Can you reduce your Inheritance Tax Bill through pension planning

We are currently waiting for draft legislation giving further detailed on changes to the taxation of pension lump sum death benefits.

There has been much publicity over the increased flexibilities on withdrawals for individuals, and we find the changes to the reduction in the so called pension “death tax” very interesting.

It is worth remembering that an individual can pay contributions into a pension scheme and receive their marginal rate of tax relief. For those with income over around £42,000 per annum this will be a minimum tax-relief of 40% and in some cases can be as much as 60%. At the same time there is no employer or employee national insurance on pension contributions and once invested in the pension they grow free of income and capital gains tax.

Use of the Flexibilities and Death Tax Reduction

Where affordable, an individual can contribute £40,000 per annum as a **gross** amount into their pension receiving tax relief. Crudely speaking, this means an individual can reduce their take home pay by around £2,000 per month over a twelve month period and see £40,000 in their pension.

This relief is further increased where an employer passes on national insurance saved, as is often the case for senior executives and, of course, applies to those running their own businesses.

It is also possible to “carry forward” up to three years allowances boosting the initial allowances to up to £190,000. We have seen some hypothetical examples where individuals have actually borrowed to increase their pre-retirement contributions; though this should be done with the utmost care.

As detailed above, a pension fund will grow free of income and capital gains tax and for those over the age of 55, an individual will be able to take out as much as they want, subject to relevant taxation from 6th April 2015. It is clear that taking the maximum possible withdrawal is not likely to be tax efficient and we would recommend that individuals, again where affordable, take 25% lump sums as if they were income over a period of time, and the remaining 75% of the fund is phased over a number of years to ensure the individual does not broach the £42,000 limit where 40% comes into payment. This makes it quite feasible for an individual to pay 15% income tax throughout their retirement. It should go without saying that the level of these withdrawals should be set at a level to be sustainable for a suitable period too.

Death Benefit

Where an individual dies before the age of 75 the new proposals are that they can either pass a lump sum as a pension fund to any individual, which could include children, grandchildren, or of course a dependant. The current requirement to pay only to a dependant will be removed.

The legislation allows for the individual receiving the benefit to also nominate a further death beneficiary which theoretically allows pension wealth to continue to cascade down many generations.

Where an individual reaches the age of 75, the death benefit taxation worsens, but as a pension is treated as income, a virtually unlimited amount would be able to be given from this income, in life without inheritance implications. To qualify for this exemption an individual needs to make these gifts regularly, and should not affect their standard of living. We would recommend an individual retains records showing their withdrawals, and evidencing the income, as well as proof of how the increased income for the pension has not affected their standard of living.

Summary

For wealthy individuals the ability to avoid 40% income tax, maybe more is extremely appealing. The increased freedoms of withdrawals removes one of the principal psychological objections to pension funds, as well as the improvement to death benefits which allows pension wealth to cascade down multiple generations without inheritance tax.

Where individuals live beyond the age of 75, which actuarially is quite likely, the pension can provide an income allowing them to make use of their gifts from normal expenditure allowance, again free of inheritance tax.

It is hard to see any savings asset which is as flexible, and tax efficient as a pension now is subject to an overall lifetime limit of £1.25 million per person within their lifetime.

Like all investments though, a pension may not be appropriate for all and we would recommend advice from a suitably qualified Financial Planner to see how pensions could be part of an holistic financial plan.