Briefing for private client solicitors

Lumin
VZ Group

Can an annuity help fund life insurance for an Inheritance Tax bill?

This briefing outlines an alternative financial planning structure for legal professionals to consider with clients as part of their wider estate planning, in light of changes to the Inheritance Tax treatment of unused Defined Contribution pensions from April 2027.

The problem

From April 2027, pensions brought into a client's estate on death may be exposed to both 40% Inheritance Tax (IHT) and up to 45% income tax on withdrawal by beneficiaries – a combined effective rate of up to 67% in the worst case. For clients who have relied on pensions as a tax-efficient wrapper to pass wealth to the next generation, this represents a material change to their planning position.

A two-part structure

Two complementary tools, used together, can convert exposed pension wealth into a more robust legacy plan:

- **Whole-of-life policy written in trust:** Pays a tax-free lump sum on death, outside probate, sized to meet all or part of the projected IHT liability. Premiums are individually underwritten by reference to age, health and personal circumstances.
- **Lifetime annuity:** After any available tax-free cash, some or all of the residual pension is exchanged for a guaranteed income for life, calibrated to meet the ongoing life insurance premiums without drawing on the client's day-to-day income.

Inheritance outcome comparison: Keep pension invested vs annuitise £400,000

Assumptions: 65-year-old single basic-rate taxpayer with an £800,000 pension fund, growing at 4.5% annually and in good health.

Basic rate tax	Do nothing	Annuitise £400,000
Pension at 65	£800,000	£400,000
Value age 85	£1,929,371	£964,686
After 40% IHT	£1,157,623	£578,811
Whole of Life payout	£0	£1,156,521
Total to beneficiaries	£1,157,623	£1,735,332
Additional inheritance		£577,710

Illustrative only, not a prediction. Growth, tax rates and terms are not guaranteed.

Source: Lumin Wealth (quotes taken from Iress)

In effect, pension capital that would otherwise be exposed to IHT is converted into a guaranteed income stream that funds the insurance premium – addressing the liability during the client's lifetime rather than leaving it to the estate. The policy and annuity should be arranged with separate providers and underwritten independently of one another.

Points for solicitors to consider

- Annuity purchase is irreversible –The capital cannot be recovered, and income typically ceases on death unless a spouse's or dependant's pension has been selected.
- Where the annuity is purchased using the taxable element of a pension, income is taxed at the client's marginal rate, reducing the net amount available for premiums and living costs.
- Whole-of-life premiums and annuity rates depend on age, health and prevailing market conditions, so suitability is client-specific and requires individual advice.
- The strategy typically works best as one strand of a wider estate plan – alongside lifetime gifting, trust structures and other available strategies – rather than as a standalone solution.
- Both the policy and the annuity require independent underwriting with separate providers, and should be arranged only following individual, regulated financial advice.

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