be an alternative, under which a charge is withheld by the PSAs before making payments to certain beneficiaries, but on remitting that charge to HMRC there is no further charge on the beneficiaries whatever the wider IHT conclusion. For example, prior to 6 April 2016 and the "pensions freedom" changes, there was a 45% special lump sum death benefit charge[3] that applied to uncrystallised funds and unused drawdown funds if the member died over the age of 75. This was a higher charge than would have applied if the assets had been in scope of IHT, but with the benefit of avoiding the procedural difficulties of full IHT integration.

Setting a new charge at a fixed percentage would reduce or remove (depending on its level) the incentive to use pension schemes as an IHT avoidance vehicle, without significantly complicating the settlement process for any of the parties involved.

Alternatively, for deaths under 75 PAYE could be applied in place of the IHT charge (the current rate for taxable lump sums paid to individuals). This would mean that those on low incomes receiving modest lump sums would likely pay less tax than the IHT charge, and those with high income or receiving very large lump sums would likely pay a similar or higher amount of tax than the IHT charge. There would be no need to test these payments to non-dependants against the LSDBA (payments above that level are already subject to income tax). The LSDBA test could continue for dependants as their payments would continue to be tax-free up to that level.

In the case of deaths over 75 lump sum death benefits are already subject to income tax, so PAYE couldn't be applied instead of an additional inheritance charge (otherwise it would be subject to PAYE twice). Instead, the fixed percentage charge would be (for non-dependants) applied prior to the PAYE, as you have proposed.

If the PSA must deduct some form of tax then, whether "once and for all" or as a downpayment of IHT, we suggest the Government consider allowing de minimis payments to be paid gross. For example, the first £30,000 could be paid gross (per scheme, not across all schemes). That would align with the trivial commutation death benefit limits and represents less than 10% of the IHT nil band. In a very "rough and ready" way it might also be considered a first approximation to the final IHT eventually due (if any) on the benefits.

However, as already mentioned above, our view is that no charge should apply in cases of financial dependency, and that continuing to be able to make those death benefit payments without an IHT or

[2] See PTM073010: Taxable lump sum death benefit payments to a trust - refund of tax to trust beneficiary

[3] The special lump sum death benefits charge was 55% from 6 April 2011 to 5 April 2015. Before 6 April 2011 it was 35%, though there were not any uncrystallised funds after age 75.

equivalent charge would be consistent with granting full tax reliefs to pension schemes which do not deviate from the purposes for which the Government intended pension schemes to be established.

It seems odd to us that the extension of IHT to pension scheme death benefits for dependants could leave them paying as high or higher combined rates of tax than some non-dependants would. For example,

1. Since 2015 it has been possible to transfer unused money purchase funds (whether in drawdown or uncrystallised) at death to non-dependant nominees and successors. Whilst in the pension scheme the investments will remain free of income and capital gains tax.

2. If the member died before the age of 75 then the benefits are also payable free of income tax to the nominees and successors (the nominees can nominate their own successors, and the income tax privilege continues if the nominator died before age 75).

3. Prior to 2015 unused money purchased funds could only be paid to non-dependants in the form of a lump sum. In the case of a death over age 75 this would mean the lump sum would be taxed at 55%, i.e. much more than 40%, except in cases of relatively small lump sums paid to individuals with modest or low incomes. Since 2015 the use of nominees' and successors' drawdown, following a death after 75, has therefore enabled beneficiaries to reduce the income tax payable on withdrawals.

4. The LSDBA, at the standard level of £1,073,100, allows lump sum death benefits to be paid free of income tax up to the level of the member's available LSDBA if the member dies before age 75. The relatively generous treatment of death benefits for a death under age 75 is not an unreasonable incentive for individuals to save into a pension even though they might not live to see the benefit of that saving. However, it applies equally to non-dependant beneficiaries as much to dependant ones.

In summary, the different taxes applying to pensions assets in different circumstances should be considered as a whole so that those dependent on the deceased member and who are likely to be reliant on their pension death benefits are not taxed more than non-dependant beneficiaries for whom the payments will often be a "windfall" (in the sense that the payments are not offsetting other losses).

END.