A E Thomson Ltd

Independent Financial Advisers

Guide to

Navigating the New Pension Inheritance Tax Rules

How to plan to secure your wealth for the next generation

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Navigating the New Pension Inheritance Tax Rules

How to plan to secure your wealth for the next generation

For years, pensions have been regarded as one of the most effective tools for passing wealth to future generations, offering unique tax advantages unavailable with other assets.

Traditionally,, pension funds have been protected from Inheritance Tax (IHT): if you died before age 75, beneficiaries could often receive your unspent pension savings tax-free, and even after age 75, funds were taxed at the recipient's marginal Income Tax rate rather than at punitive IHT levels. This special treatment has made pensions a crucial part of long-term estate planning for those aiming to leave a legacy.

Reform fundamentally alters how pensions should be viewed

However, the landscape is set to change considerably following the 2024 Budget. The Chancellor announced a major shift: from 6 April 2027, any unused defined contribution pension funds and death benefits remaining at death will be included in your estate for IHT purposes. This means your pension, which was previously outside the scope of IHT, could now be liable for a tax charge of up to 40% if your total estate exceeds the nil rate band. For many families, this reform fundamentally alters how pensions should be viewed within the wider context of inheritance and succession planning, and it introduces new challenges when aiming to maximise what can be passed on to loved ones.

A significant shift in estate planning is on the horizon

Previously, pension pots were usually protected from IHT, allowing them to be passed on tax-free (subject to Income Tax rules). This upcoming reform signifies a significant shift in estate planning, potentially subjecting children and beneficiaries to substantial tax bills that were once avoidable. While the tax-free lump sum and pension tax relief remain unchanged, the inclusion of defined contribution pots in the estate demands a complete re-evaluation of how families plan for the future.

Understanding the new tax landscape

To fully understand the implications of these changes for pension holders, it's important to comprehend how the UK's Inheritance Tax (IHT) system functions and why its scope is widening.

Inheritance Tax is a levy applied to the value of a person's estate upon death, covering assets such as property, investments, cash savings and now, with the 2027 rule change, potentially unused pension funds. The starting point is the 'nil rate band', currently set at £325,000, which allows you to pass on that amount of your estate tax-free. In the 2025 Autumn Budget, Chancellor Rachel Reeves confirmed that this threshold will remain frozen until April 2031.

More families entering the tax net

As asset values such as property and investments increase over

time, this freeze has already been raising the number of families entering the tax net. Including pension savings in the taxable estate will further accelerate this trend.

Anything above this threshold is typically taxed at 40% upon death. This nil rate band has not increased since 2009, but asset values have grown steadily, meaning more estates are likely to exceed this threshold each year, a phenomenon known as 'fiscal drag'.

Preserving pensions for as long as possible

For most people, how their wealth is organised greatly influences their exposure to IHT. Currently, pensions have traditionally been outside a person's taxable estate for IHT purposes. This has led many individuals to focus on depleting other assets (subject to IHT) first and to preserve their pensions for as long as possible, since these could be inherited IHT-free by beneficiaries, with some Income Tax implications depending on the age at death.

Pension funds will lose this special status from April 2027

However, from April 2027, most unused defined contribution pension funds will lose this special status. Instead, they will be included in the estate value for IHT calculations, increasing the taxable estate and potentially pushing beneficiaries into, or further above, the nil rate band. This means that families who once relied on pensions to avoid a large tax bill could now face a 40% charge on inherited pension funds, potentially losing a significant part of their intended legacy.

Growing importance of proactive, ongoing estate planning

For pension holders, this change underscores the growing importance of proactive, ongoing estate planning. It not only aligns pensions with other assets for tax purposes but also emphasises the necessity to consider the timing and manner of drawing or passing on retirement funds, as well as the relevance of alternative vehicles for savings and gift strategies. The IHT landscape is changing rapidly, and those with pension savings must review their estate plans to prevent their loved ones from facing unexpected tax liabilities.

The 2027 change

From April 2027, your unused pension funds will be combined with your other assets (such as property, savings and investments) when calculating the total value of your estate. If this total exceeds your available nil rate band, your beneficiaries could face a 40% tax charge on the pension money they inherit, something that, under current rules, they would likely avoid.

Impact on beneficiaries and unmarried partners

The new rules will not affect everyone equally, and the consequences for some groups could be particularly significant. The distinction between married couples or registered civil partners and unmarried partners is becoming more pronounced, and the changes may result in very different outcomes depending on your relationship status and family circumstances.

Spousal exemption continues to provide valuable protection

For married couples and registered civil partners, the established 'spousal exemption' continues to provide valuable protection. This exemption allows you to pass your entire estate, including pension benefits, to your spouse or registered civil partner without incurring any IHT. As a result, with careful planning, married couples and registered civil partners can usually delay the effects of IHT until the second partner dies, at which point both partners' nil rate bands may be combined to reduce the tax liability further.

