Fair, Friendly Financial Advice

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Pensions to fall under Inheritance Tax rules from April 2027

How upcoming changes could affect estate valuations and beneficiary payouts

In the previous 2024 Autumn Budget, the Chancellor announced that the Inheritance Tax (IHT) thresholds, which are the amount you can pass on when you die before IHT is due, will remain unchanged until 2030. However, from 6 April 2027, pensions will no longer be exempt from IHT, which will alter how estates are valued and passed on. That means that inheritance tax may have to be paid on your pension when you die.

Currently, defined contribution pensions, where you build up a pot of money to provide an income in retirement, are typically not part of your estate, and therefore, there would be no IHT to pay. The 'estate' simply refers to all the assets, such as a house, investments, or valuables, that someone owns when they die. However, from April next year, defined contribution pensions will be liable for IHT. The standard rate of IHT for estates that exceed the available allowances is currently 40%.

RECAP OF INHERITANCE TAX ALLOWANCES

The standard Nil Rate Band is £325,000 (2025/26), with an additional Residence Nil Rate Band of up to £175,000 (2025/26) when a main residence passes to direct descendants. Both allowances can be transferred between spouses, allowing a combined potential tax-free inheritance of up to £1 million in certain cases.

These thresholds are meant to stay the same; however, broadening what is regarded as part of the estate may cause more households to go over the limit. This could result in beneficiaries facing higher liabilities, especially when large pension pots are kept rather than withdrawn.

PENSIONS TO BE INCLUDED IN THE TAXABLE ESTATE

Unused pension funds and most pension death benefits, starting from 6 April 2027, will be included in the estate for IHT purposes. This marks a change from the current system, where pensions held in discretionary schemes generally fall outside the estate and are not subject to IHT. The reform seeks to promote more consistent taxation of accumulated wealth, although it may increase the administrative burden for executors managing estates.

The government has confirmed that the responsibility for reporting and paying IHT on pension funds will lie with personal representatives rather than pension providers. Death-in-service benefits will stay outside the new rules, offering some continuity for families.

PRACTICAL CONSEQUENCES FOR FAMILIES

These changes could lead to delays in distributing pension funds to beneficiaries, as valuing and including pension assets might prolong the probate process. For some households, this may cause short-term financial difficulty until the funds are released. Scheme administrators will need to value pension funds as of the date of death and report this information to HMRC to ensure accurate tax calculations.

While the reforms aim to modernise the system, they also obscure the line between retirement income planning and estate planning. Those reliant on pensions for wealth transfer may need to review their long-term position of these assets once the changes take effect.

THE ROAD AHEAD

The new framework is set to be legislated through the Finance Bill 2025/26, with further details to be revealed in the upcoming Autumn Budget 2025. The government states that these reforms form part of a broader effort to enhance fairness and fiscal sustainability as intergenerational wealth transfers increase in size and frequency. ■

PENSIONS AND INHERITANCE TAX ARE EVOLVING. WHAT DO YOU NEED TO CONSIDER?

The inclusion of unused pension funds in estates from 2027 marks a significant policy shift. Staying informed about these changes and taking any necessary action is crucial. If you need further guidance or professional advice, please contact us sooner rather than later.