Pension death benefits: estate planning

Personal tax | Inheritance tax and trusts



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A major overhaul from April 2027 will bring most pension death benefits into the scope of inheritance tax.

Key Points

What is the issue?

From April 2027, most pension death benefits will become subject to inheritance tax, removing their longstanding exemption and potentially exposing beneficiaries to combined inheritance and income tax rates exceeding 60%. This marks a major shift in estate planning, requiring individuals to reassess how pensions fit into their wider inheritance strategy.

What does it mean to me?

Pensions can no longer be relied on as an efficient means of passing on wealth, as the value of unused funds will now form part of the taxable estate. Advisors will need to help clients manage exposure by reviewing nominations, updating wills and considering alternative ways to distribute or spend pension savings during their lifetime.

What can I take away?

Proactive planning is essential, particularly for those with large pension pots, complex family arrangements or business property held within pension schemes.

At the 2024 Budget, the government announced that from 6 April 2027 inheritance tax would be extended to cover most pension death benefits. This is a significant change that will remove the effective exemption for pensions from inheritance tax. It will affect most individuals with unused benefits at the time of their death.

A consultation on the changes closed in the summer of 2025 and, following some further changes announced in the recent Budget, draft legislation can now be found in the Finance (No. 2) Bill 2025-26. There are still questions regarding the operation of the new rules, and any advice at this stage must be given with the appropriate caveats. However, there are some practical steps that individuals can take to prepare for these changes.

Overview of the changes

The changes to the taxation of pensions were covered in ‘Pensions and inheritance tax: revisiting assumptions’ by Harriet Betteridge (*Tax Adviser*, November 2025) and readers are referred to this for a detailed account of the new rules. What follows here is a brief summary.

Most pensions provide that any unused benefits can be paid to a beneficiary after the pension holder has died. These death benefits are usually held on a discretionary trust, and it is a matter for the pension trustee to decide how the death benefits will be distributed. The pension holder can write a letter of wishes which nominates an individual to receive the death benefits but this is normally non-binding – and hence outside the pension holder’s estate for inheritance tax purposes.

Death benefits paid to a beneficiary are normally taxed as the beneficiary's income (provided the pension holder was not under 75 when they died), meaning that the only tax charged is income tax at the beneficiary's marginal rate.

From 6 April 2027, the value of these death benefits will be included within the pension holder's estate. In the same way that certain interests in possession can be aggregated with a free estate, the 'pension estate' will also be aggregated with an individual's free estate, and their nil rate band will be shared proportionately. While there will be inheritance tax on the pension fund, any remaining death benefits will still be subject to income tax when they are paid out to the beneficiary.

The combination of inheritance tax and income tax will mean that the effective rate of tax on death benefits can be significant. Take the example of an individual who dies (aged 75 or over) after 6 April 2027, and who has a free estate worth £1 million and an unused pension worth £1 million. The taxable estate is therefore worth £2 million and (after deduction of the general and residence nil rate bands worth £500,000) tax at 40% will result in inheritance tax of £600,000. Half of this tax (£300,000) will ultimately fall on the pension fund, with the other half on the free estate.

The most controversial aspect of the new rules is that the primary liability for paying the tax will fall on the personal representatives who can then seek reimbursement from the beneficiary of the pension death benefit. A change announced at the Budget is that the personal representatives will be able to compel the pension scheme administrator to retain up to 50% of the death benefits for up to 15 months – the aim being that this retained fund can be used to pay the tax attributable to the pension.

As noted above, any remaining death benefits will still be subject to income tax. In the example above, after deduction of the inheritance tax, there is still £700,000 to be paid to the beneficiary. If paid as a lump sum, this is likely to be subject to income tax at 45%, resulting in a further £315,000 of tax. From the original £1 million pension fund, the beneficiary of the death benefit may only receive around £385,000 and will suffer an effective tax rate of over 60%.

Planning for the changes

The combination of inheritance tax and income tax on death benefits means that pensions are no longer an effective vehicle for estate planning. What advice can be given to clients to mitigate the impact of these changes?

Spending and gifting

For most people, the appropriate advice will be to spend their pension to fund their retirement; they should be discouraged from leaving unused funds in their pension at the time of their death. For many, this will mean taking the slightly old-fashioned approach of using the pension to purchase an annuity. This will provide a guaranteed income and avoid leaving significant sums untouched within the pension.

Of course, not all individuals need to access their pension in order to fund their retirement, as many will have other investments and assets that they can live off. In such cases, they should still be encouraged to make withdrawals from their pension, even if only to make gifts to their children and grandchildren.

This might be done in a tax-efficient way. Pension payments are taxed as income and, if the client does not need this income to maintain their normal standard of living, then payments made to the children may constitute normal expenditure out of income. If this applies, such payments would be exempt without limit from inheritance tax.

Moreover, if the children receiving these gifts contribute the payments to their own pension funds, they may – depending on their personal circumstances – be able to claim income tax reliefs that could help to offset the income tax paid on the withdrawal.

Alternatives to making gifts to children include funding a discretionary trust or paying into a life policy that can be written into trust. Again, provided that these payments qualify as normal expenditure out of income, they should not trigger any inheritance tax.

Spousal exemption

Death benefits that are payable under a pension scheme to a member’s spouse or civil partner will fall within the spousal exemption from inheritance tax. The draft rules on this are complex and further guidance from HMRC is required, particularly

for cases where spouses receive limited rights, such as an interest in possession under a bypass trust. While these questions remain, it will generally be the case that if pension death benefits are paid to a surviving spouse, then no inheritance tax will be due on the pension death benefits.

