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Private Wealth

IHT and pensions: risk, complexity, cost and delay

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More risk. More complexity. More cost. More delay.

That will be the impact of bringing most pensions within the scope of inheritance tax (IHT) from 6 April 2027.

Personal representatives (PRs) will generally be responsible for dealing with pension-related IHT even though they do not control the pension funds. Some benefits will remain exempt, including those for spouses or civil partners, charities, certain dependants' schemes and death in service benefits.

The main concern is the increased personal liability and administrative burden on PRs. They will need to identify all pensions, obtain information quickly from pension scheme administrators, use withholding and payment notices where possible, and avoid distributing estates until HMRC statutory clearance is obtained. This briefing note provides a detailed explanation of the proposed changes and how both individuals and PRs can be better prepared to avoid any risks and potential conflict.

Deaths prior to 6 April 2027

Currently, pension death benefits are free of IHT no matter who the pension is paid to, where the scheme trustees decide who should receive death benefits and how much (usually in accordance with an expression of wishes).

Trustee discretion has to date largely been the defining factor as to whether the pension fell within the IHT regime.

It has not been unusual for pension funds to shelter assets from IHT or provide for beneficiaries who would otherwise bear tax (including cohabitees and life partners).

Deaths after 6 April 2027

Value sitting in pension funds will be subject to IHT from 6 April 2027. The liability for the payment of IHT primarily rests on the PRs. This is the case even though they do not control the pension fund.

In this briefing, we provide an overview of the headline issues for those affected by the IHT changes and highlight key areas for consideration. Although draft legislation has been issued, there remain some areas of uncertainty and in particular the forms and notification process which HMRC intend to release later in the year.

The starting point – identifying pensions and where they are based

The immediate priority for PRs is to take reasonable steps to identify any pension schemes. That may include reviewing tax returns, bank statements and other paperwork, but it will not always be apparent if the deceased was not in drawdown or contributing.

If an individual is UK long term resident (LTR) their pensions will still be subject to IHT even if they are qualifying non-UK pension schemes (QNUPS) or s615(3) schemes regardless of where the scheme is established. Non LTRs will pay IHT on any pensions that were established in the UK. Non-LTRs will not pay IHT on pensions which are established outside of the UK.

The situs of the pension scheme is fundamental to determining the procedure that applies to the 'freezing' of the pension and payment of the IHT.

Who and what is excluded from charge?

Payments to a spouse or civil partner (**CP**) are exempt from IHT. Consideration will need to be given to the residence status of the surviving spouse/CP in the usual way to determine the extent of any nil-rate band available.

Payments to UK registered charities will be exempt from IHT.

Payments from a dependants' pension scheme will be an excluded benefit and therefore outside the scope of IHT. There are detailed qualifying criteria but broadly the benefit must be for a surviving spouse/CP and/or minor children of the deceased.

Death in service benefits are excluded benefits and not subject to IHT. For the payment to be exempt the member of the scheme must be in employment (or in work of a particular description) immediately before their death. A death in service benefit is typically a lump sum based on a multiplier of salary. The extent to which there may be trustee discretion on who to pay the death in service benefit to, does not impact the condition of it being an excluded benefit.

What if the person died without a will; can I still access the information from the pension scheme administrator (PSA)?

PSAs will need to provide information to PRs before a Grant of Probate or Letters of Administration (used where the deceased died intestate) has been granted.

If there is a will then, ordinarily, supplying a copy of the will, death certificate and a letter of authority should be sufficient. In most cases, a letter from a solicitor acting on behalf of the PRs will be acceptable.

Where there is no will then the process is more complex. In that case, the PSA will have to satisfy themselves that the person writing to them would be entitled to apply for a Grant of Letters of Administration based on the intestacy rules. Commonly, that would be a spouse/CP or adult children. The process for supplying that information is likely to be more in-depth although HMRC acknowledge that a solicitor's letter would also be good evidence. Further guidance will be issued in this regard.

What are the obligations of the PSAs?

The legislation puts most of the responsibility to deal with the pension IHT squarely on the shoulders of the PRs. However, there are some deadlines that the PSAs will be required to comply with.

Once the PR has made a formal request for the valuation of the pension and details of the pension beneficiaries, the PSA has 28 days to provide that valuation.

Within 28 days of being notified, or 14 days from the date the PSA determines who the beneficiaries of the pension are, they must notify the PRs whether the beneficiaries are exempt or non-exempt.

If the PSA does not provide information relating to the beneficiaries, then the PR can request full details of the pension beneficiaries. The PSA has 28 days from the date of the request to comply and must provide the full names, addresses, NI numbers (if known), and the value of the pension benefits allocated to each beneficiary.

This enables the PR to calculate the IHT at that stage.

