Law Society of Scotland

Consultation Response

Inheritance Tax on pensions: liability, reporting and payment

January 2025

Photo: Inverness

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Introduction

The Law Society of Scotland is the professional body for over 13,000 Scottish solicitors.

We are a regulator that sets and enforces standards for the solicitor profession which helps people in need and supports business in Scotland, the UK and overseas. We support solicitors and drive change to ensure Scotland has a strong, successful and diverse legal profession. We represent our members and wider society when speaking out on human rights and the rule of law. We also seek to influence changes to legislation and the operation of our justice system as part of our work towards a fairer and more just society.

Our Tax Law, Trust and Succession Law and Pensions Law sub-committees welcome the opportunity to consider and respond to the UK Government technical consultation: *Inheritance Tax on pensions: liability, reporting and payment*.[1] We have the following comments to put forward for consideration.

General comments

Making unused pension funds and death benefits liable for Inheritance Tax (IHT), and the proposed new approach to reporting and payment requirements for pension schemes, do create a number of complexities and possible unintended consequences. We have commented on these in further detail below.

It is now very common for a deceased person to have multiple pensions, and it may take PRs some time to identify and contact all relevant PSAs. It is also very common for the personal estate set out in the IHT400 not to represent the final estate, and multiple changes are not uncommon. Additional assets can come to light some time after the date of death. Estimated values for property become final after actual sale, and sale of quoted shares at a loss within 12 months means realised value is substituted. These changes are unlikely to be dealt with by agents in a single report, and submissions may be challenged by HMRC.

The reporting and payment requirements proposed will create a significant additional administration burden for PRs, PSAs and HMRC, in many cases in respect of fairly modest estates. There are multiple points in the process where delays can arise as information is managed from different sources, and we are concerned that the timescales proposed are not feasible. The current proposal also creates an overarching risk of unfairness, as we consider that the additional administration burden will fall disproportionately on PRs. In practice, this means that the additional costs inevitably incurred will lie with the estate beneficiaries who, as the consultation document identifies, may not be the pension beneficiaries.

[1] https://www.gov.uk/government/consultations/inheritance-tax-on-pensions-liability-reporting-and-payment

There would also seem to be the certainty that when pension funds become liable to IHT, it will be that liability alone which makes significant numbers of estates (deemed to own the pension fund) liable for IHT at all. A number of such estates will simply not have PRs appointed or available – significant individual funds can be paid out without confirmation (probate in England and Wales) being obtained; and the pension funds may well (and are likely to be) held in trust arrangements which do not require involvement from PRs for the personal estate at all. There thus seem significant dangers that where only the combination of personal estate and pension estate creates any IHT liability on the death at all, neither PRs nor pension fund administrators will be aware of the liability – and certainly not in any reasonable timescale. This possible knowledge gap must be taken into account, particularly where penalties and what may now reasonably be described as liability to penal interest on late paid tax are involved. There are further comments on this aspect below.

The introduction of the consultation states that “fairness and neutrality are widely recognised as fundamental principles of a well-designed tax system”. With this in mind, we have concerns as to how the exclusion of “all life policy products purchased with pension funds or alongside them as part of a pension package offered by an employer” from the changes to the IHT regime will operate in practice.

For example, the number of defined benefit schemes has reduced significantly over the years and many defined benefit pension schemes are approaching wind-up. Unless all of a scheme’s beneficiaries have died at the point of wind-up, their benefits are typically secured with an insurance company which will issue individual policies to scheme members. Depending on how the legislation is drafted, we have concerns that lump sum death benefits that have been secured with an insurer are considered “life policy” benefits and thus excluded from the IHT regime. This would result in a clear inequality in treatment between members of schemes which are ongoing and members of schemes which have secured benefits with an insurer in anticipation of wind up. Given that members typically have no say on whether or not their scheme will be wound up, it seems that this outcome should be avoided if at all possible.

There are a number of aspects of succession law and the administration of estates which differ in Scotland from those in the rest of the UK. The most obvious is in relation to legal rights (see below); but confirmation also has differences from probate. So while the treatment of pension funds may be uniform throughout the UK, the interaction now proposed between those funds and personal estate will have specific Scottish implications for executry practice. As proposals for the new IHT law and practice develop, we would be happy to engage further on these Scotland-specific points.

