Pension gifting

Ian Boasman discusses the continued importance of gifting allowances

The recent Budget threw up some surprising announcements and has, so far, created a big stir in the UK, not least with the potential for pensions to be brought into the Inheritance Tax (IHT) calculation. I say 'potential' because the Government have allowed themselves a little time to prepare for this change given the already complex nature of pensions and the impact it will have.

With this change in mind, the playing field for IHT planning becomes even narrower.

Outside of the main mitigation strategies of spending your wealth and gifting money outright, pensions have been one of the key tools over the years of ensuring assets are passed on efficiently to loved ones. They were a way of gifting money to future generations while keeping access and control until death, which made them super attractive.

However, from April 2027, pensions will form part of an individual's estate and incur IHT at 40% should that individual (or couple) exceed their nil rate bands (£325,000 each) and main residency nil rate bands (up to £175,000 each) for 2024/25. If that pensioner also dies after age 75, additional income tax at the recipient's marginal rate will also be incurred when they draw funds. As a result, that important access and control now should be weighed up and compared to the potential heavier taxation that will be incurred on death.

Most notably, it is this additional income tax post-75 that seems most excessive in addition to 40% IHT. So how can we help mitigate this problem early on?

Gifts out of regular income

Many will be aware of the rule of making gifts, and aside from the larger capital gifts that take seven years to fall out of your estate for IHT, smaller gifting allowances are available for immediate exemption. For example, an individual can make a capital gift of £3,000 per annum without worrying about the seven-year rule, which turns to £6,000 if you haven't used the previous year's allowance.

There are also gifts for weddings/civil partnerships (£5,000 for a child, £2,500 for grandchildren and £1,000 to anyone) and small, one-off gifts of £250. Further details of these can be found on the HMRC website – www.gov.uk/inheritance-tax/gifts. There is also a rule which allows an individual to regularly gift income that is not being spent, providing that it does not affect their day-to-day standard of living.

The types of income that qualify for this are:

- Employed or self-employed earnings
- Rents from property
- Dividends
- Interest
- Pension income

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As expenditure reduces in retirement with no mortgage and work travel, most become basic rate tax-payers, with income mainly coming in from the above sources. Hopefully, individuals will have structured income from the above carefully and as a result could have more of their basic rate income tax threshold remaining to take advantage of. Should they consider drawing more from their pension at 20% income tax?

If so, this will obviously increase the income coming into the household, and something will need to be done with that money, rather than letting it accrue. They could spend it and enjoy a more luxurious lifestyle, which is one way of reducing IHT naturally. Alternatively, there is also the possibility of gifting it under the gifts out of regular income rule highlighted earlier.

Although this has been a standard rule for a long time, there is a good tax planning opportunity with this regular gift….

The beneficiaries who are nominated as part of that pension under the Expression of Wishes will likely draw that pot later in their life, hopefully after pensioner's death post-75. As mentioned earlier, this withdrawal will be liable to income tax at their marginal rate of tax, which could be 45% in some cases.

Why not set up a private pension for the beneficiary now, and use this regular increased income to fund their new pension pot?

They will receive income tax relief of 20% at source… based on their earnings and employment circumstances. On top of this, a further 20% or 25% relief if they happen to be higher or additional rate tax-payers.

Not only has the beneficiary received a boost to their own retirement savings, the 20% pension uplift in tax has replaced the 20% income tax charge the pensioner was hit with for drawing that money. They have then reduced their asset base for IHT purposes and reduced the need for the beneficiary to draw from that pot later on… because they now have their own pension to draw on.

This is very useful planning for grandchildren too. There is no minimum age to set up a pension and by contributing £2,880 (net) per year for a child, this will automatically be grossed up to £3,600 through tax relief, which is effectively 20% growth overnight. Continuing to fund a child's pension between age 0-18 will likely give them a significant boost later in life, if that pension is then invested wisely.

This is one simple but effective way to plan for IHT mitigation, but to also boost the pot your beneficiaries could accrue in the future, while reducing the impact of that income tax hit on death post age 75.

As everyone's circumstances are different, the suggestions above do not necessarily suit all and therefore, it is vital that clients engage with a reputable Chartered Financial Planner to ensure that the actions they take are appropriate to their personal circumstances.

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