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Pensions and inheritance tax

Introduction

In the 2024 Autumn Budget, the Government proposed that from 6 April 2027 most unused pension funds and death benefits will be included within the value of a person's estate for inheritance tax (IHT) purposes. Currently, pensions are normally not included within an estate.

The Finance Act 2026 contained the high-level legislation to introduce these changes, with more detailed information due in regulations and guidance which will appear through the remainder of 2026 and into 2027.

Under the current rules, the tax treatment of pensions passed on after death is generous. Where the member dies below age 75 there is no income tax to pay, as long as benefits are paid within two years and don't exceed the individual's remaining lump sum and death benefit allowance if benefits are paid as a lump sum. For deaths on or after age 75, the beneficiary(s) pay income tax on withdrawals. The Government's proposals mean this will change in respect of deaths on or after 6 April 2027.

Which pensions will be included within the scope of IHT?

Most unused pensions and pension death benefits will be included within the value of the deceased's estate.

However, there are some exceptions will not be included in the estate. These are:

Included in the estate

- Uncrystallised defined contribution benefits
- Flexi-access and capped drawdown
- Dependant, nominee and successor drawdown
- Pension protection lump sums
- Annuity protection lump sums
- Remaining instalments of annuity guarantee periods (calculation required to give current value)
- Dependant, nominee, successor annuities bought from inherited funds
- Trivial commutation lump sum death benefits in respect of any of the above

Not included in estate

- A dependant's scheme pension which is an income paid to a spouse or dependant following an individual's death, normally when they were a member of a defined benefit type scheme. Plus a trivial commutation in respect of a scheme pension.
- A joint life income attached to a pension annuity purchased by the deceased
- A charity lump sum death benefit
- A lump sum death benefit within a registered pension scheme (e.g. a risk benefit such as four times salary) which is paid to an individual working for an employer when they die

It's important to note that the spousal exemption applies to pensions passed on to a spouse or civil partner. This means any pension benefits left to a spouse or civil partner will not be liable to IHT at that point even if they are included in the estate.