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?

This leaves PSAs in a position where they cannot know whether an obligation exists until a third party advises them of an obligation. PSAs may be uncomfortable accepting a statement which would, if accepted at face value, mean that no report was required if that statement was provided by a lay personal representative without professional input. Should PSAs make pre-emptive reports to HMRC to ensure that their obligations are met they may fall foul of confidentiality and data protection regulations.

If PSAs are to be obliged to report directly to HMRC at all, an obligation to report in all cases regardless of a liability would provide the PSA with certainty of obligation and a defence against any claim of improper disclosure of information. Anything other than universal reporting leaves PSAs in a position where they have to exercise discretion on the basis of information which they cannot verify. This will increase administrative costs which will, presumably, be passed on to scheme members.

As noted above, there may well be numerous situations where no-one is aware that there is an IHT liability at all.

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?

The PSA is likely to act to minimise the possibility of incurring liability. The most risk averse course of action would be to make the decision to pay any death benefits to an exempt beneficiary irrespective of any letter of wishes put in place by the scheme member or requests from the family. If payment to an exempt beneficiary is not possible the PSA may instead choose to report the unused pension funds to HMRC and lodge 40% of their value irrespective of an obligation to do so. Notwithstanding the latter course of action could prompt complaints by beneficiaries in respect of delays it may be less costly for the PSA to deal with complaints than to incur penalties and interest, which they may have to try to recover from beneficiaries if they have already made payments.

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?

PSAs will be reliant on PRs to provide the necessary information to allow them to fulfil their IHT liabilities by the 6-month deadline. Accordingly, it would be difficult, if not impossible, to ensure that PSAs can fulfil their liabilities before the IHT payment deadline. As noted, there may simply be no PRs (and no legal or practical

requirement to have them) where there is no separate liability from the personal estate alone.

In responding to this question it might be helpful to separate the PSA's reporting and payment responsibilities. If the obligation to report is universal with an exception for those who can demonstrate a reasonable belief that no liability will arise (for example where payment will be made to an exempt beneficiary), PSAs can advise PRs that if sufficient information is not made available in advance of the 6 month deadline then a report would have to be submitted regardless of any liability. This will not eliminate situations where the PSA is not advised of the death until shortly before or even after the 6 month deadline has passed and clarity would be welcomed in respect of whether penalties would be imposed in these circumstances.

A universal reporting position, even with exceptions, is likely to increase the administrative burden on HMRC, who will receive reports where, ultimately, no liability exists. Where an IHT400 is submitted in respect of the estate, reports could be matched with the IHT400 but where no IHT400 is submitted (because the estate falls within the excepted estates regulations or because the PR has failed to file a report) HMRC may be left with reports from multiple PSAs in connection with a deceased and no IHT400 under which they might be collated. Although an HMRC matter rather than a policy matter, some sort of referencing system will be required which can be used by PSAs and/or PRs to ensure all information is properly collated.

The payment responsibility presents a more challenging issue. PSAs will be reliant on information from PRs, advising them of the liability. Until the PR can calculate the tax liability, or at least the proportion of the Nil Rate Band which will be available to the PSA, the PSA will be unable to determine how much of the pension fund will have to be remitted to HMRC. As a result the PSA cannot make payments to beneficiaries and cannot provide any forecast of pension income likely to be available to a beneficiary who is due to receive a successor pension. It is difficult to see how this lack of available information is compatible with the FCA obligation to treat the customer fairly. PSAs will only be able to operate on a "worst case scenario" basis – assuming that 40% of the pension fund will be due to HMRC and preparing payment information for the beneficiary on that basis. Doing so will mean that beneficiaries will not have accurate information regarding their entitlement until much later in the administration process than we would expect now. Where no tax liability arises, the delay in releasing the retained funds could result in significantly worse provision for the beneficiary, either because additional income tax will be due on the later payment or because the annuity market is less favourable at the point of release.

One option to mitigate these difficulties might be to impose the liability on PRs instead in circumstances where they have failed to provide the necessary information to PSAs within statutory timescales to allow them to make payment.

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?

