AJBell Platinum

Pensions and inheritance tax

Overview

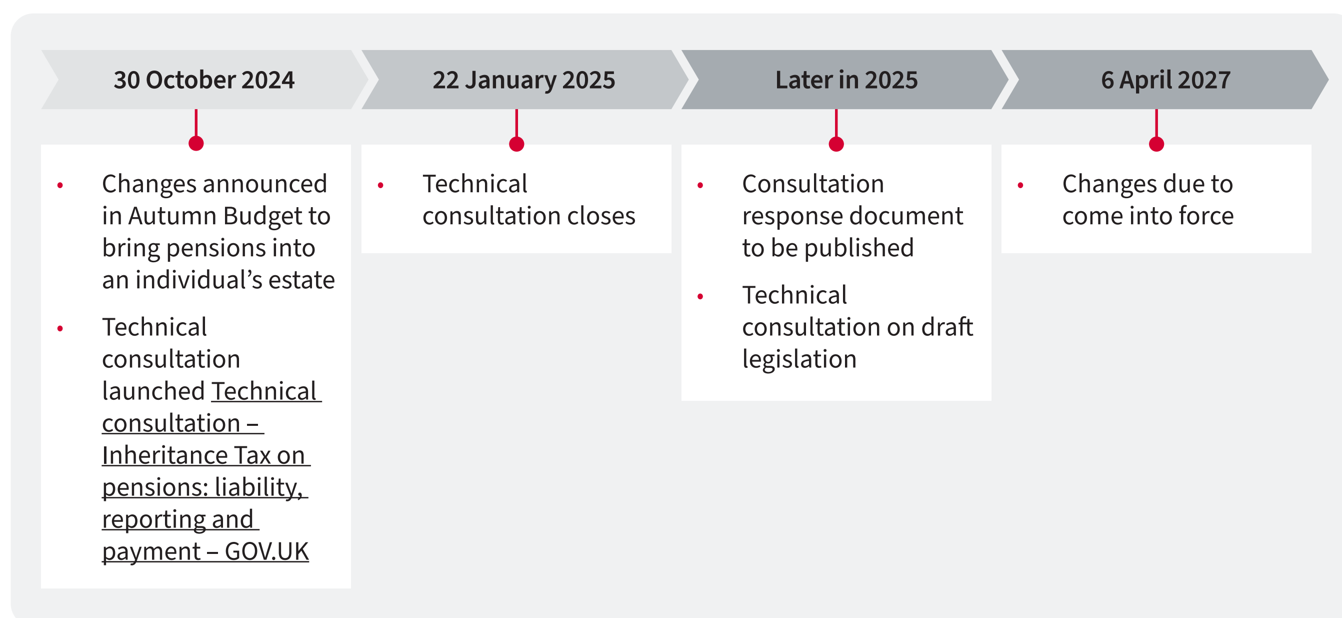
In the Autumn Budget delivered on 30 October 2024, the Chancellor announced that from 6 April 2027 pensions would be included in an individual's estate on death. Where the nil-rate band has been used up then inheritance tax (IHT) at 40% will apply on the excess.

Under the current rules the tax treatment of pension death benefits is very generous. Under discretionary schemes, when the member dies under the age of 75 and the benefits are paid as income there is no tax to pay, no upper limit, and beneficiaries do not have to be dependants. This situation has come about following pension freedoms introduced in 2015, and the subsequent removal of the lifetime allowance.

The government has stated that they will continue to incentivise pension savings but have made changes due to pension schemes being "increasingly used and marketed as a tax planning tool to transfer wealth without an inheritance tax charge, rather than for their intended purpose of funding retirement".

Timeline

The timescales that have been released to date are as follows:



Which pension death benefits will be impacted?

Most types of pension death benefits will be included in the value of the deceased member's estate. Inheritance tax will apply to unused pension funds with two exceptions – dependant's scheme pension (which is subject to income tax), and charity lump sum death benefits.

Spousal exemption will apply to inherited pension funds

It is important to note that the spousal exemption will apply. This means that any death benefits paid to a spouse or civil partner will not be liable to inheritance tax.

How will IHT be applied to pension death benefits?

It is important to note that the practicalities of how IHT will be reported and paid are subject to consultation. The information below explains how HMRC is proposing the process will work, but this is very likely to change before its introduction on 6 April 2027.

We have already identified several areas which are impractical and will be feeding this back to HMRC in our response. We expect many others in the industry to respond with similar views.