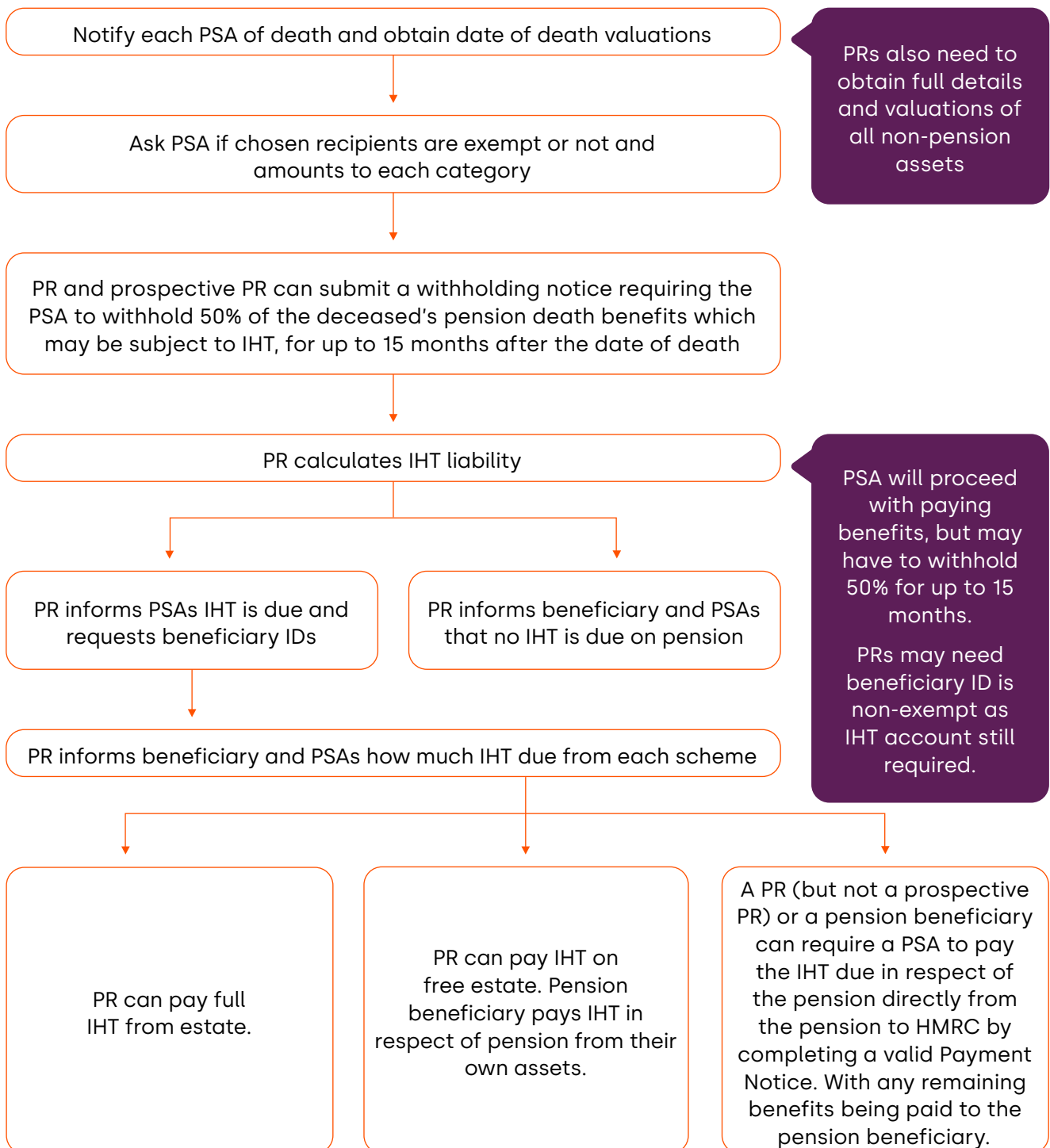
The process

The practicalities of how this will work is within draft legislation and so is still subject to change. Personal representatives (PRs) already report and pay IHT on the deceased's estate. They will now be required to report and pay the IHT due on discretionary pensions, but all parties will need to work together to achieve this.

