What is the 67% inheritance tax trap on pensions - and can you avoid it?

Under current proposals, unused pension savings will fall under the inheritance tax (IHT) regime from April 2027, after changes announced by Chancellor Rachael Reeves in the 2024 UK Budget. In some cases, this could see some beneficiaries paying an incredible effective rate of tax of 67%.

The blame lies with dual taxation. Unless the original pension scheme holder died before age 75, on top of any IHT liability, beneficiaries will face income tax on pension withdrawals that exceed their personal allowance.

Due to the way the tax is deducted, this will create an effective tax rate of 52% for basic-rate taxpayers, 64% for higher-rate taxpayers, and 67% for additional-rate taxpayers.

Where a pension worth £100,000 is inherited from someone who had already used up their nil-rate band on other assets, you would be hit with a 40% IHT bill, reducing the value of the pot down to £60,000.

Any withdrawals from this remaining £60,000 would then be taxed at marginal rate – 20% for basic-rate taxpayers, 40% for higher-rate taxpayers and 45% for additional-rate taxpayers.

- Basic-rate taxpayers: 20% of £60,000 is £12,000, so you would be left with £48,000 after tax or 52p in every pound.
- Higher-rate taxpayers: 40% of £60,000 is £24,000, so you would be left with £36,000 after tax, or 64p in every pound.
- Additional-rate taxpayers: 45% of £60,000 is £27,000, so you would be left with £33,000 after tax, or 67p in every pound.

As this illustrates, the proposed IHT changes could have significant implications for estate planning. Pensions will likely go from being one of the most tax-efficient vehicles for IHT planning to potentially one of the least efficient in 2027.

Additionally, those with an estate close to £2m should be particularly careful, as you start to lose the residential nil-rate band at this point. This is worth £175,000 and can be used alongside the regular £325,000 nil-rate band if you are leaving the family home to a direct descendant. Thus, if you are close to the £2m threshold, any pension assets could push a client over this threshold once the proposed new rules kick in from April 2027.

Against this backdrop, more clients are seeking advice as to what options are available to mitigate any tax payable in the future. I am certain that many of you will have had conversations with clients about pension IHT changes since the Autumn Budget.

Gifting is one option that might be considered, with increasing their pension withdrawals to give away more money to loved ones before they die. Similarly, the annual gifting allowances can be used too – usually £3,000 per year – or making larger gifts as a PET that could become exempt from inheritance tax after seven years.

Those in retirement need also to weigh up which assets to draw down first, and which tax wrappers to contribute to in the first place. Drawing on ISA funds before a pension used to be an obvious route, as pensions were exempt from inheritance tax while ISAs were not. However, the upcoming changes have now complicated this picture.

If clients are comfortable that they will have excess savings left over after death, considering an increase in pension spending is one strategy now being looked at seriously. This could allow them to leave other assets like ISAs untouched, which could then be given as part of a Will to beneficiaries instead of the pension after death.

Like pensions, ISAs are still subject to IHT but nominated beneficiaries won't have to pay income tax when they withdraw money from an inherited ISA. This could be particularly beneficial if they are an additional-rate taxpayer, likely to fall victim to the 67% tax trap.

As introduced previously, you could also consider giving some of your pension wealth away in your lifetime to reduce your IHT bill. There are strict rules around gift-giving, but everyone has an annual gifting allowance of £3,000. Anything more than this, and you will usually need to outlive the gift by seven years to avoid IHT.

All in all, this new legislation creates an uncertain situation – clients should be careful not to access excess pension fund as income, as nobody knows how long they will live and it is important to consider other potential future expense needs, like the cost of care.

With increasing conversations around gifting and helping clients to understand the optimum time to transfer assets to the next generation, it is not surprising that this is now in focus with clients and advisers alike. Access, to a multi-wrapper (GIA/ISA/UK SIPP) international platform solution, like Novia Global is therefore essential, to ensure that advisers can implement flexible recommendations for their clients.