Inherited problems

The government's plans to include pensions in the scope of inheritance tax has generated concern about how its rules can be feasibly implemented within the pensions industry. Laura Blows finds out more

Summary

• The government's plans to include pensions within the scope of inheritance tax (IHT) has proved controversial.
• The proposals may reduce the use of pensions for wealth transfer purposes and bring in more tax for the government.
• The pensions industry has expressed concerns about the change, including the feasibility of pension administrators being responsible for calculating IHT payments, and the fairness of unmarried couples within the threshold being subject to IHT, while those that are married or in a civil partnership are not.
• A number of suggestions for simpler ways to implement IHT into the scope of pensions have been suggested.
• Only a limited number of estates are expected to actually pay IHT, but the change may have a wider impact on many people's plans for retirement saving.

Of all the upcoming changes to the UK pensions system, arguably the one that has caused the greatest uproar is the idea of including pensions within the scope of inheritance tax (IHT).

The 2024 Autumn Budget in October saw Chancellor, Rachel Reeves, announce plans to remove the concession for pension pots to be passed on to anyone free of IHT, alongside plans to extend the freeze on IHT thresholds from 2028 until 2030.

IHT only applies to estates over £325,000, with any amount over this taxed at 40 per cent. It is not applicable to estates left to a spouse, civil partner, charity or community amateur sports club. The threshold increases to £500,000 if children or grandchildren inherit the home, and any unused threshold from an estate can be added to their partner's threshold.

"We will close the loophole created by the previous government – and made bigger when the lifetime allowance was abolished – by bringing inherited pensions into inheritance tax from April 2027," she stated, with the Budget papers describing it as "making the inheritance tax system fairer".

Industry response

As soon as it was announced, many in the industry responded with concern and calls for clarity about the proposals. Broadstone head of policy, David Brooks, succinctly summarises the current plans as "basically unworkable".

Industry professionals have highlighted significant concerns about the fairness and practicality of the IHT proposals, with 90 per cent believing that the introduction of IHT on unused pensions was retrospective and unfair, according to WBR Group's research, published in March.

Royal London pensions and tax expert, Clare Moffat, explains: "In the past, when changes were made to pensions, those who had already made plans were protected against that change, for example, when the lifetime allowance was reduced. But this change looks like it would affect every unused pension."

WBR Group's research also found that 97 per cent of respondents agreed or strongly agreed that the proposals forced pensions into an IHT regime that does not accommodate the practicalities of current pension rules or administration processes.

"Some of the main concerns I'm hearing from the industry, apart from the dislike of constant rule changing, are around the practical implications," Aon associate partner, Steven Leigh, says.

"Under the proposed process, pension administrators are being asked to work with the personal representatives to determine the IHT liability and deduct this from the pension death benefit before paying out the remainder. There is a six month time limit from date of death, but often pension administrators are not informed of a death for many months and there is a lot of potential complexity following the notification, for example the personal representatives will need to understand the overall value of the estate of the deceased, including certain pension benefits, in order to be able to calculate the appropriate IHT," he explains.

There are also a number of areas where greater clarity is needed and legislation may need amending, "such as the impact on the lump sum death benefits paid before the age of 75 where there is currently a two-year time limit, how to value DC pots when calculating IHT given that the final amount could fluctuate, and whether group life assurance policies would be counted in the IHT calculation", PMI chief strategy officer, Helen Forrest Hall, says.

"Any inconsistent treatment will lead to more complexity and a potential risk of unfairness, for example if death benefits from public sector or defined benefit pensions were to be taxed differently to those arising from defined contribution pensions, which are used by the vast majority of the private sector for ongoing pension saving," Leigh states.

It is worth noting that many cases that go to The Pensions Ombudsman concern trustee failure to properly exercise powers to distribute death benefits "so introducing more complexity could lead to an increase in complaints", Sackers partner, Eleanor Daplyn, adds.

The proposals are also "likely to trigger interest charges and penalties in cases where tax is due, as it will not be practical for personal representatives to gather all the information nor for pension scheme administrators to provide it in the time allowed", LCP partner, Alasdair Mayes, says. "The changes would cause delays in loved ones receiving their benefits at a time when they are vulnerable and in financial need, even though in many cases no tax will be due."

There is also the concern of double taxation occurring, Trafalgar House client director, Daniel Taylor, warns, explaining: "If someone dies after 75, their beneficiaries could be hit with both IHT and income tax on withdrawals, meaning they could lose more than two-thirds of their inheritance to tax.

"The perception of an additional tax may influence behaviours and potentially discourage people from saving adequately for retirement"

"That's not just unfair – it's punitive."

It could also be punitive to unmarried couples, Hargreaves Lansdown head of retirement analysis, Helen Morrissey, adds, as it "impacts unmarried couples who cannot benefit from the ability to inherit from their partner free of inheritance tax. This means they stand to receive significantly less than their married counterparts, which can put them under huge financial strain".

However, the industry isn't just highlighting problems; it is also putting forward suggested changes.

For instance, Leigh proposes for the scheme to be able to deduct IHT at a fixed rate, while Mayes says schemes should simply be allowed to pay benefits gross, and with either solution, for HMRC to liaise with the beneficiaries directly regarding any tax payment requirements.

