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Tax treatment of DC pensions on death

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Inside:

Contents

Summary

A defined contribution (DC) pension arrangement (also known as money purchase) is one where an individual makes contributions to a pension pot, which is invested, and which can then be used to provide an income at retirement.

The tax treatment of pension payments is in the *Finance Act 2004,* which provides for payments classed as 'unauthorised' to attract significant tax charges.

Reforms in April 2015 (the 'pension freedoms') gave people aged 55 and over more flexibility about when and how to draw their pension savings, subject to their marginal rate of income tax. Previously, most people effectively had to buy an annuity because, except in limited circumstances, lump sum payments would attract an 'unauthorised payments charge.' The Coalition Government changed the rules to allow people with DC pension savings to put them in a drawdown arrangement (from which they could make flexible withdrawals) or withdraw cash lump sums, subject to their marginal rate of income tax.

As part of the pension freedoms, it introduced more flexibility in the payments that could be made on death.

Whereas previously, a DC scheme member had to leave unused funds to a 'dependant' (a surviving spouse/civil partner or child under age 23), from April 2015, they would be able to nominate a beneficiary to receive their funds.

There were also reductions in the tax charges that could apply. Before April 2015, although the funds could be inherited tax-free if the individual died under age 75 and had not touched their pension savings, a 55% tax charged applied to lump sum payments from funds in drawdown (regardless of the individual's age) or if the individual was aged 75 or over at death.

The Government thought a 55% tax charge on lump sums payments would be too high in a context where drawdown was a more widely available option. It changed the rules so that from April 2015:

- If the scheme member died under age 75, payments to the beneficiary would be tax-free, if they were from a drawdown account, uncrystallised funds, or from an annuity set up after April 2015;

- If the scheme member died aged 75 or over, payments would be subject to the beneficiary's marginal rate of income tax. (Cm 8834, para 1.159; HM Treasury press release, 29 Sept 2014)

For an overview of these complex rules – see Gov.UK Tax on a private pension you inherit. Individuals considering their pension options can seek guidance from Pension Wise – the service set up to help people aged 50 and over with DC pensions understand the wider range of options available from April 2015. They may also wish to seek financial advice.

This note looks at the changes to the rules on the tax treatment of DC pensions on death from April 2015. The wider context for this – the pension freedom reforms - are discussed in Library Note CBP 6891.

1. Pension tax framework

There are two main types of private pension:

- Defined benefit (DB) schemes, that promise to pay pension benefits based on fixed factors, typically salary and length of service; and
- Defined contribution (DC) or money purchase schemes, that pay out a sum based on the value of a member's fund on retirement. The level of pension depends on factors including the contributions invested, the returns on that investment (minus any charges applied) and the rate at which the fund is converted to a retirement income.

The type of payment that can be made on death, and who it can be made to, depends on the type of arrangement. Gov.UK explains:

> A pension from a defined benefit pot can usually only be paid to a dependant of the person who died, for example a husband, wife, civil partner or child under 23. It can sometimes be paid to someone else if the pension scheme's rules allow it - but it will be taxed at up to 55% as an unauthorised payment.
>
> **Passing on a pension pot you inherited**
>
> If you inherit a defined contribution pot you can nominate someone to get any money you do not use before your death. The money must be in a flexi-access drawdown fund when you die.[1]

As it goes on to explain, the tax payable will depend on the type of arrangement and the age of the pot's owner on death.[2]

The rules are in the *Finance Act 2004* (as amended), which provides that the payments from a registered pension scheme on death can take two forms - a pension death benefit or a lump sum death benefit. The benefits that will actually be paid in any particular case, will depend on the scheme rules and the type of arrangement.[3]

Significant changes introduced from April 2015, as part of the 'pension freedoms', gave people with DC pensions more flexibility about who could receive their unused funds on death and the tax payable. For people with DB pensions, the options continued to be a scheme pension (taxed at the beneficiary's marginal rate) and a lump sum, depending on scheme rules.

1 Gov.UK, Tax on a private pension you inherit
2 Ibid
3 *FA 2004*, s167-8, Sch 28 and 29; HMRC, Pension Tax Manual – Death benefits – general principles

1.1 Before 6 April 2015

Pension death benefits could be paid to a 'dependant', i.e:

- a person married to or a civil partner of the member;
- a child of the member who has not reached the age of 23 or was dependant on the member at the time of death because of physical or mental impairment; or
- an unmarried partner who was financially (inter)dependent on the member.[4]

The types of pension that could be paid from a DC scheme to a dependant mirrored those that could be paid to the member in their lifetime, i.e:

- a dependants' annuity
- a dependants' scheme pension, or
- a dependants' drawdown pension (before 6 April 2011 called either a dependants' unsecured pension or dependants' alternatively secured pension depending on how old the dependant was).[5]

Any pension payable to a dependant was taxable as pension income on the recipient at their marginal rate.[6]

