Pensions and IHT - all change from 6 April 2027

Synopsis: The October 2024 Budget announced that most pensions funds will be brought into the estate for inheritance tax purposes from 6 April 2027.

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While many were busy speculating that the Chancellor may reduce the lump sum allowance in the October Budget, the Government were instead working on a change that could potentially have a much bigger impact on financial planning – removing the inheritance tax (IHT) exemption for pension death benefits.

From 6 April 2027, most pension funds will fall into the estate for IHT purposes. This will include funds paid out as a lump sum and those paid as beneficiary's drawdown or an annuity. Lump sum payments that will be made into a bypass trust on death will also be in scope.

Scheme pensions will be excluded. These are usually paid from defined benefit schemes and will include dependants' pensions paid from public sector schemes. Charity lump sum death benefits will also be exempt along with benefits paid from a life policy purchased with pension funds, such as an annuity bought in the lifetime of the member.

Under the current rules, most pension funds are outside of the estate as they are paid at the discretion of the pension scheme. The new rules will remove the distinction between discretionary and non-discretionary payments and the value of all benefits will fall into the estate.

The Government have issued a consultation paper explaining the changes and seeking views on the processes required to implement the changes. The consultation states that IHT will be payable on the value of the gross funds in the pension immediately before death, but before being distributed or designated to the beneficiary.

The IHT charge will be paid by the scheme and the usual pre and post age 75 income tax rules on the residual funds will still apply. This means that post 75 death benefits, or funds in excess of the Lump sum and death benefit allowance (LSDBA) pre 75, will be subject to both IHT and income tax on the residual.

The process will require the personal representatives and the pension scheme administrator/trustee having to work together to establish the IHT charge due on the entire estate and the proportion of the charge the scheme must pay.

Example

A client dies with a total estate worth £1.5m. This is made up of £1m worth of non-pension funds and a pension valued at £500,000. The client has the standard IHT nil rate band of £325,000 available. The total IHT charge is therefore £1,175,000 x 40% = £470,000. As the pension represents a third of the total estate the scheme will be due to pay a third of the IHT i.e. £156,667. The IHT due will be deducted by

the administrators and paid to HMRC. The remaining pension fund of £343,333 can then either be paid out as a lump sum to an individual or trust or used for income, i.e. drawdown or an annuity.

If the client died under 75, and the funds were within the available LSDBA, the beneficiary has no further tax to pay. If the client died aged 75 or over, or the funds were in excess of the LSDBA, the beneficiary would be subject to income tax at their marginal rates (45% for trusts) on the fund or excess as and when the funds are taken.

The new rules will apply to all overseas pensions schemes as well as UK pension schemes.

The IHT spouse/civil partner exemption will still apply in the normal way and, so, any funds that pass to a spouse or civil partner will remain free of IHT on first death.

As the new rules do not apply until 6 April 2027, advisers (and providers) have time to fully consider the changes. In addition, the complexity of the implementation and potential harshness of the 'double taxation' for deaths over 75 may lead to changes before the implementation date.

However, some initial points to consider…

- Where clients are funding their pensions purely for estate planning purposes, advisers should now reconsider the appropriateness of this.
- Where clients have deferred taking tax free cash from their pension beyond the age of 75, advisers should review this. Taking the tax-free cash will ensure that this is only subject to IHT on death and not IHT and income tax.
- Where clients have left pension funds undrawn mainly for estate planning purpose this should be reviewed. As above, this is particularly important where clients are over 75.
- Where pension funds are not required – taking the tax-free cash and making gifts will now be a much more attractive option than leaving them in the pension. Taking a regular taxable income and making gifts using the normal expenditure out of income exception could also be considered.
- Review all death benefit nominations. Passing the pension funds to a spouse/civil partner may give more opportunities to remove the funds from the estate before second death.
- Binding nominations may now be far more appropriate. The key disadvantage of using them has been removed. However, note that it may take time for schemes to update their rules to allow them.
- Payment of death benefits into a bypass trust may still offer advantages. Although this will not escape IHT on first death, the trust will keep the funds outside of anyone's estate on second death and subsequent deaths.

- Essentially, the original main purpose of these type of trusts will be reinstated.
- Where death in service benefits are set up under pension scheme rules it may now be more appropriate to consider writing these as an excepted group life scheme instead. Death in service lump sums from the pension scheme will be caught by the new rules whereas, currently, those from excepted group life schemes or relevant life policies will remain exempt.

Where a SIPP/SSAS is heavily invested in commercial property, the new rules will create further liquidity issues. Any IHT due by the scheme has to be paid within six months of death.

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