Whilst these proposals may have administrative advantages for HMRC, they may create issues for both beneficiaries and the pension industry. The proposal could lead to significant delays for paying out benefits on death, causing unnecessary financial hardship to some. This is not limited to multiple of salary death in service benefits, but also funeral grants, refunds of contributions, five-year guarantee payments and trivial commutation of survivor's pensions on death.

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?

We presume that the intention is for joint and several liability to extend only to those beneficiaries who have actually received funds from the pension, in which case the 12 month period seems unnecessary, with payment of funds being a more logical starting point. It would be unreasonable to impose liability on beneficiaries who have not yet received funds, as this would require them to meet an inheritance tax liability out of their own funds (which might not be sufficient).

However, the imposition of joint and several liability between parties of vastly unequal means is likely to result in behavioural changes. PSAs will be conscious of cost, uncertain success and reputational issues in pursuing individuals for payment and may choose to delay payment until clearance is obtained from HMRC. Alternatively, they may make an operational decision not to recover costs below a particular level. This additional cost to the PSA will likely be passed onto scheme members. Beneficiaries may be reluctant to access their successor pensions or purchase an annuity if there is a possibility that they will be asked to return up to 40% of the funds following an adjustment to the Inheritance Tax liability.

As noted elsewhere, matters affecting overall liability may change on several occasions during the administration of an estate. Here the sale of shares at a loss just within 12 months of death is the best example, as that will clash with the 12 month point mentioned in this question.

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?

It would be reasonable to expect PSAs to maintain records of those to whom payments have been made, in line with their existing AEOI responsibilities, but not to maintain up to date details. Presumably HMRC will be in a better position to access current details via the NINO or UTR of adult beneficiaries or of the parent or guardian of minor beneficiaries. If funds are paid into a trust, contact details should be available to HMRC via the TRS. Similarly, if additional IHT is due by a beneficiary

who has received funds from a pension, could this instead be collected through the existing PAYE system? An additional tax payment made at source would be easier for individual beneficiaries to manage than a large one-off payment of IHT.

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

Clarity would be appreciated in respect of how HMRC envisages penalties and interest being imposed in respect of late reporting and/or payment by PSAs. Under the proposed system, PRs and PSAs will be mutually reliant on each other providing information and, where failures arise, it may not be obvious which, if any, party is at fault.

Mutual reliance may also cause a "chicken and egg" scenario, particularly where there is more than one relevant PSA. If PRs are responsible for advising each PSA as to how much Nil Rate Band is available to use against the pension fund they will need to know how much of the fund each PSA intends to distribute to non-exempt beneficiaries. The PSAs may be unable to confirm how much of the fund will be distributed to non-exempt beneficiaries until they know how much Nil Rate Band will be available to them.

Bringing pensions into the IHT net will inevitably delay the payment of pension funds to beneficiaries while the IHT position is investigated, calculated and confirmed. If PSAs adopt a defensive approach, declining to make any payment until their obligations are clear, pensions may not be paid for a significant period after the date of death. Where a beneficiary is reliant on a successor pension as their primary source of income, a delay of this length could cause real hardship, particularly where other assets within the estate cannot be released until Probate or Confirmation is obtained.

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

Deeds of Variation can be entered into (and therefore the Inheritance Tax liability altered) for up to two years from date of death. If an Inheritance Tax liability due on a pension fund can be altered for up to two years PSAs cannot safely distribute the funds until after that point but if payment is not made within 2 years of the death an income tax liability is imposed on the beneficiary. An increased income tax liability being incurred by a beneficiary because of a PSAs response to increased complexity in the pensions environment seems iniquitous.

In Scotland, legal rights claims on the estate of the deceased do not prescribe for 20 years from the date of death unless expressly renounced. Specific provision is made for this (and adjustments of tax as a result for certain (although not all) situations where this can occur – see Inheritance Tax Act 1984, section 147). This can result in uncertainty regarding the final distribution of the estate existing for a lengthy period and it is unclear how PSAs may respond in this scenario.