In the case of lump sum death benefits, the legislation did not specify who it should be paid to.[7] The lump sums that could be paid included:

- An "uncrystallised funds lump sum" (from funds that have not yet been put into payment);[8] and
- A drawdown pension fund lump sum (where a member in drawdown arrangement died).[9]

A "special lump death benefits charge" of 55% (from April 2011) to apply to specified lump sum death benefits. [10] These included:

- A drawdown pension fund lump sum (at any age);[11] and
- An uncrystallised funds lump sum paid when the member died at age 75 or over.[12]

If the member was under 75 when they died, an uncrystallised lump sum death benefit was tax-free unless the lifetime allowance charge was payable.[13]

4 *FA 2004,* s167 and Sch 28 (15)
5 HMRC, Registered Pension Schemes Manual (RPSM), RPSM10101010 - Technical Pages: Death benefits: Benefits from a money purchase arrangement
6 RPSM04101020 - Technical Pages: Taxation: Authorised member payments: Taxation of pensions
7 *FA 2004,* s 168 (1)
8 *FA 2004,* Sch 29 (15); RPSM10106030
9 *FA 2004,* Sch 29 (17); RPSM10106060; RPSM10101010 - Technical Pages: Death benefits: Benefits from a money purchase arrangement
10 FA 2004, s206, as amended by *FA 2011, s65 and Sch 16*
11 RPSM10106010 - Technical Pages: Death benefits: Lump sums from 6 April 2011: Introduction
12 RPSM10106030 - Technical Pages: death benefits: lump sums from 6 April 2011: uncrystallised funds lump sum death benefit
13 RPSM10106030

1.2 From 6 April 2015

The Coalition Government changed the rules with effect from 6 April 2015. The changes were made by the *Taxation of Pensions Act 2014*, to coincide with the new rules allowing individuals aged 55 and over more flexibility about when and how to draw their DC pension savings.[14] The main changes were to:

- Enable individuals with a drawdown arrangement to nominate a beneficiary to receive their pension on death;

- Provide that unused funds could be paid as a lump sum tax-free if the member died before the age of 75, and the funds were either untouched (uncrystallised), or in a flexi-access drawdown arrangements (subject to certain conditions, for example, as to the time within which payments are made).

- Where the individual was aged over 75 at the time of death, payments to a beneficiary are subject to their marginal rate of income tax.

There is an overview of the tax treatment of different types of pension death benefits and lump sums from April 2015 on Gov.UK:

Payment	Type of pot	Age	Tax you usually pay
Most lump sums	Defined contribution or defined benefit	Under 75	No tax
Most lump sums	Defined contribution or defined benefit	75 or over	Income Tax deducted by the provider
Trivial commutation lump sums	Defined contribution or defined benefit	Any age	Income Tax deducted by the provider
Annuity or money from a new drawdown fund (set up or converted and first accessed from 6 April 2015)	Defined contribution	Under 75	No tax
Money from an old drawdown fund (a 'capped' fund or a fund first accessed before 6 April 2015)	Defined contribution	Under 75	Income Tax deducted by the provider
Annity or money from a drawdown fund	Defined contribution	75 or over	Income Tax deducted by the provider
Pension provided by the scheme	Defined contribution or defined benefit	Any age	Income Tax deducted by the provider

Source: Gov.UK - Tax on a private pension you inherit

You may also have to pay tax if the pension pot's owner was under 75 when they died and any of the following apply:

- you're paid more than 2 years after the pension provider is told of the death

- they had pension savings worth more than £1,055,000 (the lifetime allowance')

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14 For more detail, see SN06891 Pension flexibilities (the 'freedom and choice' reforms) (Sept 2018)

- they died before 3 December 2014 and you buy an annuity from the pot.[15]

Individuals aged 50 and over with DC pension savings can seek guidance from Pension Wise on the options available to them. Pension Wise can offer appointments by phone and in person and has information on its website – your pension when you die.[16]

There is detailed guidance in HMRC's Pension Tax Manual - PTM07100 – Death benefits: essential principles.

[15] Gov.UK, Tax on a private pension you inherit

[16] For more on the background, see Library Briefing Paper CBP 7042 Pension guidance: Pension Wise – the guidance guarantee (September 2018).