Aegon head of pensions, Kate Smith, agrees with the idea of a "simpler and more effective" alternative, such as levying a tax on pensions in scope where above a certain level, for instance, £100,000.

"This has the added benefit of avoiding encouraging individuals to run down their pension too quickly to avoid an IHT charge," she adds.

Alternatively, the six-month window to pay IHT could only start once schemes have made a decision about who is to receive a death benefit, or the scheme only be liable if and when they have been provided with all the information necessary to work out the tax due, Daplyn suggests.

In January, HMRC confirmed that it is reviewing the issues and views expressed in the response to its IHT and pensions consultation and that it will publish both a formal response and draft legislation "later in the year".

Potential benefits

The government's consultation response will hopefully show, through its taking on board of industry concerns, that it did not decide to change IHT simply to make pensions administrators' work harder and add extra challenges to the recently bereaved; there must also be upsides to the proposal.

Daplyn highlights how the government has been clear that "a key driver for this change is to reverse a trend towards individuals using pension savings as an IHT planning tool".

Broadstone supports the government's objective to ensure that pensions are used for the primary purpose of providing an income for the member. "While individuals may have other assets to use in their retirement or later life, we do not believe that pensions should be used as a vehicle for wealth transfer," Brooks says.

However, some of the benefits that will be caught in the IHT net under the proposals do not really fit within this view of pensions being used for wealth transfer, Daplyn states.

"For example, a multiple of salary lump sum on death in service will be caught, but in many circumstances that isn't something a scheme member will have any control over, so it's difficult to see how it can be used for the 'mischief' (i.e. IHT planning) that is being targeted.

Although an individual may include these in their financial plans, this would be more in terms of ensuring their family would be appropriately provided for should they die unexpectedly and their income is no longer available, rather than estate planning/management of potential IHT liability," she explains.

The IHT change may be viewed as creating more of a level playing field between pensions and many other investments in terms of IHT planning, Leigh says, but ultimately "the main benefit is a hoped-for increase in tax to help with UK public finances".

Caught in the net

The government has said that it expects most estates to not meet the requirements for IHT to apply. However, inheritance tax receipts are still expected to hit c.£14 billion by 2030, Cartwright Pension Trusts senior investment consultant, Arash Nasri, says.

"Government numbers indicate that the pension IHT rule changes will cause a further 10,500 estates to become liable to some level of inheritance tax for the year 2027/8. This is against the backdrop of c.213,000 estates with some level of inheritable pension wealth. In effect, an approximate extra 5 per cent of estates with any pension assets to inherit will now pay some IHT. This is in addition to the c39,000 estates which are liable for IHT anyway; and which will now pay more," he states.

Mayes highlights how HMRC predicts that the first few years of the IHT change will raise less than £1.5 billion per annum.

"However, we expect the impact to be significant in the medium term, raising twice that each year, and the revenue to the Exchequer over the next 20 years could easily be in excess of £40 billion," he adds.

Moffat provides an example of how it is not only the extremely wealthy that may be caught in the IHT change.

"If a single person with no children, a house worth £250,000, a pension worth £500,000 and not much in the way of other assets, died today then there would be no IHT to pay. But the proposed change means that from 2027 there would be IHT on £425,000," she explains.

"If these changes go ahead as planned, the pensions landscape will never look the same again"

Yet according to Morrissey: "It's important to note that while IHT can be levied on estates worth in excess of £325,00, there is also the residential nil rate band that covers the main property being passed down to children and grandchildren, which is worth £175,000.

"Added to this, assets passed to spouses do not attract IHT regardless of value and they also have the ability to inherit the unused proportion of their spouse's nil rate bands. This means that many people could pass down assets worth up to £1 million before IHT becomes an issue."

Despite only a minority of people being expected to be impacted by these changes, Leigh is concerned that "the perception of an additional tax may influence behaviours and potentially discourage people from saving adequately for retirement".

Research conducted so far seems to validate his worry.

In November 2024, research from PensionBee found that 47 per cent of respondents expressed concern about the government's planned changes to IHT.

Meanwhile, "since the changes were announced at the end of last year, 82 per cent of IFAs are re-evaluating the role of pensions in their clients' plans... The upshot of all of this is that advisers are increasingly recommending clients withdraw more pension savings now to either enjoy the benefit or to gift the money", Standard Life retirement savings director, Mike Ambery, says.

Looking ahead

Smith hopes that, in the near future, the government will consider the nature of modern-day relationships when reviewing IHT. "IHT is designed around a number of exemptions and thresholds, specifically the nil-rate band of £325,000 and the spouse exemption for legal spouses and registered civil partners," she says. "This enables these individuals to inherit significantly more, after IHT, than other potential beneficiaries, such as common-law partners or children who may be financial dependants.

"Given the steady decline in opposite-sex marriage, the increase in co-habitation, and the number of children born to unmarried parents now exceeding the number born within a marriage, we believe this is out of step with today's societal norms."

For the pensions industry itself, Taylor says that "this could be the beginning of a long-term shift where pensions are treated more like other taxable assets rather than a protected form of savings. If this happens, the industry will need to rethink how pensions are structured to remain attractive and viable".

He warns: "Make no mistake – these changes go ahead as planned, the pensions landscape will never look the same again. We urge the government to engage with the industry, consider the practical challenges, and find a solution that works for both savers and pensions administrators before it's too late."

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