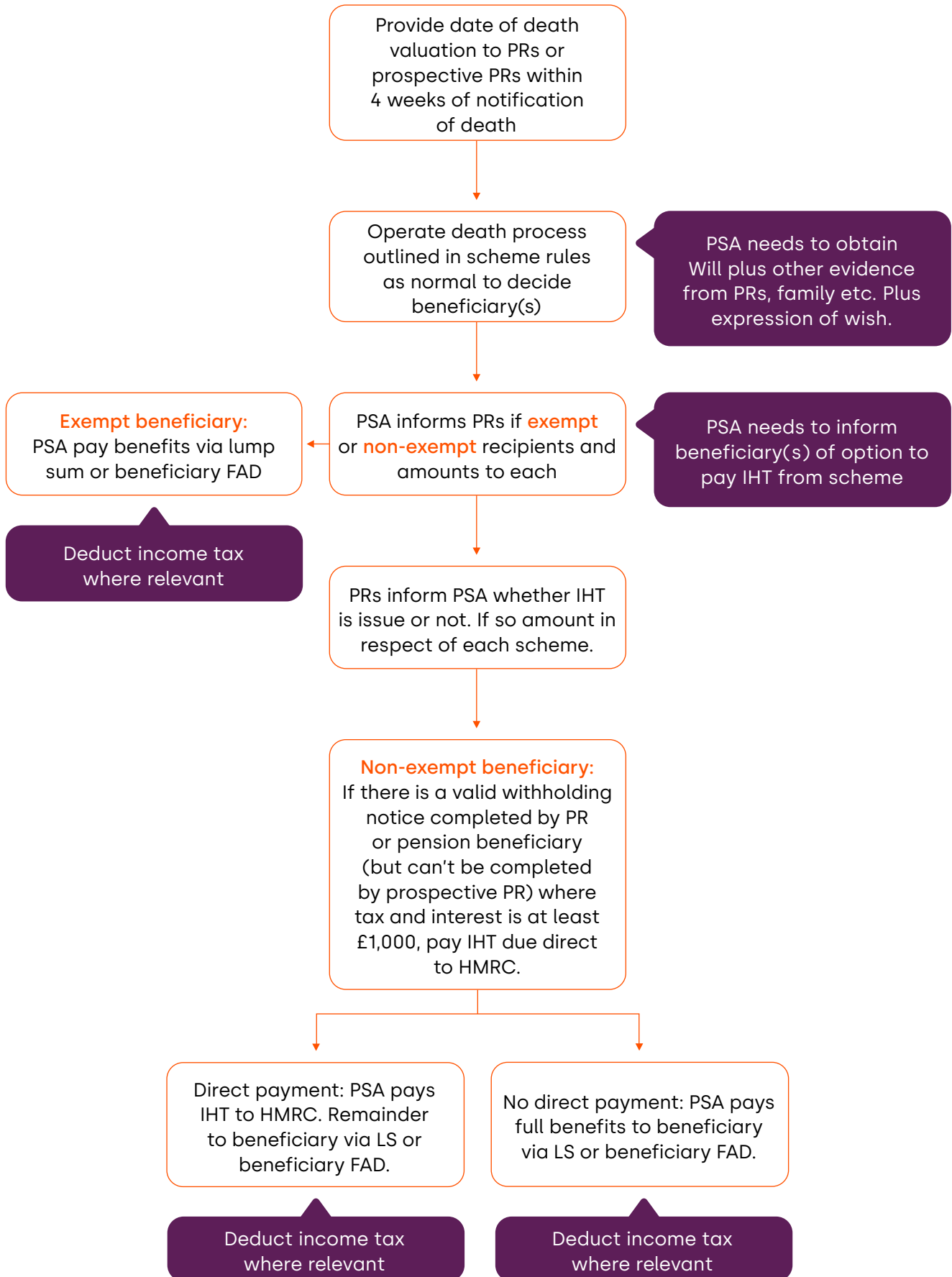
There is an unusual tripartite position where a pension scheme administrator

(PSA) and PRs will need to share much information. But ultimately it's the pension beneficiaries who will decide whether IHT is paid from the pension, not the PRs. A further complication is that a prospective PR has the ability to carry out some tasks and the right to some information. A prospective PR is generally where there is no Will and the individual has a reasonable belief they will become the PR.

Personal Representatives



Pension Scheme Administrators



Once the PSA is informed of death, it has four weeks to provide a valuation of the pension as at the date of death. It's important to appreciate this is a value for the purposes of valuing the estate, and the benefits paid to a beneficiary at a future date won't be exactly that amount. There is uncertainty around the valuation if there are illiquid assets held within the scheme, and we await HMRC clarity on that aspect.

The PRs or prospective PRs will need to obtain a valuation from each pension scheme and for all of the non-pension assets. PRs or prospective PRs will be able to direct the PSA to withhold 50% of taxable benefits for up to 15 months. The PR or pension beneficiary (but not the prospective PR) can complete a Payment Notice requiring the scheme to pay IHT direct to HMRC if tax and interest is £1,000 or more.

If the scheme is set up using a discretionary disposal process, it will investigate, obtain evidence and decide potential beneficiaries as normal. It will need to inform PRs or prospective PRs whether it intends to make payments to exempt or non-exempt beneficiaries (for example, spouse or children) and how much to each category, as this affects the overall IHT calculations.

Pension schemes will be required to make the liability position clear and explain to non-exempt beneficiaries that IHT may be due on the pension when informing them about their benefits, how they can access them and options for paying IHT.

If no IHT is due on the estate the PRs will inform the PSA who can pay benefits as normal. If pension benefits are left to exempt beneficiaries such as a spouse or civil partner, hopefully the process won't be too onerous.

If IHT is due, there are three options

1. PRs can pay the IHT due for the whole estate including the pension.
2. PRs can pay the IHT due on the free estate and work with pension beneficiaries (once appointed) to pay the Inheritance Tax due on the pension component.

3. The PR or pension beneficiary (but not a prospective PR) can complete a valid Payment Notice requiring the PSA to pay IHT direct to HMRC and pay the balance to the beneficiary.