2. Policy development

2.1 Pension tax simplification – *Finance Act 2004*

The 'pension tax simplification' regime which came into effect from 6 April 2006 under the *Finance Act 2004* (*FA 2004*) replaced eight different tax regimes governing pensions with a single set of rules applying to saving across pension schemes. The aim was to simplify the system.[17]

In a preceding consultation document, published in December 2002, the Labour Government said it would continue to require people to turn their pension fund into an income stream by the age of 75:

> 5.44 Another way of vesting pension savings […] is drawdown. Someone with personal pension savings can vest some or all of their fund, take a tax free lump sum within the normal rules, place the remainder into a drawdown account with a financial firm, and draw an income stream within certain limits. By the time they reach age 75, all the remaining fund must be used for pension income. This approach gives people a good deal of control over the pattern of their retirement income, at the cost of some financial efficiency. Some people with larger funds find this trade-off acceptable or even attractive.
>
> 5.45 The Government's proposals retain the age 75 rule. That is, all pension funds build up with the benefit of tax relief must be drawn as benefits by that age. However, in line with the general principles about retirement benefits, there will be more flexibility about how people may determine the pattern of their income, including income in drawdown.[18]

Drawdown was already an option up until age 75. The Government would also introduce "alternatively secured pensions" as an option for people over the age of 75 with "principled objections to the pooling of mortality risk."[19]

The Government could continue to allow pension schemes to provide dependants' pensions, in recognition of the fact that working people often had dependants who needed support:

> **Death benefits**
>
> 5.29 Simplification of the taxation of pensions will also set a consistent set of rules about what kinds of benefits pension schemes may pay on the death of a member. As now, the actual death benefits available will be set in scheme rules.
>
> 5.30 The existing tax rules all permit, but do not require, pension schemes to pay benefits on the death of a working scheme member. This is to recognise that working people often have dependants who will need support. The rules about the death benefits which schemes may pay have developed over the years.

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[17] HM Treasury, Simplifying the taxation of pensions: increasing choice and flexibility for all, December 2002, para 2.6
[18] Ibid para 5.4
[19] HM Treasury, Simplifying the taxation of pensions: the Government's proposals, December 2003, para 3.4

> Like many of the other tax rules for pensions, they do not always make a coherent picture.
>
> 5.31 The reformed tax rules will allow all pension schemes to pay the same range of benefits if scheme members die before vesting their pension savings, namely:
>
> - unlimited tax free lump sums, except for the recovery charge; and/or
> - taxable income benefits for survivors or dependants.
>
> 5.32 Whichever mix of benefits is to be paid, the funds providing them must first be tested against the lifetime limit. [20]

Where an individual died after starting to receive a pension, a dependants' pension could be paid. The new rules would allow limited lump sums could be paid (taxed at 35%) if the scheme member died under the age of 75. If they died over the age of 75, it would not be possible to pay any capital sums:

> **Death while receiving benefits**
>
> 5.33 For scheme members who die after starting to receive benefits from the scheme, the tax rules will allow:
>
> - up to age 75, limited lump sums, taxable at 35 per cent, of no more than the value of the vested funds used to provide the pension income less the sum of the pension payments paid before death; and
> - taxable income benefits for survivors or dependants.
>
> 5.34 These new rules reflect the fact that pensions get favourable tax treatment so that they can establish income in retirement. This is why it will not be possible to pay any capital sums past age 75, the age by which pension savings must be used to deliver retirement income. They also signal that pension tax relief is not provided to encourage estate planning.

In its response to the consultation in December 2003, the Government said that it was these proposals that had attracted particular comment. However, it would proceed with these arrangements in order to ensure that pension savings were used to provide an income in retirement:

> **Death benefits – before the pension fund vests**
>
> 3.9 Post A-Day the Government proposes that death benefits from funds which have not come into payment ("unvested") can be paid either as pensions to dependants or, before the member reaches 75, as a lump sum:
>
> - under a pension promise provided by an employer;
> - from a life assurance policy; or
> - from pension funds earmarked for the member.
>
> 3.10 Any lump sum paid will not be taxed as pension income, but will need to be tested against the lifetime allowance and a recovery charge of 55 per cent paid on the excess, where appropriate. This change is a direct result of the decision to allow all funds over the lifetime allowance to be taken as a taxed lump

[20] Ibid

sum. However, there will be no test against the lifetime allowance where the death benefits are paid as dependants' pensions.

Death benefits – after vesting

3.11 Once the pension fund has vested and benefits are in payment there will be limits on how much can be returned on the death of a member. Two proposals in the consultation document attracted particular comment:

- the prohibition of return of capital if the member dies on or after age 75 was seen by some as unfair, arbitrary and creating a cliff edge; and
- the limit on the amount of undrawn funds that can be returned as capital if the member dies before age 75 could generate a windfall to the pension provider on the death of any member without dependants.

3.12 The Government does not accept the arguments for returning capital after the age of 75. Pension saving is to provide an income in retirement for the member which, on death, may continue to be paid to any dependants. It is not a route for conserving and passing on capital, regardless of whether or not this is properly taxed.