Unmarried partners face significantly greater challenges

In stark contrast, unmarried partners face significantly greater challenges. Since assets left to an unmarried partner do not qualify for the spousal exemption, any pension funds inherited by them will be added directly to your estate's taxable value. If your total estate, including the inherited

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pension, surpasses the £325,000 nil rate band, your partner could face a tax bill of up to 40% on the inherited amount.

This can significantly reduce the intended benefit and, for some, lead to a noticeable decrease in income or quality of life during retirement, especially if much of a couple's wealth is invested in pension savings. Moreover, many unmarried couples may not realise how vulnerable they are without the automatic legal protections that marriage or civil partnership provides in inheritance matters.

Triggering or significantly raising the overall IHT bill

Children and other beneficiaries will also be directly affected. Previously, children could inherit a parent's remaining pension fund with little or no IHT, depending on the parent's age at death and the total estate value. Now, pension money left to children or any other beneficiary (excluding a spouse or registered civil partner) might increase the estate's value above the nil rate band, triggering or significantly raising the overall IHT bill. This change diminishes the effectiveness of pensions for intergenerational wealth transfer, prompting many to reconsider traditional estate planning strategies.

Beyond the straightforward tax consequences, the administrative burden on families may increase. The Treasury has indicated that Pension Scheme Administrators (PSAs) will be responsible for reporting and paying any IHT due on unused pension funds before the funds are distributed to beneficiaries.

Maintaining up-to-date documentation

This new process adds an extra step, requiring beneficiaries to engage with pension providers and HMRC to resolve tax issues at a potentially stressful time, which may delay the release of funds. Clear communication with pension trustees or scheme administrators, along with maintaining up-to-date documentation, will become even more vital for bereaved families navigating these new requirements.

- **Married couples and registered civil partners:** The 'spousal exemption' currently allows you to leave your entire estate to your spouse or registered civil partner free of IHT. This protection remains. Therefore, if you pass your pension to your spouse, no immediate IHT should be due.
- **Unmarried partners:** This group is particularly vulnerable. Because they do not benefit from the spousal exemption, any pension funds left to an unmarried partner will be counted towards the estate's value. If this pushes the estate over the £325,000 threshold, the surviving partner could see their inheritance significantly reduced by tax, potentially impacting their standard of living in retirement.
- **Children and other beneficiaries:** Similarly, passing a pension pot to children will now count towards the estate value, potentially triggering or increasing an IHT bill.

Administration changes

The Treasury has stated that Pension Scheme Administrators (PSAs) will be responsible for reporting and paying the IHT owed on unused pension funds. This introduces additional administrative complexity and ensures the government collects the tax at the source before funds are distributed.

Rethinking retirement funding

The long-standing practice of 'spend other assets first, touch the pension last' might no longer be the most tax-efficient strategy. For many years, advisors advised leaving pension funds untouched for as long as possible because they are outside the IHT net. This meant individuals would use their cash savings, Individual Savings Accounts (ISAs), and other investments, assets subject to IHT, before accessing their retirement fund. Not only did this help maximise the inheritance for loved ones by keeping pension balances high and tax-free, but it also allowed the pension fund to grow in a tax-friendly environment.

Protecting pension wealth for inheritance purposes

With the arrival of the 2027 rules, however, both ISAs and pension funds will be included in your taxable estate. Consequently, the pension's previous tax advantages will be lost, and strategies that relied heavily on protecting pension wealth for inheritance will need to be reconsidered. Retirees and those nearing retirement will need to pay closer attention to the sequence in which they withdraw their assets. For some, a more tax-conscious approach might involve accessing pension funds earlier in retirement, using the funds to enjoy life or make financial gifts while alive, thereby taking advantage of exemptions such as the seven-year rule for gifts.

Using excess pension withdrawals to fund lifetime gifting

Individuals may also want to review their investment allocations and use of alternative vehicles. ISAs, while still included in the estate for IHT, provide the benefit of tax-efficient income and capital gains throughout life. However, given the new landscape, savers might seek to balance withdrawals between pensions and ISAs, maximise the use of annual allowances or explore using excess pension withdrawals to fund lifetime gifting strategies or invest in assets that qualify for IHT relief, such as certain types of business or agricultural property.

More effective to gift assets during their lifetime or to use trusts

Families who previously planned to leave a significant pension fund as a windfall for heirs should reconsider whether this still aligns with their goals, given the increased impact of IHT. Those who want to safeguard wealth for the next generation might find it more effective to gift assets during their lifetime or to use trusts, insurance policies or other customised estate planning tools. Ultimately, adjusting to the new regulations requires a more nuanced approach to retirement income, ensuring flexibility, and seeking professional advice to tailor your withdrawal and wealth transfer strategy over time.

Spending vs. saving

Historically, savers were encouraged to deplete ISAs (which are subject to IHT) while preserving pensions (which were not). From 2027, as both asset classes may be liable for IHT, retirees might be more inclined to draw down their pension funds during their lifetime to enjoy their wealth, rather than hoarding it for inheritance.

