WKM planning strategies

Our client planning gems

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Lifetime Allowance Planning with an inheritance tax twist

The 2023 Budget announced that the Lifetime Allowance is to be overhauled but as the Finance Act is yet to document these changes, we feel the following planning has merit to be discussed and be aware of.

Having a large pension fund created from years of careful contributions and sacrificing immediate income, can be the Achilles heel of your financial plan.

There are multiple reasons for this:

1 The lure of tax-free cash. Most clients with large pension funds also have wealth in the non-pension environment, which is not as tax-privileged. Pension funds benefit from valuable tax exemptions for income, capital gains, and inheritance tax. The latter is less well known and would allow a meaningful amount of capital to form part of your legacy on death and be available as a lump sum for a spouse, parent, children, or non-family member). With careful planning, the funds will be exempt from inheritance tax. The only tax potentially paid by the beneficiary would be income tax on the withdrawals they make from the funds should the donor die after the age of 75. Death of the donor before age 75 will allow the beneficiary to with the funds from the pension scheme income tax-free. Any funds not drawn by the beneficiary can be passed to their beneficiaries on a never-ending basis, held as additional pension funds to their allowable lifetime allowance.

If the member withdraws tax-free cash to form part of their retirement income, this could increase their estate subject to inheritance tax on their death.

Inheritance tax is complex and beyond the scope of this article, but the following example illustrates where the best intentions can lead to compounded problems later in life.

Example

Description	Capital Value £
House Value	800,000
WKM ISAs	500,000
Cash	50,000
Private Pensions	1,000,000
Total	**2,350,000**

The client is married and based upon the above number the couple will benefit from a combined residence nil-rate band and a standard nil-rate band of £650,000 and £350,000 respectively, a combined total of £1,000,000.

At present the assets included in their estate for the inheritance tax calculation are as follows.

Description	Capital Value £
House Value	800,000
WKM ISAs	500,000
Cash	50,000
Total	**1,350,000**

The potential Inheritance tax (IHT) due would be **£140,000 (£1,350,000 - £1,00,000 = £350,000 at 40% = £140,000)**

The client has not drawn the 25% tax-free lump sum from their pensions but is considering doing so, which would provide them with £250,000 income and capital gains tax-free from the pension fund. If they draw this lump sum, their estate calculation on death changes as follows:

Description	Capital Value £
Tax-free cash drawn	250,000
House	800,000
WKM ISAs	500,000
Cash	50,000
Total	**1,600,000**

The potential inheritance tax due now is **£240,000 (£1,600,000 - £1,000,000 = £600,000 at 40% = £240,000)**

There is logically an argument that the clients will spend the tax-free cash during retirement and then draw an income from the remaining pension fund to supplement their ongoing income needs. Assuming an annual expenditure need to be funded from capital (excluding their State Pensions) of £50,000, it will take five years for the tax-free cash to be "spent" which will mean nothing is drawn from the pension fund nor importantly the ISAs. The ISAs will continue to grow.

When death occurs the additional growth of the ISAs will be added to their estate and taxed at 40%. This tactic, while initially tax efficient, becomes inheritance tax inefficient, a problem which will compound over the years if withdrawals are not made from the ISAs.

An alternative strategy would be to allow the pension fund to continue to grow but instead draw the £50,000 needed from the ISAs. This decreases the value of the ISAs and therefore decreases the overall inheritance tax liability. While the pension fund (under ordinary rules) cannot pay tax-free cash greater than 25% of the lifetime allowance its growth will be exempt from inheritance tax on death. Any excess above the lifetime allowance is taxable at 25% if left in the pension fund.

Further, the client should consider the compound growth of the tax-free cash inside the pension fund while it remains undrawn. While the pension fund is growing exempt from inheritance tax, the ISAs grow subject to inheritance tax. A 40% swing on the inheritance liability can be considerable.

Another strategy to think through is: could the tax-free cash be withdrawn and gifted early to the next generation on the basis that the remaining ISA and pension capital will be sufficient to cover the annual living costs? While the gift would be subject to the usual 7-year rule on potentially exempt transfers again it is worth considering as the donor can then enjoy the recipient with the funds earlier.

2 Lifetime allowance planning

Following on from the above should be lifetime allowance planning. When should you be concerned with your pension fund limit and when will it affect you.

The first set of rules to consider is the benefit crystallisation rules. Most notably we need to think about two in particular.

i) When we draw tax-free cash from the pension fund
ii) When we reach age 75

The specific calculations prescribed by HMRC are complex and so I will illustrate the planning strategy via ballpark examples.

First Example

Description	Capital Value £
Pensions	1,000,000
WKM ISAs	1,000,000

Initially, when considering their income tax position, one strategy may be to draw their tax-free cash at 25% and reduce their pensions to £750,000. For simplicity, assume the lifetime allowance is £1,000,000.

£250,000 / £60,000 = 4.1 and so in year 5 there is a need to draw an income from the pension fund.