3.13 The Government wishes to ensure that pensions remain a vehicle for providing income in retirement, especially in later years. To preserve the integrity of this purpose, the Government confirms that a registered pension scheme will not be permitted to provide benefits that involve direct or indirect capital payments triggered by the death of a pension scheme member aged 75 or over.[21]

2.2 Extension of drawdown beyond age 75 – *Finance Act 2011*

The Conservative Liberal Democrat Coalition Government's *Programme for Government* included a commitment to "end the rules requiring compulsory annuitisation at 75."[22]

A consultation document published in July 2010 explained that from April 2011, there would "no longer be a specific age by which people effectively have to annuitise." The option of drawdown would be available throughout retirement, rather than just to age 75. However, to ensure that people did not exhaust savings prematurely, there would be a cap on the amount that could be drawn down each year unless the individual could show that they had secured a sufficient minimum income to prevent them from "falling back on the state"[23]

In addition, to ensure that people did not use pension saving as a "tax-privileged means for passing on wealth," any unused funds remaining on death would be taxed at a rate designed to reflect the value of tax relief received (probably around 55%):

2.22 Consistent with the mainly tax-deferred nature of pension saving, it is important that pension benefits continue to be taxed

[21] HM Treasury, Simplifying the taxation of pensions: the Government's proposals, December 2003
[22] The Coalition: our programme for government, 2010, para 2.14
[23] HM Treasury, Removing the requirement to annuitise by age 75, July 2010

> at a rate which reflects the value of relief given and which ensures that the cost of providing tax relief remains sustainable. The Government intends that:
>
> […]
>
> - any unused funds remaining upon death will be taxed at a rate designed to recover past relief given unless they are used to provide a dependant's pension. (In this case, the pension will be taxed as income of the dependant in the normal way). The Government expects that an appropriate recovery charge will be around 55%;
> - to make the new framework as simple as possible, the Government intends that the recovery charge should generally apply to all death benefits. However, death benefits for those who die before age 75 without having accessed their pension savings will remain tax-free; and
> - inheritance tax will not ordinarily apply to unused pension funds remaining after death in addition to the recovery charge. However, the Government does not intend pensions to become a vehicle for the accumulation of capital sums for the purposes of inheritance. The Government will therefore ensure that the tax rate on unused funds remaining on death does not leave open incentives for pension saving to be used to reduce inheritance tax liabilities. The Government will monitor this closely and will take further action if there is evidence of such activity. [24]

Some respondents to the Government's consultation argued that this was unfairly high, particularly where the scheme member had been a basic rate taxpayer. The Government estimated that 75% of individuals currently in drawdown would have received most of their tax relief at the higher rate. It rejected calls for a lower charge (such as 35%) on the grounds that this "would not fully recover the relief provided for many people, and would create an incentive for some people to save into a pension in order to avoid [inheritance tax]." Death benefits for those who died before age 75 without having accessed their pension savings, would remain tax-free.[25]

When the legislation was before Parliament, the then Shadow Economic Secretary to the Treasury, David Hanson, asked about the potential impact of the provisions on liability for inheritance tax:

> Schedule 16 introduces a tax charge of 55% on lump sums left in pension pots at death by those over the age of 75. That is calculated to be the equivalent of the 40% inheritance tax charge, with an additional 15% to take account of the tax relief given on pension pot accumulations. However, the amount of tax relief can vary hugely, depending on people's circumstances. The 55% rate will therefore over-recover tax from some and under-recover tax from others. Will the Minister give his view on the impact of the clause on inheritance tax avoidance?[26]

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[24] Ibid
[25] Ibid para 3.15-25
[26] PBC Deb 7 June 2011 c472

The then Financial Secretary to the Treasury, Mark Hoban, explained the Government's position:

> Simplicity underpins many of the key elements of the clause under debate today. [...] There will be a single recovery charge on unutilised funds remaining on death of 55%. As the right hon. Gentleman said, the recovery charge can be as high as 82% for those above the age of 75. Perhaps he should also have mentioned that lump sum death benefits relating to individuals who die before the age of 75 and before taking a pension are tax free. Lump sum death benefits relating to individuals who die before age 75 after taking a pension are liable to tax at 35%. That is under measures put forward by the right hon. Gentleman's Government when they were in office. Therefore, rather than having no tax, or having tax paid at 35% or up to a rate of 82% on an unutilised pot at death, we have moved to a single tax rate of 55%. I must say that I have received much correspondence from colleagues suggesting that the 55% rate should be reduced, and their constituents have written to them asking for lower rates to be introduced, but I believe that 55% achieves the right balance, and let me say why.
>
> By setting the charge at 55%, we have sought to recover the amount of relief received by a typical individual who may be subject to the charge. The governance modelling suggests that a 55% charge would ensure that there are no tax advantages for pension death benefits compared with other assets on which inheritance tax is payable. Accordingly, it is not appropriate to levy inheritance tax on top of the recovery charge. We recognise that most of the people who will take advantage of the measure will be those who paid the higher rate of tax, and a 55% rate is, therefore, applicable. That would lead to cases in which people received tax relief at the basic rate of an over- recovery, but it is better to have a single simple rate, rather than a variable rate that depends on the rate of tax someone may have paid at some point in their life as they built up their pension pot. The single rate is appropriate. It means a higher tax charge for those who die before the age of 75 and a slightly lower tax charge for those who die afterwards, but it ensures that the tax relief that the Government have given to encourage people to build up a pension pot is actually fully recovered at the point of death. That is the right way to do it. Of course, if the unutilised pot is used to provide a pension for a dependent, which may be a spouse or a minor, that will be tax-free, as is the case at the moment. That is the right level of protection to ensure that tax relief is recovered by the Government.[27]

