



INSIGHTS

IHT on Pensions – the new reality and decisions ahead

The inheritance tax treatment of pension wealth has undergone a fundamental and far-reaching change.



26 JANUARY 2026
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Following the latest Budget, there has been a collective sense of relief that some of the more extreme measures trailed in advance — wealth taxes, exit charges and similar proposals — did not ultimately make their way into legislation. However, that relief should not be mistaken for a return to the status quo. While confidence was undoubtedly damaged by the pre-Budget whispering campaign and selective leaks, the reality is that one of the most significant changes to long-established estate planning assumptions has already been set in motion: pensions are no longer sacrosanct from inheritance tax.

With draft legislation now published and implementation dates approaching, the focus has shifted decisively from speculation to understanding how the new rules will operate in practice — and, critically, what practical steps individuals may need to consider in response.

Unfortunately, in many cases work is still needed to deal with the seismic changes from the October 2024 Budget. Not least the raid on pension funds, which are no longer outside the scope of Inheritance Tax. So, where do we stand?



TRIDENT TAX



How will the changes work?

The government has published the draft legislation for the new IHT charge on pension funds. We can see how the charges are intended to work subject to any amendments that may follow. The changes will come into force from 6 April 2027.

The intention is for IHT to apply to a member's pension fund on their death when it transfers to a beneficiary, subject to spousal relief and relief for charitable gifts. Consequently, where the member is married or in a civil partnership, the IHT charge will only apply on the second death net of any amount gifted to charity.



The sting, and it is a significant sting that is causing considerable resentment, is that subsequent payments out of the pension fund (net of IHT) will still be subject to Income Tax.

On an unused pension fund of £500,000, the tax bill on pensions subsequently paid to a higher rate beneficiary would be £200,000 under the current legislation; an effective tax rate of 40%.

From April 2027, £200,000 will be paid in IHT and the remaining £300,000 would be chargeable to

income tax at 40%, resulting in an overall tax burden of 64%. If the recipient of the pension is an additional rate taxpayer, the effective tax rate increases to 67%.

Not all pensions are caught

The charge applies to:

- ▶ Registered pension schemes
- ▶ Qualifying non-UK pension schemes (QNUPS)
- ▶ Section 615 schemes (specific schemes for non-resident employees of a UK employer)

The charge will reach most but not all pension arrangements. For example, all Qualifying Registered Overseas Pension Schemes also met the definition of a QNUPS up until 5 April 2017 but that is not automatically the case since then and each non-UK scheme should be considered on its own merits.

Unregistered UK schemes and any non-UK schemes that do not qualify as a QNUPS will not be within scope of the new charge, including non-UK Employer-Financed Retirement Benefit Schemes ("EFRBS"). EFRBS were often associated with PAYE avoidance planning ("disguised remuneration"), but some were established as genuine pension arrangements and are therefore outside the scope of the disguised remuneration income tax charging provisions.



Not all payments are caught

Pensions payable to “*dependants*” (i.e. spouses and dependent children of the scheme member) and death in service benefits payable from a registered pension scheme, a QNUPS or a Section 615 scheme are excluded from the new IHT charge.

This offers some good news, but the exclusions are unlikely to offer sufficient comfort for clients to avoid the need for any post-6 April 2027 planning.

Take the long view and crunch the numbers

We need to be mindful that pensions still offer significant opportunities for reducing income tax and corporation tax liabilities while growing funds in a tax-free environment. That compounded tax-free growth can deliver a much better return over time than financial assets held personally by a client.



A key consideration is how much of a pension fund will be required by the client for his or her retirement, how much might be surplus to such requirement and what that will mean to the forecast value of a client’s estate. Will the compounded, tax-free growth in the pension be enough to offset any additional IHT?

There may be relatively little IHT cost to a pension fund where a couple own property of only modest value and are able to rely on a combined nil rate band of £1 million to shelter all or most of their estate from IHT charges.

However, the analysis can change significantly where the value of a joint estate without the pension fund is materially more than **£1 million** and particularly if the value of a joint estate is above **£2 million** (when the residence nil rate band is subject to reduction and possible elimination).

Extracting a tax-free lump sum and gifting that out of the member’s estate may alter the numbers to generate a significant saving in the overall calculation of IHT brought into charge, particularly if such a strategy is combined with making regular gifts out of future pension income that is surplus to the scheme member’s cost of living requirements.

