‘Important Update: New IHT Rules on Pensions and the Consequences’

In the run up to the General Election on 4th July 2024, it was widely expected and feared by many, that if the Labour party came to power that taxes on both individuals and businesses would increase. Fast forward a few months and this has somewhat been the case.

During her Autumn Budget speech on 30th October 2024, Chancellor Rachel Reeves introduced tax increases despite promising ‘not to increase taxes on working people’. Whilst direct taxes have not been increased such as Income Tax, National Insurance or VAT (Value Added Tax), other indirect taxes such as Capital Gains Tax have been increased (from 10% & 20% to 18% & 24%).

It was also announced that employer’s National Insurance contributions would increase, which could add further a financial burden to companies, particularly in the private sector.

The Chancellor has made these changes in order to address the alleged ‘£22 billion’ black hole left by the Conservative government, and also to increase the government’s revenue in order to try and reduce the country’s national debt over time. So in other words, the government are unlikely to allow people to grow their assets without paying tax in the process.

The New Rules

As part of the Autumn Budget Statement, a particularly important change occurred – from 6th April 2027 the value of any Defined Contribution or Personal Pensions that you still have on death, along with Pension Lump Sum death benefits will now form part of your estate for Inheritance Tax (IHT) purposes. Previously, your pension pot(s) sat outside your estate and so upon your death would not have been subject to the 40% IHT charge.

From April 2027 this will no longer be the case and your pension pot(s) will be included in your estate and become subject to IHT. Although the change is only expected to impact less than 10% of estates each year, this is still a significant number of people who will be affected and this figure will more than likely grow; therefore it is important that individuals re-assess their financial position in order to ensure that on their death they are being tax-efficient.

Understanding the Details

However, it is worth pointing out that your pension pot(s) will only be subject to the 40% IHT charge if your overall net worth (bank accounts, investments, properties and pension pots) on death is more than £325,000, which is the current IHT threshold.

- Currently, individuals have a Nil Rate Band (NRB) of £325,000. What this means is that upon your death the first £325,000 of your estate is not subject to IHT, with any residual estate above this being subject to the 40% charge.
- There is also the £175,000 Residence Nil Rate Band (RNRB) which is applied to your main residence. This means that the first £175,000 of your house value is not subject to the 40% IHT charge (but this only applies if the property is left to direct descendants). The RNRB is clawed back at a rate of £1 for every £2 where the net value of your estate exceeds £2 million.

The Chancellor, Rachel Reeves, also announced that the current NRB will be frozen until 2030, two years longer than it had originally been frozen to. As an example of how more and more people will become liable to the IHT charge - if your estate is worth £400,000 currently your IHT charge would be £30,000. If your estate grows at 5% per annum until 2030 then it would be worth £510,500 by that point but if you also have a pension fund of £200,000 then it would be worth £710,500. The £325,000 NRB won't have increased at all so your IHT charge in 2030 would be £154,200.

To make matters worse, this new "Pensions Inheritance Tax" change could mean your pension is effectively 'double taxed'.

- Currently, if you were to die prior to the age of 75, your pensions would pass to your beneficiaries (children, family etc) tax free.
- If you were to die over the age of 75, then your pension would become liable to income tax at the beneficiaries' marginal rate of income tax at 20%, 40% or 45% when they draw money from it.

From April 2027 if you die after the age of 75 your remaining pension could become liable to both the 40% IHT charge plus the income tax charge on your beneficiaries when they took the money from your pension pot. For a higher rate (40%) Income Tax paying beneficiary this could work out to be an effective tax rate on your pension pot of 64%! For any estates worth more than £2 million this would be further exacerbated due to the gradual reduction in the RNRB (Residence Nil Rate Band).

Managing your Potential IHT Issue

Here at Fogwill & Jones we can help. There are still ways in which you can mitigate the consequences of your pension forming part of your estate and paying Inheritance Tax which our friendly, expert financial advisers would be able to advise you on and help you with. Some of the ways that can be utilised are:

- Spending your money
- Gifting

With regards to gifting, individuals have an annual allowance of £3,000 (which can be carried over from the previous year if unused, becoming £6,000) in which they can give away money tax-free.

Additionally, smaller gifts of up to £250 can be given to as many people as required each year and remain tax-free. This smaller gifts allowance cannot be combined with the £3,000 allowance. There are also special allowances that exist for gifting money for weddings or children's living costs.

Also, you can gift money out of your surplus income. This is slightly more complex however, and it would be best to consult a professional before doing so.

Lastly, gifts to charity are exempt from the IHT charge. If at least 10% of your estate is left to charity then the IHT charge that you will pay will be reduced from 40% down to 36%.

It is highly recommended that individuals keep a record of all gifts that they make so that upon death it is far easier for the personal representatives of the deceased to submit the relevant information.

We Can Help

The UK has one of the most complex tax systems in the world and so it is vital that individuals regularly check in with finance professionals to ensure that they are being tax-efficient and also abiding by the rules. The new rules on IHT for pensions only further complicates the tax landscape of the UK. Going forward, upon a person's death, their personal representatives will need to liaise with the deceased's pension scheme provider and His Majesty's Revenue and Customs (HMRC) in order to ensure that any IHT charges that are due are paid within six months from the date of death.

Individuals attempting to deal with a deceased person's estate and arranging payments of tax to HMRC are far more likely to be hit with a fine for missing information required or submitting the wrong information by mistake, or not adhering to legal time scales; so it really is crucial that experts in this area are sought!

In order to make things easier for you, our sister company, Fogwill & Jones Legal Services which provides services for Wills, Trusts & Estates (probate) can help when it comes to liaising with HMRC and arranging to settle any potential IHT liability that you may have. We have years of experience doing this highly specialised work and know the fine line between tax avoidance (legal) and tax evasion (illegal), which means we could create tax savings for you and hopefully reduce your IHT charge.

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