2.3 Freedom and choice consultation

The pension tax legislation in place before April 2015 strongly encouraged the purchase of an annuity for most people. The main alternatives to were to take a lump sum (for people with small pots) or to enter a drawdown arrangement (although there were restrictions on the amount that could be drawn down each year unless the individual

[27] Ibid c474-5; These reforms are discussed in more detail in SN00712 Pensions: income drawdown (May 2014).

could show they had other secure pension income above a certain amount).[28]

In Budget 2014, the Government announced that from 6 April 2015 it would allow people aged 55 and over more flexibility about when and how to draw their DC pension savings, subject to their marginal rate of income tax. Announcing the policy, the Chancellor, George Osborne, said that people "should be trusted with their own finances."[29]

The Government launched a consultation on its proposals for Freedom and choice in pensions in March 2015. As part of this, it would look again at the tax treatment of pensions on death. In particular, it said that with drawdown available to more people, the 55% tax charge would be too high:

> 3.16 As set out above, the new system will give people much more flexibility to plan for retirement, with the option of entering into a drawdown product or keeping their pension invested for longer. The government therefore wants to ensure the tax rules that apply for pensions on death continue to be appropriate under the new system. When the government removed the requirement to annuitise before the age of 75 in 2011, it also introduced a flat 55% tax charge for pension funds held at death in certain circumstances.
>
> 3.17 The 55% charge replaced a 35% charge for those under age 75 and aggregate tax charges of up to 82% for those over age 75. The government believes the tax rules that apply to pensions on death need to be reviewed to ensure they are appropriate under the new system. In particular, the government believes that a flat 55% rate will be too high in many cases given that everyone with defined contribution pension savings will now have the freedom to enter into drawdown rather than an annuity. We will engage with stakeholders to review these rules to ensure that taxation of pension wealth at death remains fair under the new system.[30]

In its response to the consultation in July 2014, the Government said discussions with stakeholders had confirmed this view.[31]

In his speech to the Conservative Party Conference on 29 September 2014, Chancellor of the Exchequer George Osborne said the 55% charge would end.[32] An HM Treasury press release explained that under the existing system, a 55% tax charge applied to lump sum death payments from a drawdown arrangement (regardless of age) and to "uncrystallised" funds where an individual died at age 75 or over. The Government would change the rules to: allow individuals with a drawdown arrangement to nominate a beneficiary to pass their pension to if they died; enable unused funds in a drawdown arrangement to be paid as a lump sum tax-free if the individual died before age 75; and reduce the tax charge on lump sum death payments from 55% to 45%:

[28] FA 2004, Part 4, chapter 3; See Library Note SN06891 Pension Flexibilities
[29] HC Deb 19 March 2014 c793
[30] HM Treasury, Freedom and choice in pensions, CM 8835 March 2014
[31] HM Treasury, Freedom and choice in pensions: the government's response to consultation, Cm 8901, July 2014, para 2.43
[32] George Osborne: Speech to Conservative Party Conference 2014

> From next year, individuals with a drawdown arrangement or with uncrystallised pension funds will be able to nominate a beneficiary to pass their pension to if they die.
>
> If the individual dies before they reach the age of 75, they will be able to give their remaining defined contribution pension to anyone as a lump sum completely tax free, if it is in a drawdown account or uncrystallised.
>
> The person receiving the pension will pay no tax on the money they withdraw from that pension, whether it is taken as a single lump sum, or accessed through drawdown.
>
> Anyone who dies with a drawdown arrangement or with uncrystallised pension funds at or over the age of 75 will also be able to nominate a beneficiary to pass their pension to.
>
> The nominated beneficiary will be able to access the pension funds flexibly, at any age, and pay tax at their marginal rate of income tax.
>
> There are no restrictions on how much of the pension fund the beneficiary can withdraw at any one time. There will also be an option to receive the pension as a lump sum payment, subject to a tax charge of 45%.[33]

As a result, under the new system:

> […] anyone who dies below aged 75 will be able to give their remaining defined contribution pension to anyone completely tax free, whether it is in a drawdown account or untouched as long as it is paid out in lump sums or is taken through a flexi access drawdown account. This does not apply to annuities or scheme pensions.
>
> Those aged 75 or over when they die will be able to pass their defined contribution pension to any beneficiary who will then be able to draw down on it at their marginal rate of income tax.
>
> This tax cut will apply to all payments made after April 2015.
>
> Beneficiaries will also have the option of receiving the pension as a lump sum payment, subject to a tax charge of 45% (if the deceased was over 75).
>
> […]
>
> The Lifetime Allowance (currently £1.25m) still applies.[34]