To work out the IHT in respect of each pension, the PRs will need to apportion the nil rate band (NRB). The NRB is a threshold below which an estate does not incur IHT, effectively allowing a portion of the estate to be passed on tax-free. The current NRB is £325,000 with assets above this normally taxed at 40%. The NRB can be used during a lifetime by the chargeable value of gifts made by the deceased within seven years before their death or on death of the individual.

Any NRB unused by a spouse or civil partner can be transferred, as a percentage, to the surviving spouse.

The available NRB is apportioned between the non-pension assets and each pension scheme paying benefits to a non-exempt beneficiary. Once the NRB is apportioned, the PRs will be able to calculate the IHT due in respect of a non-exempt beneficiary's entitlement to benefits within a particular scheme.

Option for direct payment from scheme

A PR or pension beneficiary can request a PSA pays the IHT they are due, in connection with that pension scheme, direct to HMRC.

If the amount due is £1,000 or more (but less than the value of the beneficiary's entitlement) the PSA must pay the tax from the pension scheme. It must do so within 35 days of a valid request, otherwise it becomes jointly liable for IHT on the scheme's assets.

The PR may have submitted a withholding notice and require the PSA to pay the IHT from the pension to HMRC, but if not, this is a choice for the beneficiary to make if they believe it's the best option. They could choose to retain the pension rights in full.

If a PR or beneficiary asks the PSA to pay IHT it can only be the IHT in respect of that scheme – they can't pay wider IHT bills from the scheme or try to pay IHT due in respect of another pension.

Tax position regarding direct payment

If a PR or beneficiary asks the PSA to pay IHT from the scheme to HMRC, this will be an authorised payment. If the PRs have paid IHT in respect of the full estate, HMRC will make a comparative refund to the PRs.

A further complexity can arise if the pension beneficiary chooses not to ask the scheme to pay the IHT.

Any income tax payable – for example if death is over age 75, or a lump sum and death benefit allowance (LSDBA) tax charge is due – is levied on the benefits after IHT has been paid.

If pension beneficiaries choose to take their pension benefits in full, they can contact HMRC to arrange a refund for any income tax paid on the amount of the IHT charge.

Six-month rule and late payment interest

Under current rules IHT must be paid within six months following the end of the month in which the individual died. This means all of the above steps must be completed within that timescale or late interest penalties will be added to the IHT bill. Since 6 April 2025 the interest rate is 4% above base rate, so a substantial additional cost may be levied.

Further complexities

There are a variety of further complexities within this process. These include

Illiquid assets: Timescales will be more problematic if schemes contain illiquid assets. Providing a date of death valuation within four weeks may not be straightforward. And there may be practical difficulties if there aren't sufficient realisable assets in the pension to pay the IHT bill but a PR or pension beneficiary requests this to happen. We have asked HMRC to consider this issue and provide some guidance.

Changes to assets: It is not uncommon for PRs to discover additional pension or non-pension assets at a later date. Or for there to be a change to the date of death valuation of an asset. In either case the IHT calculated may need to be recalculated and this will require a reconciliation exercise which may affect pensions and other assets. This could involve HMRC requiring additional tax to be paid, or it making a refund of overpaid tax to PRs and pension beneficiaries.

Tax implications

These proposals will include pension wealth within the estate for IHT purposes. The current income tax treatment of pensions remains the same. So for deaths before age 75 there is no income tax – providing benefits are paid within the two-year timeframe and don't exceed the individual's remaining LSDBA if paid as a lump sum – but there could be IHT.

For deaths on or after age 75 there could be IHT and income tax to pay.

And for some the inclusion of pensions in the estate could mean the loss of the residential nil rate band which is tapered once the net estate exceeds £2m.

This means effective tax rates will often be 50%-60% where death is after age 75 and the estate exceeds the nil rate band. And potentially as much as 90% in extreme cases.

