

Pension death benefits: inheritance tax

Synopsis: Inheritance tax (IHT) legislative position and when it may apply to lump sums paid from pension schemes.

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General rules

The Government has now legislated (through the Finance Act 2006) for unused pension funds and death benefits payable from a pension to form part of a person's estate for IHT purposes from 6 April 2027. There are some excluded benefits for IHT purposes in this new legislation – notably all death in service benefits. Secondary legislation is due later in 2026 and HMRC has stated that guidance and supporting material will be published for April 2027.

The position outlined in this paper is in line with legislation and regulations which are in force currently.

Death benefits paid from pensions are, currently, generally paid free of IHT because of the framework under which they are written (usually a trust or deed poll) and that the Scheme Administrator or Pension Scheme Trustees have discretion as to who should benefit on the member's death. This remains the case if a dependant, nominee, or successor is named by a pension scheme member/beneficiary. HMRC has confirmed that will not cause the member/beneficiary to be treated as making a transfer of value for IHT purposes on death provided...

- the member/beneficiary does not have power under the Schemes Rules to irrevocably choose the beneficiary who should be entitled to death benefits on their death; and
- the Scheme Trustee/Scheme Administrator has a discretionary power to choose who should receive death benefits.

So, for example, even though the pension scheme member may have nominated a person to receive income drawdown death benefits, the Scheme Administrator could still override this nomination and pay lump sum death benefits.

There could also be cases where the Scheme Administrator has, in effect, no option but to follow the member's nomination. Say, for example, a scheme member has named a dependant to be entitled to flexi-access drawdown death benefits. If the Scheme Administrator wants to pay flexi-access drawdown benefits, the Scheme Administrator may have to pay benefits to that dependant (because there are no other dependants). Here HMRC takes the view that, provided the Scheme Administrator has the option to pay an alternative benefit (i.e. a lump sum) and can determine who would receive such alternative benefit, the member would not be treated as making a transfer of value of their fund on their death.

HMRC has also confirmed that the naming of a dependant/nominee who is entitled to flexi-access drawdown death payments followed by the Scheme Administrator exercising their discretion in their favour, would not give rise to an IHT exit charge. This is on the basis that a flexi-access drawdown fund is an arrangement under which property is held for the purposes of a registered pension scheme and so, because it falls within s.58(1)(d) IHTA 1984, is not relevant property. Any payment out of a flexi-access drawdown fund is therefore not an exit from a relevant property trust.

There would also be no IHT exit charge on payments of flexi-access income drawdown death payments out of a trust of a registered pension scheme, even if paid more than two years after the member's death. There could still be other tax charges – income tax or the special lump sum death benefit charge - but that varies depending on the circumstances and in particular the age of the member at the date of death (under age 75 or age 75 or over).

Since 2011, the omission to exercise a right rule in section 3(3) IHT Act 1984 has not applied to a member's entitlement to tax free cash and pension payments under a registered pension schemes due to the amendment in section 12(2) IHT Act 1984. HMRC has confirmed that the exemption will also apply to a beneficiary's entitlement to flexi-access drawdown death benefits on that beneficiary's death.

Therefore, for those members who die under age 75, provided lump sums are paid out of the pension fund within two years of the member's death (or the date the Scheme Administrator could reasonably have known of the member's death) or funds are designated to drawdown within two years of the member's death, there should be no tax charge on the payment (assuming benefits are within the lifetime allowance where applicable). Moreover, flexi-access income drawdown death benefits should be free of IHT and undrawn flexi-access funds should not count as a part of the taxable estate of the beneficiary entitled.

The same principles will apply to death benefits in the plan on the death of a beneficiary who is a dependant, nominee or successor.

If it is desired to pay out a lump sum then, rather than making a payment to an individual beneficiary, there can sometimes be circumstances where there would be wider advantages in the pension scheme trustees making a payment to a trust instead (for example for reasons of control). By using an appropriate trust, this will enable the trustees/scheme administrator to by-pass a beneficiary's taxable estate yet still give that beneficiary (for example a spouse) access to the trust fund.