More generally, IHT400s are almost inevitably submitted on the basis of estimated values, particularly for heritable (immoveable) property. There is then an adjustment – often driven and demanded by HMRC – where the property is sold during the course of administration. This may well take the estate beyond the 6 month limit for payment (and in any event, payment requires to be made in Scotland on moveable property before an application for confirmation can be made and estimates may also be used in relation to some such property).

Where a cohabitant claim is made through the courts under the provisions of the Family Law (Scotland) Act 2006, the capital sum awarded may alter the PSA's inheritance tax liability. Since the courts can take into account pension funds received by the cohabitant in assessing their claim this may add an element of complication and therefore delay to s29 claims.

There may also be complex situations where a scheme member dies during divorce proceedings where pension sharing orders have not yet been finalised.

Some pension schemes include business and agricultural property. It is not clear how this may interact with agricultural property relief (APR) and business property relief (BPR).

Generally, it is not clear how it is envisaged that the proposals will interact with a range of other allowances and reliefs, adding further complexity to an already complex landscape. For example, it is unclear how the proposals will interact with the reduced 36% rate- will the pension be treated as another component or will pensions be excluded from the 36% rate? It is also unclear how the proposal will interact with the residence nil rate band (RNRB) in terms of availability of the RNRB to set against pension funds and the effect on the £2m taper threshold. PSAs may also consider that they are under an obligation to exercise their discretion to distribute the pension in the most tax efficient way possible, and we consider that this would be an unintended consequence of the proposals.

Whilst we note that the consultation applies only to UK registered pension schemes, and that changes will apply to UK registered pension schemes and Qualifying Non-UK Pension Schemes (QNUPS), we understand that certain large pension funds with UK members are already based off-shore and it is possible that these proposals may lead to other schemes moving to an off-shore model. It can be very challenging for PRs to obtain information from off-shore pension schemes.

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?

Imposing a liability on PSAs which can only be determined by reference to the deceased's estate, about which the PSA has no information other than that provided by the PR, seems cumbersome and likely to cause PSAs to alter their

decision making behaviour to minimise their exposure to risk rather than in the best interests of beneficiaries.

Since the PRs are already under IHT reporting and payment obligations, imposing additional obligations onto PSAs adds a layer of complexity which may have a distorting effect on how benefits are taken or on how PSAs allow benefits to be taken. There would be far less administrative disruption and potential for disputes over who owes what responsibilities to whom if reporting obligations were incorporated into those under which PRs already operate. Complementary obligations could be created, obliging PSAs to provide information to PRs, in the same way as Trustees of Q-IIP trusts are required to provide information to PRs for inclusion in the IHT418. An alternative reporting method, similar to the IHT100, could be introduced where an IHT400 is not required or where the PSA would prefer not to rely on the PRs including the pension in the IHT400.

If the responsibility for passing pension information to HMRC lies with the PRs, PSAs would have to rely on the PR advising them of the tax due. It would seem that a mechanism similar to IHT423 could be implemented to facilitate payment.

If PSAs have concerns about further liabilities arising after the initial payment of tax, a limited clearance procedure could be implemented. Clearance could act to fix the amount of Nil Rate Band applied to the pension, which would remove any mechanism by which the IHT liability on the fund could be increased. If clearance fixes the maximum liability imposed on the pension fund, confirms that the PR has reported the pension value accurately to HMRC and confirms that the tax due has been paid, the PSAs could safely make payments to the beneficiaries and there would be no need to implement joint and several liability.

Subsequent changes to the available NRB available (through discovery of failed PETs, other assets or liabilities) would have to be accommodated by elements of the estate which had not received clearance. Where failed PETs are discovered this could mean that a full NRB would not be available to set against them because part of the NRB has been irrevocably allocated to the pension fund. This may increase the liability due on the failed PETs, which could in turn encourage early disclosure by donees. Whether or not clearance would also block an increase in the available NRB (possibly as a result of a Deed of Variation redirecting assets to an exempt beneficiary) would be a policy decision.

In respect of feasible alternatives, the impact of adjustments to the IHT400 could be mitigated by providing that no adjustment is required to the original apportionment of NRB if the adjustments do not change overall IHT by more than say 10%, in either direction. Alternatively, unused pension funds and death benefits could be subject to a flat rate tax based on their value, separate to the wider IHT liability of the deceased's estate.

For further information, please contact:

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