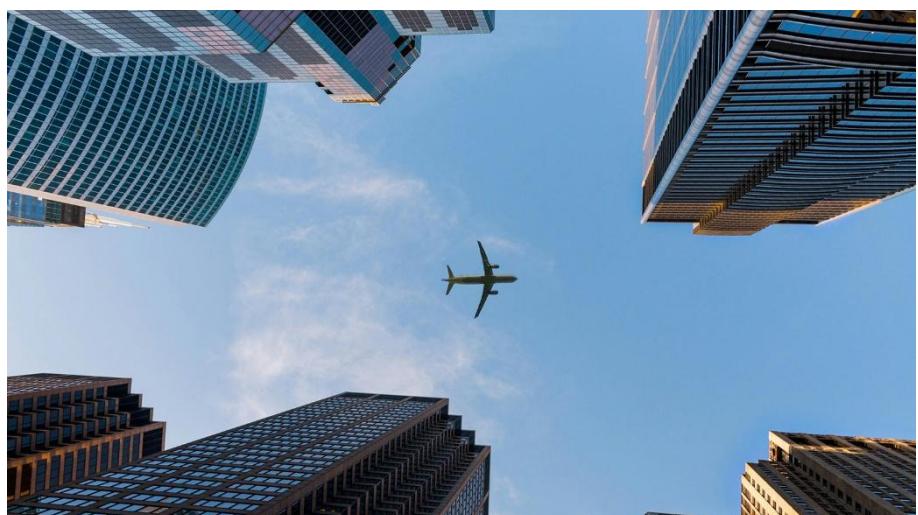
Nevertheless, there will be many who will suffer IHT at **40%** on their pensions but also suffer a further IHT cost of **£140k** through the loss of combined spousal residence nil rate bands. We must also remember that anything left will be charged to income tax as explained above.



The nuclear option

An individual caught in the cross hairs of the new provisions can look to become non-resident in a “*favourable tax jurisdiction*” (i.e. one with materially lower income tax rates and a beneficial double taxation agreement with the UK in relation to pensions). Once they are no longer UK tax resident, they may be able to withdraw their pension in a single lump sum without UK tax being payable and suffer a materially lower rate of tax in their new jurisdiction.

However, one potential risk is that the pension will be within the scope of the UK’s temporary non-residence rules. The individual will need to remain non-UK tax resident for more than five years, which usually means six full tax years, otherwise they will be liable to income tax on the pension drawn while abroad in the tax year they return to the UK.



SHOULD THEY RETURN TO THE UK AFTER THE PERIOD OF TEMPORARY NON-RESIDENCE HAS EXPIRED, THE VALUE EXTRACTED FROM THE PENSION WILL BE IN THEIR ESTATE FOR IHT BUT AT LEAST THE DOUBLE DIP OF IHT AND INCOME TAX WILL HAVE BEEN AVOIDED. THE INDIVIDUAL CAN ALSO PLAN TO MITIGATE THE IHT ON THE VALUE OF THE PENSION THROUGH GIFTING, ETC.

A case study on how the new IHT charge will mean less tax revenue overall

A company sold its business premises now worth £8 million to a SSAS pension arrangement established for the benefit of the managing director and his wife. Separating the premises from the trading entity made commercial sense despite the SDLT cost involved as it would be protected from any potential claims or extraordinary losses. The property was also outside the director’s estate for IHT, but the value of the property would be charged to income tax when it was paid out as a pension. Standard tax planning that has been used for decades. A year later, the government announced the new IHT charge on pensions.

In this case, the director has taken “*the nuclear option*” and will leave the UK. Significantly, they will now become non-UK resident before they sell their business. Previously, they planned to remain UK tax resident and would have paid capital gains tax on any gains they made on the sale of the business.

So, what taxes will the government lose in this case as a consequence of the new IHT charge?



- ▶ The income tax on the £8 million pension fund. The director will remain non-UK resident for at least six years.
- ▶ The capital gains tax on the sale of the business. The six years of non-UK residence also prevents any capital gains tax recovery.
- ▶ The income tax or capital gains tax on the investment income that the £8m pension lump sum and the proceeds from the sale of the business will make in the future.

The sting in the tail is that, once they have been non-UK resident for six years, they may as well stay non-UK resident for ten years and fall outside the charge to IHT completely. Which sadly, is now the plan.

Way forward

The consequences of the changes will vary from client to client. We will need to identify those who are affected and understand the consequences for them. The already difficult conversations about how to mitigate any potential exposure to IHT will now be even more complicated.

Assets and property that would previously have been left to the next generation may now need to be sold as part of a strategy to mitigate additional IHT on pensions, including the possibility of leaving the UK, whether permanently or at least for a period of 6 (and maybe 10) tax years.

Want to know more?



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