If the Scheme Administrator makes a lump sum death benefit to the trustees of a trust which is a potential beneficiary under the Scheme Rules, this will be tax free if the member died under age 75. If the member died aged 75 or over, the payment will be taxed at 45% (as a non-qualifying person). Income and capital gains on investments in the trust will be taxed in the normal way in later years.

Cases where IHT can still apply

Since 6 April 2011, the provisions in s.3(3) IHTA 1984 – omission to exercise a right – no longer apply to the payment of death benefits from a registered pension scheme. This rule created substantial complications, and its application was not necessarily helped by the High Court decision in Fryer. The good news is that s.3(3) can now be largely ignored with regards to pensions plans.

There are therefore now two circumstances in which IHT can apply on the deceased's estate as regards lump sum death benefit payments...

- where the deceased's estate has a right to death benefits; and
- where there is a general power of appointment.

Each of these is considered below. There are other circumstances where IHT can apply as a result of action taken during the member's lifetime (in particular during the two-year period prior to their death) and also in relation to guaranteed annuity payments continuing to be paid to the Estate on death.

Deceased's estate has a right to death benefits

Any death benefits payable to the deceased's estate or personal representatives, as of right at the date of death, form part of the deceased's estate for IHT purposes.

There is an exception to this rule where an annuity becomes payable to a dependant of the deceased but the deceased had the option of taking the lump sum instead. So, for example, if an annuity becomes payable on the death to the widow, widower, surviving civil partner or dependant and the deceased had the option of taking a lump sum instead, that lump sum is not treated as part of the death estate.

To avoid a charge under this provision, it is important to make sure that the trustees/Scheme Administrator have discretion over the payment of death benefits. This will avoid the death benefits being treated as part of the deceased's estate even if the trustees exercise their discretion in favour of the deceased's estate.

Note that with certain lump sum death benefits paid from older individual contracts (Section 32 buy out plans, retirement annuity contracts) and a small number of occupational schemes there is no discretion over who should receive the benefits. However, individuals with these types of benefit may be able to assign them into a trust during their lifetime using trust wording given by product providers. This means that the subsequent payment of death benefits will be at the discretion of the trustees and so will be paid free of IHT.

General power of appointment

If the deceased pension scheme member had a general power of appointment over the death benefits, or a power of nomination which binds the scheme trustees or personal representatives as to whom to pay the death

benefits to, including their own estate, then under s.5(2) IHTA 1984, the lump sum will be treated as forming part of the deceased member's taxable estate. The exception to this is if the deceased member had irrevocably exercised the power of appointment during their lifetime while they were in good health.

So, for example, in a case where...

- the death benefits are held on discretionary trusts with the settlor having the power to appoint benefits; and
- the settlor is a beneficiary or can add themselves as a beneficiary,

then because the deceased had power to appoint funds to themselves or their own estate, the death benefits will be treated as forming part of their estate under s.5(2) IHTA 1984.

This provision will also apply in cases where the deceased had an unfettered power to sign a nomination which binds the trustees of the pension scheme to make the payment of the death benefits to the person named by the deceased. Here, the death benefits will be treated as an asset of the estate.

An unfettered power to nominate, in this context, means that the deceased could nominate to anyone they wished, including their personal representatives. Care must be taken not to confuse a binding nomination with a non-binding letter of wishes, as these are sometimes called nominations. A non-binding letter of wishes will not give rise to a problem in this respect (unless it is badly drafted so that, for example, the pension scheme member has the right to revoke an existing expression of wishes up until their death and, if they did so without indicating another person, the death benefits would be paid into the member's estate).

Therefore, problems will not arise in this area provided...

- the member cannot appoint death benefits under the trust and/or the member is not a beneficiary under the trust; or
- the death benefits are distributed at the trustees' discretion even if the distribution is in line with a non-binding letter of wishes expressed by the member to the trustees.

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