Protective measures – the withholding notice (WN)

A fundamental element of the new legislation is the ability for the PR to issue a WN. The WN instructs the PSA to withhold up to 50% of an individual's benefit entitlement under the scheme.

The WN can be issued when the PR knows or has reason to believe that IHT may be due in relation to the pension.

During the period in which the WN is in place, no benefit may be paid to the beneficiary over and above 50% of their entitlement. If their entitlement has already been partly paid, then no further payments can be made to exceed that 50% threshold.

The timing of the WN is crucial and in most cases, should be issued as soon as possible to enable the PR to limit any potential future personal liability in respect of the pension IHT. The latest a WN can be issued is 15 months after the end of the month in which the deceased died but only has effect in that period. A WN can cease to have effect by withdrawal by the PR, being time barred or because the tax has been paid, although in relation to the latter one presumes this refers to statutory clearance having been obtained from HMRC.

Risk area: the WN can only apply to a beneficiary's "benefit entitlement". Take the example of a situation where there are two beneficiaries, Susan and Ann, Susan's share has been fully paid out by the PSA and Ann's share has not. The WN can apply to up to 50% of Ann's share but the PR will need to meet the cost of Susan's share of the IHT (with a joint and several liability) because it has already been paid to her.

Risk area: WNs do not apply to QNUPS or s615(3) schemes, so there is a very real risk that the PRs will bear the burden of the IHT and will then be obliged to recover this from the pension beneficiaries.

In short – the PR has a short window of limited protection and must act promptly where they know or reasonably expect IHT to be payable.

Protective measures – the Payment Notice (PN)

A PN can be issued by the pension beneficiary or the PRs. Unlike WNs, there is no time limit for PNs and they can be given beyond the 15-month period during which the WN has effect. Payment must be made to HMRC within 35 days of the issue of the notice. If the PSA does not pay, they become jointly and severally liable with the PR for the IHT.

HMRC will produce templates in due course for PRs to use.

A PN can be withdrawn in the 35-day period, but only before the IHT is paid. If payment results in an overpayment of IHT, this is refunded to the PRs through the estate, rather than credited to the pension scheme or pension beneficiary.

Risk: In the case of an intestate estate, i.e. there is no appointment of a PR arising from a will, the prospective PRs have no ability to issue a PN. They will be reliant on the pension beneficiary doing so. Given that the rules on who can benefit under an intestacy are set out in law, the beneficiaries may be very different from those nominated under a pension (for example, cohabitees/life partners/charity/friends).

Risk: As with WNs, PNs do not apply to QNUPS or s615(3) schemes.

What happens if a pension falls in value since death or the assets are illiquid?

It is not unusual for there to be movements in the stock exchange such that shares may have fallen in value since the date of death. Under normal IHT principles, if those are listed shares sold within one year of death, the difference in IHT can be reclaimed. This is known as loss relief.

HMRC have stated that loss relief will not be available to pension funds and nor will payments of IHT be able to be made by instalments or interest free.

By way of example:

If a pension comprises a portfolio of shares and is worth £1m at death but, one week later, falls to £300,000, the IHT liability will remain at £400,000 and the beneficiary (or the PR, if the beneficiary does not pay) will have to fund the shortfall from other assets.

It is not unusual for Self-Invested Pension Plans (SIPPs) to hold assets such as commercial property, wine, art and other luxury items. These are often illiquid and designed to be held for the long term.

Payment of IHT in those cases will be particularly challenging.

Risk: There could be a significant delay in liquidating assets to meet any IHT liability. In the meantime, the IHT will have to be paid by the PR or pension beneficiary. PSAs will need to think about how to generate liquidity.

Do pension beneficiaries suffer IHT and income tax?

If IHT is paid in relation to any pension benefits, the amount that corresponds to the IHT (and interest) does not count towards the beneficiary's taxable income. The balance of pension benefits payable to the beneficiary will be subject to income tax.

From a housekeeping/administrative perspective it will be easier for the pension beneficiaries to regulate their income tax position if the PSA pays the IHT directly, otherwise they will receive the pension fund gross and will have to reconcile the position on income tax with HMRC.

What happens if the value of the estate changes?

If the value of the estate changes because either a) assets are discovered that were previously unknown to the PRs or b) the estate has gone down in value and loss relief can be claimed, then the IHT must be recalculated. That would have always been the case.

Now, there is a further complication. It means the IHT attributable to one or more pensions may need to be recalculated.

That could mean that further IHT is payable. If there is an overpayment of the IHT attributable to the pension, the PRs will be responsible for distributing that overpayment as it is not repaid to the PSA.

What happens if a pension is discovered after the estate has been distributed?

This poses a significant risk to PRs. If both the estate assets and pension have been distributed, then the PRs will be personally liable to meet the cost of the additional IHT.