The Government intended to also make lump-sum payments subject to tax at the marginal rate, rather than a flat-rate charge of 45% and would engage with the industry on how to do this from 2016.[35]

In the Autumn Statement 2014, the Government said it would also change the rules for beneficiaries of individuals who died under age 75 with a joint life or guaranteed term annuity:

> **1.222** The government has now decided to go further. **From April 2015, beneficiaries of individuals who die under the age of 75 with a joint life or guaranteed term annuity will be able to receive any future payments from such policies tax free. The tax rules will also be changed to allow joint life annuities to be passed on to any beneficiary.** These

[33] Gov.UK, Chancellor abolishes 55% tax on pension fund at death, 29 September 2014
[34] Ibid
[35] Ibid

> changes mean that people will no longer have to worry about their pension savings being taxed at 55% on death.[36]

An Autumn Statement policy costings document summarised the reforms as follows:

> The 55% charge levied on some payments from the pensions of people who died is being simplified to allow individuals to nominate a beneficiary, including non-dependants, to pass to on their death any unused funds in drawdown arrangements or uncrystallised pension funds. If the individual dies before they reach the age of 75, they will be able to pass their remaining defined contribution pension to the beneficiary tax free. The beneficiary will pay no tax on the money they withdraw from that pension, whether it is taken as a lump sum, or paid through income withdrawal from a drawdown fund. If the individual dies with a drawdown arrangement or uncrystallised funds after they reach age 75, their nominated beneficiary will be able to access the pension funds flexibly, at any age, and pay tax at their marginal rate of income tax if taken as income withdrawal or 45% if paid as a lump sum.
>
> This will apply to first payments made to a beneficiary after 6 April 2015. For the 2015-16 tax year, if an individual dies over the age of 75 and their remaining pension is paid out as a lump sum death benefit, a charge of 45% will apply. This will be reduced to marginal rate from April 2016.
>
> Payments from joint life or guaranteed annuities to beneficiaries including non-dependants, can be paid tax free from April 2015 where the original policyholder dies under the age of 75. This will apply to joint life and guaranteed annuities where the first payment is made to a beneficiary after 6 April 2015.[37]

Exchequer impact (£m)	2015-16	2016-17	2017-18	2018-19	2019-20
	-50	-155	-165	-175	-185

It explained that a "behavioural response to control for individuals increasing contributions into pensions to avoid Inheritance Tax" had been incorporated into the costings. The main uncertainties for the costings related to the behavioural response of individuals to the policy changes.[38]

The Office for Budget Responsibility (OBR) said there was a 'very high' level of uncertainty around both the central costing for the pension flexibilities and the changes subsequently announced (which included the changes to the tax treatment of pensions on death):[39]

2.4 *Taxation of Pensions Act 2014*

The Government legislated for these changes in the *Taxation of Pensions Act 2014*. Section 2 of the Act did two main things:

- Section 2(2) provided that where a lump sum death benefit is subject to the special lump sum death benefit charge, the charge only applies where the member had reached age 75 at their death;

[36] HM Treasury, Autumn Statement, Cm 8961, 3 December 2014
[37] HM Government, Autumn Statement 2014: policy costings, December 2014
[38] Ibid
[39] OBR, Economic and fiscal outlook, December 2014, p220, para A.9

- Section 2(3) reduced the rate of the charge from 55% to 45%.[40]

Section 3 and Schedule 2 enabled pension death benefits from DC schemes to be paid to a nominated beneficiary, rather than just to a dependant.[41] They also ensure that:

> […] when the death of the member or beneficiary occurs before age 75, any payments of income withdrawal to a beneficiary will be made tax-free if they are designated within a two-year period. They also ensure that any uncrystallised funds are tested against the deceased's lifetime allowance.[42]

The current rules are in Pension Tax Manual - PTM070000 - Death benefits: contents.

Initial responses

An article in the *Financial Times* said the Government and wealth advisers disagreed on who would benefit most - although the Treasury had predicted that people with smaller pension pots would be among the many to benefit, advisers said the wealthy had most to gain and that the changes would "not help those who are still struggling to build up sufficient funds to pay for their retirement."[43] The Government had gone "much further than most observers expected:

> It was known as the "death tax" – a 55 per cent charge on whatever is left in a pension pot if it is bequeathed. The government pledged to review the levy as part of the Budget changes, and was expected to announce its conclusions in the forthcoming Autumn Statement. Many experts thought he would reduce the charge to 40 per cent, the same level as inheritance tax. Instead, Mr Osborne announced at the Conservative party conference this week that the 55 per cent tax on whatever is left in a pension pot when someone dies is to be abolished completely.[44]

The changes were welcomed by organisations including the Association of British Insurers and the Confederation of British industry on the grounds that greater flexibility would encourage pension saving.[45] However, the National Association of Pension Funds commented that the change was "likely to affect only people with larger pension pots."[46] The extension to annuities was also welcomed, although one provider commented that there was no similar easement for dependants' scheme pensions.[47]