Death under age 75	Recipient		
	Spouse or civil partner	Other individual e.g. child	Bypass Trust
IHT? ¹	No	Yes	Yes
Income tax? ²	No	No	No
Potential effective total tax ³	Zero	Up to 40%	Up to 40%

Death on or after age 75	Recipient		
	Spouse or civil partner	Other individual e.g. child	Bypass Trust
IHT? ¹	No	Yes	Yes
Income tax? ²	Yes, at beneficiary's marginal rate	Yes, at beneficiary's marginal rate	Yes at 45%
Potential effective total tax ³	Likely 20%-45%	Likely 40% - 67%	Likely 45% - 67%

¹ IHT only payable on excess pension above the nil rate band allocated to pension.

² 'No' is only if paid within two-year window and only up to remaining LSDBA if paid as a lump sum. Otherwise some income tax will be due and Scottish rates of income tax may differ.

³ potentially more if residential nil rate band is reduced or lost entirely.

Vulnerable customers

Those who have recently experienced the death of a family member are more likely to display characteristics of vulnerability. Especially as many may also have concerns or issues around future financial security. Together this means these individuals may be at greater risk of harm and be more susceptible to behavioural biases.

Including pensions with the estate for IHT is likely to drive behaviour which focuses on speed of process – given the six-month window – at the expense of client understanding, and client support. Ideally, firms will have customer service that responds flexibly to the needs of vulnerable consumers. And for some bereaved clients that may mean taking slightly more time to understand and consider options, rather than rushing into decisions. Overall, this process with its very tight deadlines and financial penalties doesn't fit well with the support firms may want to provide to vulnerable customers.

Planning

None of this is easy and none of it will help beneficiaries receive money quickly. The one small glimmer of light is if benefits are paid to a spouse or civil partner, then schemes should be able to pay benefits more quickly.

The revised process imposes a significant amount of additional complex work on PRs. Many more will need to take legal or tax advice which obviously comes at a cost, reducing the amount beneficiaries will inherit. But does create an opportunity for advisers to work closely with solicitors and other professional connections to jointly help families.

Consolidation to as few schemes as possible in advance of death (and potentially as few beneficiaries as possible) may be the order of the day moving forwards, to try and avoid more family disputes.

The inclusion of unused pensions in the estate and having this subject to IHT could have a significant impact on the wider financial

arrangements of those who are affected. Wills and savings plans may need to be reorganised. Planned sources of retirement income may need to be altered. For example, taking tax-free cash around age 75, which means that (at worst) that amount is only subject to IHT, rather than IHT and income tax.

For those with greater wealth, for the last ten years pensions have often been one of the last options used to generate income. Other wrappers have been accessed first with pensions left until last due to their IHT efficiency. If these proposals are introduced, then that will change. Although to what degree will depend on the client's circumstances. For those who were going to use most of their pension wealth to provide a retirement income, it is likely to be tweaks to that set up. For those who were primarily using pensions to cascade wealth to the next generation, greater changes may be needed.

For those higher net worth people, taking more from the pension at a younger age may be an option. But the key is then what happens to that money in terms of IHT planning. In simple terms, the withdrawals need to be spent, sheltered or gifted - or there was little IHT benefit in making the withdrawals.

Greater use of trusts seems likely. Loan trusts, gift trusts and discounted gift trusts may all have a part to play depending on the client's circumstances, needs and priorities. And within those, holding an investment bond as a non-income producing asset may be attractive.

Gifting to children, grandchildren and other family is also likely to be a key consideration. Whether that is directly giving funds, paying for costs such as school or university fees, or paying into a pension or ISA for those family members.

Others may wish to retain control of their pension and withdraw as and when it is needed. And set up a protection policy which will pay a lump sum following their death of an amount equivalent to the potential IHT exposure, allowing family to quickly and easily pay the IHT bill.

Or a joint life annuity may be a consideration as that won't fall within the estate. However, if the second life pre-deceases the member, then no benefits will be payable following death.

This is a very significant change for clients, and they will need help and assistance to work out the best option. Many clients will be unaffected, while many others will need to consider the best way to move forward. Knee-jerk decisions are unlikely to give the best outcome, rather helping clients take a considered approach based on their individual circumstances, their needs for their own later life as well as how and when they want to help family.

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