Proposed process:

1. Member dies.
2. Personal representative (PR) informs pension scheme administrator (PSA) of death.
3. Within two months PSA informs PR of value of pension funds, and of any spousal exemption.
4. Once PR has information on all the estate, they use a new HMRC calculator to calculate nil-rate band apportioned to pension.
5. PR notifies PSA of nil-rate band available for pension and IHT reference number of estate.
6. PSA calculates IHT, liquidates funds as required, and pays to HMRC.
7. PSA distributes death benefits to beneficiaries.

Under current rules IHT must be paid within six months of the end of the month in which the death occurred. It is proposed that this will continue to apply when IHT is paid by PSAs.

This means that steps 1-6 above must all be completed within this six-month window, or late payment interest will apply on the amount of IHT for which the scheme is liable. It was announced in the Budget that this rate will increase from 6 April 2025 from 2.5% to 4% above base rate.

Under the proposed rules the PSA is liable for the IHT. This means it would not be possible for the pension scheme's IHT bill to be paid from outside the scheme. It is suggested that after 12 months the liability will move to being jointly held between the PSA and the beneficiary. This is so that where adjustments to IHT have been made, and the pension death benefits have been paid out, HMRC can pursue the beneficiary for repayments directly.

Case studies

Helen

- Single, dies age 73
- £700,000 in SIPP; £800,000 in estate (excluding SIPP)

Current rules

- No IHT on pension
- IHT payable at 40% on £475,000 (£800,000 - £325,000 nil-rate band) = £190,000
- £700,000 can be distributed from SIPP
  - Tax-free if taken as income
  - Tax-free up to available lump sum and death benefit allowance (LSDBA) if taken as lump sum; income tax on any excess above LSDBA

Death occurs after 6 April 2027

- Estate valued at £1,500,000
- IHT payable at 40% on £1,175,000 (£1,500,000 - £325,000 nil-rate band) = £470,000
- IHT payable by pension (£470,000 x £700,000/£1,500,000) = £219,333
- £480,667 can be distributed from SIPP
  - Tax-free if taken as income
  - Tax-free up to available lump sum and death benefit allowance (LSDBA) if taken as lump sum; income tax on any excess above LSDBA

Henry

- Single, dies age 78
- £700,000 in SIPP; £800,000 in estate (excluding SIPP)

Current rules

- No IHT on pension
- IHT payable at 40% on £475,000 (£800,000 - £325,000 nil-rate band) = £190,000
- £700,000 can be distributed from SIPP subject to income tax for beneficiary

Death occurs after 6 April 2027

- Estate valued at £1,500,000
- IHT payable at 40% on £1,175,000 (£1,500,000 - £325,000 nil-rate band) = £470,000
- IHT payable by pension (£470,000 x £700,000/£1,500,000) = £219,333
- £480,667 can be distributed from SIPP subject to income tax for beneficiary

Effective tax rates

When IHT is deducted from pension funds, and then income tax is payable when those funds are distributed, there will be higher effective rates of tax incurred for the beneficiary. This is demonstrated in the table below with an example size fund of £100,000.

	IHT	After IHT	Income tax	After Income tax	Effective tax rate
£100,000	40%	£60,000	20%	£48,000	52%
£100,000	40%	£60,000	40%	£36,000	64%
£100,000	40%	£60,000	45%	£33,000	67%

Planning

There will be many clients who intended to pass funds on via the pension scheme due to the current generous death benefit rules which lend themselves to taking income from other assets first and using pension funds last. When the new rules come into force this situation may change.

It is important to note that these changes are not due to come into force until 6 April 2027. This means there is no need for urgent action, and if death occurs before this date, then the pension should still be outside the estate in most circumstances.

Looking further ahead the advantages of tax-relieved contributions and tax-free growth will continue to be valuable.

Where members die before age 75, funds will continue to be paid out tax-free in most circumstances if paid to a spouse or civil partner. They will also be tax-free if there is sufficient nil-rate band available.

If the member dies after age 75 the spouse or civil partner can still receive the death benefits subject to income tax without IHT applying. This is also the case where benefits are paid elsewhere and there is nil rate band available.

Should the changes go ahead as planned, the clients who will be most impacted by the change will be those who are not leaving benefits to their spouse (which will include most couples on second death), are over 75, and have large funds that they are unlikely to use in their lifetime and are over the available nil-rate band. For these clients it may make sense to take income and make gifts in their lifetime. As well as the annual gifting allowance of £3,000, regular gifts out of income can be made without IHT applying. The exemption applies when the gifts form part of the client's normal expenditure, are made out of income, and don't impact the client's normal standard of living. Appropriate records should be kept if regular gifts are made. Although the income will be subject to income tax for the client, passing it on this way should prevent the beneficiary incurring the higher effective rates of tax shown in the table above.

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