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[40] HMRC, Pension Flexibility: Draft guidance on clauses for the Taxation of Pensions Bill, 21 October 2014, p37
[41] *Taxation of Pensions Act 2014* – Explanatory Notes, para 220
[42] PBC Deb 18 November 2014 c64-5 [David Gauke]
[43] 'Rich forecast to benefit most from axing tax on drawdown pension pots', *Financial Times*, 30 September 2014
[44] Nail in the coffin of the 'death tax', *Financial Times*, 3 October 2015
[45] ABI welcomes move to abolish 55% tax on pension income drawdown funds 29 September 2014; CBI comments on Chancellor's Conference speech, 29 September 2014
[46] NAPF comments on Chancellor's proposal to abolish 55% tax charge on inherited pension pots, 29 September 2014
[47] ABI responds to Autumn Statement 2014, 3 December 2014; Ros Altmann, Comments on the Autumn Statement, 3 December 2014; Towers Watson, Analysis of Treasury announcements on pensions in the Budget and Autumn Statement, 3 December 2014

Debate in Parliament

When the *Taxation of Pensions Bill 2014-15* was before Parliament, the then Shadow Economic Secretary, Cathy Jamieson asked for "absolute assurances" that at no point would the measures in the Bill result in individuals being able to benefit twice from tax relief:

> I want to return to the document I mentioned earlier, which covers the Government's consultation in July 2010 on the removal of the requirement to annuitise. In the section entitled "Principles for a new tax framework for retirement", the document states:
>
> "On death, pension savings that have been accumulated with tax relief should be taxed at an appropriate rate to recover past relief given, unless they are used to provide a pension for a dependant."
>
> I wonder how the measures in the schedule fit with that principle. According to the explanatory memorandum, for deaths before the age of 75, lump sum death benefits and flexi-access drawdown pensions from these funds can be paid tax-free, subject, for example, to the member having a sufficient lifetime allowance.
>
> It has been suggested that those two issues do not entirely fit together. We are looking for absolute assurances from the Minister that at no point would anyone be able to benefit twice from tax relief. That is what the principles outlined in July 2010 sought to prevent.[48]

Mr Gauke responded that:

> The primary purpose of pensions is for people's retirement, but if someone dies before they get to use their pension for that purpose, beneficiaries should be able to have those funds. However, we do not want pensions to become a vehicle for inheritance tax planning, so once someone is 75 they will be able to pass the funds on to others in a flexi-access drawdown account, but they will need to pay their marginal rate of tax on them.[49]

Ms Jamieson also asked who would benefit from the changes:

> The broader debate about the changes has mainly centred on whom they would benefit most. The Treasury predicts that savers with smaller pension pots worth between £20,000 and £50,000 would be among the many to benefit. However, according to the National Association of Pension Funds, while the change may encourage some to save more into their pension assured that they will be able to pass on the lion's share without tax, the reality is that it is likely to affect only those with large pension pots. Once again, while the Government's intention is moving in one direction, others in the industry differ on the practical implications.[50]

Mr Gauke responded that the well-advised were probably always less likely to be hit by the 55% in any case. The change would protect those hit inadvertently:

> Some 320,000 people retire each year with defined-contribution pension savings of all sizes. These people will no longer have to

[48] PBC Deb 18 November 2014 c75
[49] Ibid c79
[50] Ibid c83

> worry about their pension savings being taxed at 55% on death, if they choose to access it flexibly.
>
> I suppose I should also make the point that the well advised were probably always less likely to fall into hitting this particular charge, so probably, all other things being equal, the previous arrangement would have been less likely to affect wealthy individuals having sought advice and so on. The fact is that we have taken this threat away. There was concern that people were inadvertently finding themselves in a position where their estate was being taxed at 55%, whereas if they had acted differently that was less likely to happen. We have removed that threat, as it were.
>
> Potentially many millions of people will benefit from the threat being removed. That is not to say that millions of people paid this tax charge—they did not—but it does mean that the risk of what could be viewed as a punitive charged is removed. Particularly in the context of more people accessing their pension flexibly, it is right that we made that change, because there was a risk that ever more people would find themselves paying the charge.[51]

He also explained why the age of 75 continued to feature in the rules:

> The age of 75 is a feature of the existing pensions tax system. It is the age at which individuals stop receiving tax relief on pension contributions, and at which most people will bring their pension into payment. Individuals who die under the age of 75 with untouched pension funds are already able to pass them on to anyone tax-free. The changes simply extend the tax treatment to those under 75 who have money in a drawdown account. The primary purpose of pensions is for people's retirement, but if someone dies before they get to use their pension for that purpose, beneficiaries should be able to have those funds. However, we do not want pensions to become a vehicle for inheritance tax planning, so once someone is 75 they will be able to pass the funds on to others in a flexi-access drawdown account, but they will need to pay their marginal rate of tax on them. That is the sensible approach.[52]

Ms Jamieson moved an amendment that would have required the Government to publish the analysis it had carried out of its reforms, in particular, the distributional impact and behavioural assessment.[53]

Regarding the distributional analysis, Mr Gauke responded that:

> Although the measures in the Bill are clearly taxation measures, they do not, in and of themselves, make individuals materially worse off or better off. They increase the choices available to individuals over how they access their savings and allow people to delay or bring forward their income, but do not alter the amount of savings that they have in aggregate.