This is the biggest risk for PRs in the future. Through no fault of their own they could find themselves with a significant IHT liability and having to fund that from their personal assets.

By way of example (in relation to a death on or after 6 April 2027):

Lily Smith died leaving an estate of £1m. She also had a pension of £1m. The beneficiaries of her estate are her children from her first marriage, Joan and Jackie. The beneficiaries of the pension are the children of her second marriage, Tony and James. Tony and James live in Los Angeles.

The executors of Lily's estate are her two long standing friends, Chris and Harry. Chris and Harry made all reasonable enquiries and paid the IHT on Lily's estate. They were aware of the pension and agreed with

Tony and James that a PN would be issued. The PSA paid the IHT and distributed the remainder of the pension to the children.

Chris and Harry were comfortable that they had paid all the IHT and administered the estate correctly. They distributed the balance of the estate to Joan and Jackie.

Six months after distributing the estate, Chris and Harry are notified that Lily had a workplace pension with XYZ Ltd worth £200,000. XYZ Ltd paid the pension to Tony and James.

Chris and Harry are obliged to file a corrective account to HMRC and pay £80,000 IHT plus interest. They have no estate assets from which to pay the IHT. They cannot locate Tony and James who are liable for the IHT.

Without statutory clearance, Chris and Harry will be required to personally meet the cost of the IHT attributable to the pension. They must sell some of their own assets to do so.

To mitigate against this risk the PRs should not make any distributions until they have obtained statutory clearance from HMRC.

Statutory clearance – a must!

PRs can be discharged from any liability on undiscovered pensions if they have received clearance from HMRC. The pension beneficiaries will remain liable for the tax in that case.

Clearance should only be applied for once the PR considers that they have reported all the assets, met all the liabilities and the tax position is finalised. If any new pension assets come to light, the PRs are discharged from the IHT due on the new pension asset.

It is worth noting that the current timescale for HMRC issuing clearance at the end of an administration is 6–12 months.

What do these changes mean for PRs?

From 6 April 2027 there will be significant risk and potential personal liability associated with the role of PR. This can be mitigated in part but more than ever, professional advice will be needed to ensure that PRs are protected so far as possible.

Administration of estates where the deceased has left a pension will typically take longer, be more complex and costly. There is also a very real risk that in cases where the beneficiaries of the estate and the pension are different, that it will lead to tension or dispute.

What do these changes mean for beneficiaries of estates?

Almost certainly the receipt of interim distributions during the administration of the estate will be limited until such time as the PRs receive statutory clearance.

There are risks that beneficiaries will receive less from the estate than they otherwise would have if the PRs had to meet the IHT cost of the pension where there is limited if any recourse to the pension or the pension beneficiaries.

The costs of the administration of the IHT on pensions fall squarely on the PRs meaning that residuary beneficiaries will ultimately receive less.

What should you do now?

1. Record keeping will be essential

Keep a log of all your pensions with your will and where possible, provide a list to your executors. This will make their job easier at the time. Keep the list up to date.

2. Consider the terms of your will and whether this needs to be updated

Where you have a pension and are leaving assets to charity it will be important to consider the overall figures and whether this still accords with your wishes. When calculating the 10% to charity, to qualify for the 36% effective rate of tax, the value of the pension is taken into account. This means that a greater proportion of your estate must pass to charity to qualify for the reduced rate.

You may decide it is simpler and easier to leave your pension to charity assuming that the chosen charity is exempt from IHT. Administratively that may be simpler and reduce the IHT burden on your estate.

3. Consider possible lifetime IHT planning

It is possible to make regular gifts out of income from a pension if the pension is in drawdown. Whilst that might not mitigate any income tax exposure, it would reduce the value of the pension on death and potentially mitigate the overall IHT liability. As always, care needs to be taken in determining whether or not this exemption is available in any given factual situation, and record keeping is important.

Number crunching

The pension values will be brought into account when determining and apportioning the nil-rate band and residence nil-rate band.

Where previously an estate may have been below the taper threshold for the RNRB (£2m) the value of pensions will be included from 6 April 2027. This may mean that an estate pays more IHT overall not only because of the IHT on the pension, but also because of the reduction in reliefs.

How can we help?

It cannot be overstated what a significant change this represents to the administration of estates and potential risk to PRs.

Delays in relation to beneficiaries receiving their inheritance is likely to be pushed to at least beyond the date on which statutory clearance is obtained which could be 18 months to two years after death.

The issues that may impact on an estate may be more than just tax. Disputes between different groups of beneficiaries, litigation/enforcement to recover IHT and navigating another layer of complexity and reporting.

We have a wealth of experience in advising individuals, families and trust companies. We can advise on how the changes will impact you and your estate or how, as a PR, you can ensure you protect your position.

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