After 4.1 years of compound growth on an assumed investment return of 5%, the pot values are as follows:

Description	Capital Value £
Pensions	916,885
WKM ISAs	1,222,500

If we ignore income tax on the £60,000 then drawing this from the pension fund would see it last 26 years and be drawn down to £nil.

The ISAs on the other hand would have grown to £4,489,000 remaining inside the estate and potentially subject to an inheritance bill of 40% (!) This naturally gives latitude to make gifts from the ISA capital or consider conversion into AIM shares to claim an IHT exemption.

Alternative Example

Alternatively, if the £60,000 was drawn from the ISAs first then starting at £1,000,000 and growing at 5% pa these would last 32 years until they are drawn down to £nil.

Under this scenario the pension would have increased to £4,850,000 and still only capable of providing a 25% tax free lump sum limited to the lifetime allowance of £1,000,000 so £250,000. So let us assume this is drawn and again it funds the next 4.1 years of retirement income.

The pension value has then risen to £5,618,000 and at this level the income need is not just met but exceeded by compound growth. On death (again keeping it very simple) £750,000 of the pension fund is allowed as the remaining lifetime allowance and all growth above it is subject to a 25% lifetime allowance excess charge.

You can quickly see the tax on passing funds to the family in scenario 1 is higher than in scenario 2 due to the greater capital in the second and a lower tax rate.

To finesse this one further step, if a client is able to let go and pass their ISAs to their family earlier in scenario 2, they can both avoid any potential inheritance tax by surviving the gift by 7 years and begging withdrawals on their pension fund sooner.

If you run the numbers, you will see lots of sweet spots per client to create greater family wealth by early succession planning rather than one original owner hanging on to all the capital until the end.

Pension Contributions & Annual Allowance

To be eligible to receive tax relief on pension contributions the individual must:

a. Be under the age of 75

b. Be a relevant UK individual (there are five either/or tests but broadly most individuals with UK earnings or were resident in the UK for the tax year in question qualify

To make these there are effectively three routes:

1. From your employer as part of your contract or surrender of salary/bonus/compensation for a dividend waiver

2. By you personally

3. Made by you for someone else such as a grandchild.

There is now an annual £60,000 gross pension contribution allowance.

If you have underutilised this over the three previous completed tax years you can catch up by bringing those allowances into the current tax year. The rule is you must have fully utilised this year's contribution allowance to be able to carry forward the allowance from the oldest year first, noting you cannot carry forward a negative contribution allowance.

The contribution maximum is also sensitive to all earned and unearned income for the tax year. In 21/22 if this income is higher than £200,000 then the annual allowance for that year can fall to £4,000, and in the three preceding tax years this income limit was lower at £110,000. Interesting that you still have your carry-forward years to bring forward. It is therefore vital to know what the client's total income has been for the three preceding completed tax years as well as what pension contributions they made personally and those their employer made for them (as the latter need to be added back to work out the total client income).

Once you have calculated the maximum contribution you then need to consider if the contribution should be made by the client personally, their employer, or at all.

If made by their employer (including the client acting as their employer where they own their own limited company) the contributions are ordinarily fully relievable for corporation tax relief (assuming there is a business expense argument for the contribution being made) and they are not a benefit in kind on the employee.

If made by the employee this can reduce their earned income and tax relief is granted by expanding their basic rate tax allowance by the amount of the contribution plus 20% (grossing up).

If the client has no employer or no income above £3,600 their pension contribution for tax relief purposes is limited to £3,600. Contributions above this are allowed but the system works to remove any income tax benefit for doing so.

Sweet Spot

A few exist for clients, my favourite being salary sacrifice for those earning between £100,000 to £125,000pa. Assuming they have a typical employer pension contribution they would likely have the available annual allowance to make a gross pension contribution of £25,000 to drop their income below £100,000 and reclaim their personal allowance when making the contribution, saving 60% income tax. If the contribution is made by their employer they will also benefit from a National Insurance saving of 2% and the employer will save 13.8%, a total of £3,950.

An alternative strategy if they earn say £180,000 pa is that they make no pension contributions one year and put in £80,000 the next as salary sacrifice using their carry forward allowance. This will maximise tax relief over and above making £40,000 each tax year (ignoring investment growth).

Investment Company Planning

With the restrictions on income tax rates of 60%; and tight pension contribution limits, many of our clients who run their own limited companies are building up corporate cash reserves. While this secures their trading position it doesn't particularly allow them to build wealth while those funds remain in cash.

Accordingly, we have created a corporate investment account.

The strategy here is to:

1. Either draw the account down in the years where there is no other personal income (dividends) or significant capital gains to withdraw funds up to either the £50,000 or £100,000 annual "limits" or

2. Never draw the funds but reconsider the future share ownership for the company as a mechanism for other family members to become shareholders to benefit from investment growth, which will then be outside of the original member's final estate subject to inheritance tax

You can create holding company and subsidiary structures to keep the funds away from your main trading vehicle. That allows for additional thoughts on the sale of the trading vehicle. It is quite likely you will want to benefit from your Business Asset Disposal Relief (Entrepreneurs Relief) upon sale by selling the shares of the company and then consideration could be given to making a director's loan into a family investment company as the re-investment vehicle. It allows for future reworking of the ownership and owing to the restrictions on other tax-efficient savings methods (annual harvesting of the capital gains allowance, ISAs, pension contributions, VCTs and EIS) it offers a great amount of flexibility.