Individuals should review and, if necessary, update their death benefit nomination. In most cases, it will be a simple matter of expressing a wish to leave all death benefits to a surviving spouse, but some may wish to provide more detailed instructions.

If any nil rate band remains available, the nomination may express a wish to pay an amount within that band to the children, with the balance passing to the spouse.

In addition to the spousal exemption, the charitable exemption will also apply to death benefits and again clients may wish to update their nomination letter to include charities.

While it will be possible to exempt pension death benefits from inheritance tax by paying sums to charity, what is less clear is whether the reduced rate of inheritance tax can be obtained in this way. This should be possible but there is no express reference to this in the draft rules and clarification is needed from HMRC.

Residence nil rate band

Individuals will need to be mindful of the impact of the new rules on the availability of the residence nil rate band which, when combined with a spouse’s unused allowance, can provide an additional £350,000 of nil rate band in a death estate. The allowance starts to be restricted for estates worth more than £2 million and is lost entirely once the estate is worth more than £2.7 million.

As pension death benefits will now be treated as part of the death estate, the value of the pension will be taken into account when determining whether the residence nil rate band is subject to tapering. Some people may have structured their affairs so that their estate falls below the £2 million threshold without taking into consideration the value of their pensions.

Where individuals are at risk of losing the residence nil rate band because of the value of their pensions, they might be encouraged to make gifts to their children, ideally from their pension fund, to bring the net value back below £2 million. While

there is a risk that the payment could be taxed as a failed gift (unless it qualifies as normal expenditure out of income), this strategy can at least ensure that the residence nil rate band is preserved.

Reviewing wills

A further problem may arise where wills leave the residue of the estate to the spouse, and also provide specific gifts or pecuniary legacies to children or other non-exempt beneficiaries. Wills may have been structured in this way in the expectation that the full nil rate band will cover the specific gifts and legacies. However, as the pension death benefits will now utilise a proportion of the nil rate band, the testator may have less nil rate band available for their free estate than they initially thought.

The sharing of the nil rate band with the pension death benefits may therefore have significant consequences. Where a testator leaves a pecuniary legacy to a child with the residue passing to their spouse, if there is insufficient nil rate band to cover the legacy (because it is now shared with the pension) then the chargeable part of the legacy will need to be grossed up before it is taxed. This may leave estates with far more inheritance tax to pay than envisaged.

A better approach in such cases is not to leave a specific sum to a child, but instead to leave ‘such sum as is equivalent to my available nil rate band’. A nil rate band discretionary trust may also be appropriate for clients in such cases.

Of course, the amount of nil rate band that is available to the free estate will depend upon how the pension death benefits are distributed. One option for those who wish to ensure co-ordination would be to appoint their executors as the trustees of a spousal bypass trust that receives the pension death benefits. In this way, the same individuals can decide how both funds should be distributed.

High risk cases

In addition to the planning strategies outlined above, there are certain situations that may be considered high risk in light of the changes to pension taxation. Advisors may wish to review matters carefully in the following two cases.

Divorced clients

Advisors should take particular care when advising clients who have been divorced and remarried. While divorce automatically revokes a will, it does not revoke a death benefit nomination. If a client had entered a pension scheme when married to their first spouse, that first spouse is likely to remain as the main beneficiary of the death benefits. This can often result in the first spouse receiving the pension, while a second spouse receives the free estate.

This situation is obviously unattractive for tax purposes, as the spousal exemption will not apply to the first spouse. Furthermore, this is like to result in friction between the executors and the pension trustees.

Under the rules, the starting point is that all of the tax will be paid from the free estate (i.e. at the expense of the second spouse) with the executors then needing to seek reimbursement from the beneficiary of the pension fund (i.e. the first spouse). In complex family situations, where tensions can already run high, claiming such reimbursement may prove contentious.

Where a client has been divorced, they should be encouraged to review their death benefit nomination as a matter of urgency. It would be preferable, both for tax and administrative purposes, to remove a former spouse as a beneficiary of the death benefits. If the client still wishes to make provision for a former spouse, this is better done by way of a legacy under the will.

Business property in a self-invested personal pension

For individuals with a trading business, it has been common practice to transfer property from the business into a pension fund (usually a self-invested personal pension or a small self-administered scheme). If the pension fund owns the freehold to the land on which the business is run, the business can then pay rent to the pension fund for its use. This can provide corporation tax advantages for the business, and the income and capital growth is tax free within the pension.

For older business owners who have arrangements of this nature, the proposed changes will create a significant exposure to inheritance tax. The value of the business properties held within the pension will be taxed at 40% on death, meaning that – unless there are large cash reserves to pay the tax – it may be necessary to sell the properties, potentially placing the business at risk.

No business or agricultural property relief is available for assets held within a pension. This is particularly unfortunate, as the properties might have qualified for relief had they remained within the business.

In such cases, individuals should explore whether it is possible for the properties to be purchased back from the pension and reintegrated into the business.

In conclusion

The changes to pension taxation will create several challenges for advisers and taxpayers, but there are certain steps that individuals can take to mitigate their impact. For most, the best advice will be to use their pension for its original purpose – namely, to fund their retirement. Problems will only arise where there are significant funds that remain untouched at the time of death.

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