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Pensions - Tax Treatment on Death

Alongside the changes from April 2015 to the access of defined contribution pension funds, significant changes were made to the tax treatment of pension funds on death. This factsheet summarises the rules for **defined contribution schemes** which may allow a pension fund to pass free of all taxes on the estate of the deceased and free of all taxes on the beneficiaries of the pension fund.

IHT and pension funds

Pension death benefits can be subject to inheritance tax (IHT). This will be the case if the member has control over who the beneficiaries will be as HMRC will take the view that essentially the death benefits form part of the member's estate for IHT.

Many schemes do not give members the choice and all death benefits are paid at the discretion of the scheme administrator. This means they will be free of IHT. Of course, the administrator will want to pay out according to the member's wishes so it is important that a member makes a 'letter of wishes' to the pension provider suggesting to whom the funds should be paid.

Income tax charges on pension funds

Prior to 6 April 2015, there were also income tax charges on death to reflect the principle that income tax relief would have been given on contributions into the pension fund and therefore some tax should be payable when the fund is paid out. For example:

- if the fund was paid as a lump sum to a beneficiary, tax at 55% of the fund value was payable
- if the fund was placed in a drawdown account to provide income to a 'dependant' (for example a spouse), the income when taken was taxed at the dependant's marginal rate of income tax.

There were some exceptions from the 55% charge. It was (and still is) possible to pass on a pension fund as a tax free lump sum where the individual has not taken any tax free cash or income from the fund and they die under the age of 75.

The position from 6 April 2015

The government introduced significant exceptions from the tax charges for benefits first paid on or after 6 April 2015.

Under the revised rules, anyone who dies under the age of 75 is able to give their defined contribution pension fund to anyone completely tax free, whether it is in a drawdown account or untouched.

The fund can be paid out as a lump sum to a beneficiary or taken out by the beneficiary through a 'flexi-access drawdown account'.

Those aged 75 or over when they die will be able to pass their defined contribution pension fund to any beneficiary who will then be able to draw down on it as income or as a lump sum at their marginal rate of income tax. On death after age 75 the benefits can be paid as a lump sum to a trust with a 45% tax charge.

The tax treatment did not apply to the extent that the pension fund exceeded the Lifetime Allowance (£1,073,100 for 2022/23). This excess was separately taxed at 55% if taken as a lump sum or 25% if taken as income. The excess charge has been abolished for 2023/24.

Tax treatment of inherited annuities

Beneficiaries of individuals who die under the age of 75 with a joint life or guaranteed term annuity are able to receive any future payments from such policies tax free. If the individual dies aged 75 or over beneficiaries can receive payments at their marginal tax rate.

How we can help

These changes may for some turn traditional IHT planning on its head. Please do contact us for guidance on the options available and the effect on your current IHT plans.

Professional advice is always recommended before actions are taken in respect of IHT planning.

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