Income planning

Something that has been apparent for the last twenty years is that the difference between income and capital gains taxes has remained and it is possible to benefit from both allowances simultaneously to great net effect. For many of our clients, we would advocate having the best net cash flow rather than focusing on income. Our analysis begins with an expenditure survey rather than income so we can understand what is needed first and then turn to what is already coming in.

- Pension funds attract up-front tax relief on pension contributions in return for a tax-free lump sum at retirement with the remaining funds being extracted under income tax rules.
- The State Pension is also paid under income tax rules.
- ISAs and VCTs provide tax-free income and are also exempt from capital gains tax.
- EIS are also efficient investment vehicles but from a capital gains tax perspective but not income, although nearly none provide an income to investors for this reason.
- Annually we can make a capital gain of c. £6,000 (the annual capital gains allowance) which is exempt from tax, with any gains above this added to income for the year but taxed under separate rates (currently though not historically).
- Dividends are taxed at lower rates than savings or ‘earned’ income and there is also an allowance of tax-free income of either £1,000 or £500 for a basic or higher rate taxpayer.

During retirement, a fantastic result can be to blend your portfolio withdrawals from the above tax wrappers to achieve the strongest net position.

Example, a married couple both aged 60

Description	Capital Value £
WKM SIPP	650,000
WKM ISA	200,000
WKM General Investment Account (GIA)	200,000
WKM Family Investment Company	500,000
Total	**1,550,000**

On a very simple 5% return ideal, a 6% withdrawal can be made from the entire portfolio and the funds will be exhausted over 32 years. The gross number on the above would therefore be £93,000.

The following would be a tactic of minimising both ongoing and potential inheritance taxes.

Description	Capital Value £
WKM SIPP	650,000
WKM ISA	200,000
WKM General Investment Account	200,000
WKM Family Investment Company	500,000
Total	**1,550,000**

As the pension fund is the most tax efficient during its life, as its investments do not incur taxes nor does the capital transfer on death attract inheritance tax, it should be drawn down against but as the lowest priority.

0 – 5 years

So, keeping with drawing £93,000, initially it could come from the following investments:

Description	Capital Value £
WKM General Investment Account (GIA)	42,230
WKM Family Investment Company	50,270
Total	**93,000**

The GIA withdrawals would be based upon the initial capital investment and be tax-free, but should the portfolio make a capital gain greater than £6,000 pa then its gains will be taxable. On the above size of account, the investment would need to be sizeable into the double digits. A dividend income is likely on the GIA and in the above numbers, you can net this off on the dividend the company would forward.

In the above, the only taxable income would be the dividend from the company at an approximate calculation of :

Income	£
£0 - £12,570 @0%	0
£12,751 - £50,270 @7.5%	2,820
Total	**92,717**

After 5 years the revised capital values based on the above withdrawals and return assumptions could be as follows:

Description	Capital Value £
WKM SIPP	840,000
WKM ISA	260,000
WKM General Investment Account	0
WKM Family Investment Company	350,000
Total	**1,450,000**

5 – 12 years

To maintain the same gross income of £93,000, the client could maintain the dividends from the company and now subsidise from their ISA portfolio:

Description	Income £
WKM ISA	42,230
WKM Family Investment Company	50,270
Total	**93,000**

The income tax is as above on the company dividends, so the net income is unchanged. Moving this position on 7 years will see the ISAs depleted to zero and capital values become as follows:

Description	Capital Value £
WKM SIPP	1,200,000
WKM ISA	-
WKM General Investment Account	-
WKM Family Investment Company	65,000
Total	**1,265,000**

Income is now drawn from the SIPP (we will ignore any lifetime allowance issues and assume the allowances over 13 years have increased). A SIPP may be constructed to allow partial withdrawals of tax-free cash to masquerade as income, bringing a 25% reduction in the income tax liability. Now the income tax position becomes slightly more painful, but all assets are now outside of the estate:

Description	Income £
WKM SIPP	93,000
WKM Family Investment Company	0
Total	**93,000**

Tax on the £93,000	£
First 25% £23,250 @0%	0
Second £12,570 @0%	0
Next £37,700 @20%	7,540
Last £19,480 @40%	7,792
Total tax	**15,332**
Net income	**77,668**

Over 20 years the SIPP value is reduced to £zero but before this date the tax-free cash will also have been fully withdrawn by likely year 15 and so the above tax position would likely increase in the final years between 15 and 20.

The above is a simplified look at the planning techniques available to us and does not take inflation into account, which is a key consideration in the affordability piece associated with our financial planning.

This document was collated in August 2023 and information included may be subject to change.

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- The price of shares and investments and the income derived from them can go down as well as up, and investors may not get back the amount they invested
- Past performance is not necessarily a guide to future performance
- No advice is given in these slides and the examples are for illustration purposes only

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