Regarding the behavioural effect, the Treasury considered that:

> […] the publication of detailed behavioural assumptions can have the potential to affect that behaviour and, as such, is potentially detrimental to policy-making.[54]

[51] PBC Deb 18 November 2014 c83
[52] Ibid c79
[53] Ibid c84
[54] Ibid c89

2.5 *Finance Act 2015*

As outlined above, the Chancellor announced in September 2014 that:

- The tax charge on certain lump sums from 55% to 45% from April 2015; and
- The Government would engage with industry on how to make lump-sum payments subject to tax at the beneficiary's marginal rate from April 2016.[55]

In the Summer Budget 2015, it confirmed that:

> **2.79 Taxation of pensions at death** – As announced at Autumn Statement 2014, the government will reduce the 45% tax rate that applies on lump sums paid from the pension of someone who dies aged 75 and over to the marginal rate of the recipient from 2016-17. (Summer Finance Bill 2015)[56]

In more detail:

> Legislation will be introduced in Summer Finance Bill 2015 to amend *FA 2004* and *ITEPA 2003.*
>
> Changes are being made so that where a lump sum death benefit is taxable it will be subject to the recipient's marginal rate of tax where the lump sum is paid directly from the pension scheme to an individual who is the ultimate beneficiary.
>
> Taxable lump sum death benefits paid to an individual who is the ultimate beneficiary will no longer be subject to the special lump sum death benefits charge at 45%. They will be taxed as pension income and tax will be deducted under PAYE.
>
> The tax charge will remain at 45% where the taxable lump sum death benefit is paid to someone other than an individual who is the ultimate beneficiary, such as a trust or a company.[57]

The Government had set out its analysis of the impact of the reforms at the time of the Autumn Statement: [58]

Exchequer impact (£m)	2015-16	2016-17	2017-18	2018-19	2019-20
	-50	-155	-165	-175	-185

It said that this Exchequer impact:

> […] formed part of the figures for 'Pensions flexibility: decisions since Budget 2014', which are set out in Table 2.1 of Autumn Statement 2014 and have been certified by the Office for Budget Responsibility.[59]

As explained in section 4.10 above, the OBR judged that there was a 'very high' level of uncertainty around the forecast Exchequer impact of the pension flexibilities as a whole because it depended on "take up and on other behavioural responses."[60] With regard to the taxation of the costings included a "behavioural response to control for individuals

[55] Gov.UK, Chancellor abolishes 55% tax on pension fund at death, 29 September 2014
[56] HM Treasury, Summer Budget 2015, HC 264, 8 July 2015
[57] HMRC – Taxation of lump sum death benefits, July 2015
[58] Ibid
[59] Ibid
[60] OBR, Economic and fiscal outlook, December 2014, Annex A, para A.6 and A.9

increasing contributions into pensions to avoid inheritance tax."[61] However, the Government did not want to publish further detail of this on the basis that this in itself had the potential to affect behaviour.[62]

The changes are in the *Finance Act 2015*. As summarised in the Explanatory Notes, section 34 and Schedule 4 amended:

> [..] the existing pension tax rules in Part 4 of Finance Act 2004 to allow anyone, including non-dependants, to receive payments from an annuity on the death of a member. The Schedule also amends the *Income Tax (Earnings and Pensions) Act 2003* to allow payments of these beneficiaries' annuities to be tax-free on the death of an individual before age 75. These changes are similar to, and build on those made in the *Taxation of Pensions Act 2014* to *Finance Act 2004*, which were in respect of payments of income withdrawal from a drawdown fund on the death of an individual. The changes in this section and Schedule will have effect on or after 6 April 2015.

A Tax Information and Impact Note explained the expected economic impact as follows:

> This measure is not expected to have any significant macroeconomic impacts.
>
> A behavioural response to control for individuals increasing contributions into pensions to avoid Inheritance Tax is incorporated into the costing.[63]

As regards the equalities impact, it said:

> These measures will affect the recipients of lump sum death benefits where someone dies at age 75 or over. The recipients could belong to any age group. The government expects these measures to affect proportionately more women than men, as men are more likely to have pension savings and to die first.
>
> No other impacts are anticipated in respect of groups sharing other protected characteristics.[64]

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[61] HMRC, Taxation of lump sum death benefits, July 2015
[62] PBC Deb 18 November 2014 c89
[63] HMRC, Taxation of lump sum death benefits. TIIN, July 2015
[64] Ibid

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