Does it make sense to gift surplus pension income?

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Pension freedom changed the dynamics of estate planning, with many individuals now gifting or spending assets which are part of the estate before touching their pension pot which remains IHT free.

So gifting pension income using the 'normal expenditure out of income' IHT exemption might seem a pointless exercise. After all, why give away something which isn't in your estate in the first place?

But if pension withdrawals can be taken tax free (or at least at a lower tax rate than the beneficiary may pay on any inherited pension) there may still be a strong motivation to do so as part of an effective estate planning strategy.

There is no statutory limit on what can be given away and successful claims on regular gifts are immediately outside the estate. Combined with the flexibility offered by pension freedom, this can be remarkably efficient.

Estate planning with pension income

Many clients don't start thinking about estate planning until after they have ceased working. The first priority must, of course, be ensuring their own income security in old age. But once this is done, should thoughts turn to gifting? Even with a fall in income in retirement, some clients may still have more coming in than they need.

Fixed incomes

Income from annuities or DB pensions can't be adjusted, so any excess may end up simply being accumulated in the estate and could be subject to IHT on death. Even if it's subsequently given away as a lump sum it would take seven years to be outside the estate.

However, if that surplus income is given away on a regular basis and the exemption claimed it is immediately outside the estate and offers an opportunity to pass on pension wealth tax efficiently.

This is perhaps an easier decision to make for these clients as the question is simply about what to do with their surplus income, and not whether to take more income from a flexible pension, unless they also have one of these.

Flexible incomes

Those in drawdown have greater freedom to pass on their accumulated pension savings. Any unused funds on death are available as either a lump sum or as inherited drawdown.

The remaining pension funds are typically free of IHT, so there's unlikely to be an IHT advantage in taking more drawdown income than is needed. But there could be other motivations for doing so.

On a practical level, beneficiaries may need the money now rather than after the client has died. Or the client may simply wish to see their loved ones enjoy the money.

There could also be an income tax benefit. If the client dies after 75, any undrawn tax free cash entitlement will be lost. So what could have been taken tax free before their death would become taxable in the beneficiary's hands.

However, if surplus income can be generated by making withdrawals which are tax free (or at a lower tax rate than the beneficiary is likely to pay) then there may be good reason to do so.

This takes us to a critical question.

What counts as 'income' from a flexible pension?

Flexi-access drawdown, (where there are no limits on what can be taken and withdrawals can be taken as combination of tax free cash and taxable income), gives significant scope to take withdrawals tax efficiently.

When it comes to gifting those withdrawals, the IHT rules also help here. The 'normal expenditure out of income' exemption doesn't use the income definition used for income tax purposes. As income is not defined in the IHT Act, it follows normal accountancy practice to determine what is income.

HMRC have confirmed to us that regular withdrawals from flexible pensions, irrespective of the levels withdrawn and whether taken as tax free cash or taxable income, always count as income for the purpose of the IHT exemption. This creates an opportunity for at least 25% of the pension fund to be taken and gifted both income tax and IHT free.

Other conditions

But it is important to remember that the gifts still have to satisfy two additional conditions.

Firstly, the gifts have to be part of normal expenditure. Taking the full 25% tax free cash entitlement and giving it away is a one-off gift. The exemption clearly will not apply and the gift will be a potentially exempt transfer. There has to be an established pattern of gifting. Spreading the gifting of tax free cash over a number of years using a phasing strategy, so that all the tax free cash is taken by the client's 75th birthday, is a better option.

The second condition is that the gifts should leave the client with sufficient income to maintain their usual standard of living. Any pension withdrawals needed to maintain this standard will not be 'surplus'. Similarly, the amount of the gift which qualifies for the exemption may be limited if the client has to draw on other capital assets, such as ISAs, bonds or OEICs, to supplement their lifestyle.

There is an obvious estate planning advantage as making gifts of assets which form part of the estate before giving away pension funds which do not. So capital gifting may take precedence over income gifts unless other savings have already been exhausted.

Record keeping

Last but not least, it is good practice for anyone who intends using the exemption to keep not only details of the gifts made but also their income and expenditure. This can be captured on the IHT403 form. Ultimately it will be down to the executors to make the claim. And it can be extremely difficult to collate this information post death.

Source: Standard Life Technical Consulting.