The role of ISAs

This change could steer attention towards ISAs. Although ISAs are part

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of the taxable estate, they provide tax-efficient growth and withdrawals during your lifetime. The appeal of pensions as a straightforward wealth-transfer tool is diminished, creating a more level playing field between pensions and ISAs.

Actionable steps to protect your estate

Below are several key steps and considerations to help you safeguard your estate and adapt your retirement and inheritance strategies to the new landscape.

- **Review your 'expression of wish' forms:** Ensure all your pension providers have current forms listing your chosen beneficiaries. This is important, not only to clearly document your wishes, but also to help expedite the transfer of pension funds to your loved ones after your death. Remember, these forms should be updated whenever your circumstances change, such as after marriage, divorce or the arrival of new family members.
- **Reassess pension nomination strategies:** In addition to ensuring your expression of wish forms are up to date, consider whether your current nominations align with your new estate planning objectives, particularly in light of the IHT changes. For example, you could change the balance between what is left to a spouse versus other beneficiaries or explore pension trusts in specific or complex family situations.
- **Consider gifting strategies:** If you want to reduce the value of your estate liable to IHT, think about making financial gifts during your lifetime. Gifts given more than seven years before your death generally fall outside your estate for IHT purposes under the 'seven-year rule'. You might choose to support children or grandchildren financially while you are alive, which can also provide the satisfaction of seeing your gifts put to use. For larger gifts, keep precise records: note recipient names, dates and amounts to help your executors demonstrate eligibility for IHT relief.
- **Utilise gift allowances:** Make use of the annual gift exemptions (£3,000 per tax year) and small gift allowances for birthdays, weddings or other special occasions – these can be an effective way of passing on wealth in a tax-efficient manner. Furthermore, regular gifts from surplus income are exempt from IHT, as long as they do not affect your standard of living; keeping records of regular gifts and your income/spending can help meet HMRC requirements.
- **Evaluate the order of withdrawals:** Check the sequence in which you plan to access different assets in retirement, taking into account the new IHT rules. You may need to rebalance withdrawals across ISAs, pensions and other investments to manage income tax and IHT exposure over time.
- **Understand pension scheme rules and guarantees:** Before taking any action, especially transfers or consolidations, verify whether your existing pension schemes include valuable guarantees, such as guaranteed annuity rates or protected tax-free cash. Some older schemes offer benefits that could offset the impact of IHT, and losing them could be harmful.
- **Explore the use of trusts or insurance:** In more complex estates or for those with significant pension wealth, trusts and life insurance can

sometimes play an important role in mitigating IHT or providing liquidity to pay potential tax bills. Professional advice is recommended before implementing these strategies.

- **Keep detailed records:** Keep detailed documentation of all pension arrangements, nominations, gifts and other aspects of your estate planning. This not only benefits your beneficiaries but also helps your executors manage HMRC matters effectively.
- **Seek professional advice:** Estate planning and pension strategies are complex, especially as regulations evolve. Obtaining professional financial advice will help you develop a personalised plan tailored to your needs, allowing you to balance your income, lifestyle and legacy goals without making hasty, reactive decisions.

By addressing these steps proactively, you can respond confidently to the pension IHT changes, help reduce the tax burden on your heirs and continue to shape your financial legacy for future generations.

Conclusion

Including pensions in Inheritance Tax marks a significant shift in financial planning. What was once a safe method for passing down intergenerational wealth will soon be regarded like any other asset, reducing the effectiveness of certain strategies.

Although these changes won't take effect until April 2027, this transition period is a crucial time to act. Early, strategic planning can help you minimise tax liabilities, maximise remaining allowances and ensure your legacy is passed on to your chosen beneficiaries as efficiently as possible. ■

Is it time to reassess your estate and retirement planning strategy?

By taking the time now to reassess your estate and retirement planning strategy, you can identify risks before they become problems and proactively adapt your approach rather than react. The earlier you start planning for the upcoming changes, the more options and flexibility you'll have to safeguard your wealth, honour your wishes and provide security for those you care about most.

Don't leave your legacy to chance. Contact us to discuss your circumstances and develop a plan for the future.

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A PENSION IS A LONG-TERM INVESTMENT NOT NORMALLY ACCESSIBLE UNTIL AGE 55 (57 FROM APRIL 2028 UNLESS THE PLAN HAS A PROTECTED PENSION AGE). THE VALUE OF YOUR INVESTMENTS (AND ANY INCOME FROM THEM) CAN GO DOWN AS WELL AS UP, WHICH WOULD HAVE AN IMPACT ON THE LEVEL OF PENSION BENEFITS AVAILABLE.

Ready to begin

safeguarding your legacy today for the future of your loved ones?

For many families, this reform must be considered within the wider context of inheritance and succession planning, as it presents new challenges in optimising what can be passed on to loved ones.

Start planning your future today. To find out how we can help safeguard your legacy, please contact us.

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