For financial advisers only

Technical Insights – Quick reference guide

IHT treatment of pension gifting

In the 2024 Autumn Budget, it was announced that pensions will come within the scope of IHT from 6 April 2027.

As a result, we have seen increased interest from advisers in how IHT exemptions and gifting may be used in financial plans. This includes the use of pension income and lump sums.

This 'technical insights' document outlines some of the key information and considerations you need to know when helping your clients with their IHT planning.

What is the tax treatment when my client gives money away?

When giving money away, there are a number of outcomes for IHT purposes.

The gift could be:

- Exempt
- Potentially exempt
- Chargeable at a lifetime rate of 20%

'***Your guide to inheritance tax and trusts***' can help your clients understand more about each of these types of lifetime gifting.

How can I determine whether my client's gift is exempt?

Underneath the 'exempt' classification there are some key exemptions to call out:

- **Annual exemption**

You can give away up to £3,000 in each tax year, free from IHT. If the allowance is not used, then it can be carried forward a maximum of one year. This means a couple who are married or in a civil partnership could give away a combined £6,000, or £12,000 if the previous year's allowances were unused.

- **Spouse/Civil partner exemption**

There is no IHT to pay on transfers between most married couples or civil partners living in the UK*, whatever the amount. However, this gift increases the estate of the spouse or civil partner, so only serves to defer IHT until their death. That is why many couples decide to make gifts to their children or grandchildren, rather than to the surviving spouse/civil partner.

** For those married to a non-UK domiciled spouse/civil partner living in the UK, exemption is limited to £325,000.*

- **Gifts out of normal expenditure**

This is a useful exemption which can avoid having to wait for seven years for a gift to fall outside your estate for IHT purposes.

Three conditions must be met for gifts to qualify as a gift out of normal expenditure

The exemption under section 21 of the Inheritance Act 1984 allows for an individual to make exempt gifts, reducing their taxable estate, as long as it can be demonstrated that the gift meets three conditions:

1. It forms part of the individuals (settlor's) **normal** expenditure
2. It was made **out of their income**
3. It doesn't **cause a reduction in their standard of living**

If all these conditions are met then there is no limit on the amount which can be gifted and immediately exempt from IHT.

What do I need to consider when working out whether my client's gift meets the conditions as a gift out of expenditure?

HMRC will usually consider a payment (in this case, a gift) to be regular or habitual if it has been made across three or four years, with the intention of continuing to make further, similar payments. However, even if the individual should die after only one such gift, it's possible to establish that it meets this requirement, if it can be shown that it was your client's intention to make the gift regularly on a habitual basis.

Documentary evidence of intention is therefore important. The facts of each case will be considered by HMRC on its individual merits. Gifts do not have to be of a fixed amount and can vary from year to year, but generally the individual should evidence an established pattern over a number of years to be considered habitual or regular.

1. Out of income

Income can include	Income doesn't include
Dividends from investments	Capital from existing savings and investments
Income from UK pensions, including payments from capped or flexi-access drawdown	Regular withdrawals taken from 'non-income producing' investments e.g. (5% withdrawals from bonds)
Earned income	
Interest from bank accounts	

2. Reduction in standard of living

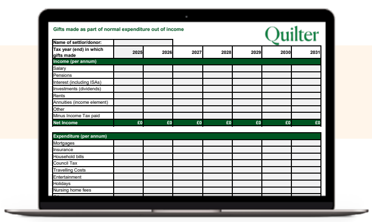
The individual's normal standard of living is assessed at the time of the gift(s). If we refer to the previous dictionary definition used by HMRC, standard, regular, typical, habitual or usual, it would need to be demonstrated the pre and post standard of living was not impacted by the gift claiming the exemption for.

Gifts will not qualify for the exemption if the individual has to resort to capital to meet their normal living expenses e.g. mortgage payments, bills, other loan repayments etc.

3. Record keeping

As the exemption is claimed after death it would be prudent for your clients to keep a full record of any payments for which they intend to claim the 'normal expenditure out of income' exemption. This will allow their LPRs, upon their death, to complete HMRC's form IHT403 (page 8). This form asks for a breakdown of expenses in order to justify the claim that their standard of living had not been affected by the gifts made.

We have produced a handy tool which can exist with this record-keeping process.
You can access the tool here: ***Expenditure tool***



Combining the exemptions with pension income and lump sums

Considering the exemptions above, we are seeing an increased volume of questions as to how these can be combined with pension income and lump sums.

Firstly, we should clarify that although paid tax free and as a lump sum, pension commencement lump sums are still classed as income payments (albeit tax free) and as such could consider normal expenditure rules.

Is it possible for my client to gift a lump sum from their pension scheme?

Yes, it is possible to make a lump sum gift. How it will be treated for IHT will depend on whether the gift is considered exempt or not. If the gift is not exempt and it is made outright to say an adult child, this gift would be a Potentially Exempt Transfer (PET). There is no IHT liability at the time the gift is made, and if the person making the gift survives for seven years then the PET falls out the member's estate for IHT purposes.

If the member dies within the seven-year period, the value of the gift will use up part of the nil rate band (currently, £325,000) if not already utilised. If taper relief applies then after three years the gift value is reduced, but still taken into account for IHT purposes.

Does gifting some or all of my client's pension commencement lump sum (PCLS) meet the criteria for the gifts out of normal expenditure exemption?

It depends. The criteria to meet the gifts out of normal expenditure as set out above must be met. Depending on how a client has taken their PCLS will of course have a bearing on how easily or not it is to meet the criteria. Remember, the gift is supposed to be regular and/or habitual.

What is regarded as 'income' from my client's Collective Retirement Account with Quilter?

The Collective Retirement Account (CRA) is a 'Money Purchase' personal pension. It enables clients to build up a retirement fund through regular or one-off contributions, that can be used to provide a future income.

The CRA allows tax efficient regular income options (TRIO). Each of the three options provide automated regular payments:

- Pension commencement lump sum only (i.e. £100,000 taken over say 36 months).
- Pension commencement lump sum plus full income (i.e. 25% of the payment will be tax free up to the PCLS being exhausted; the rest of the payment, 75%, will be taxable at your marginal rate).
- Pension commencement lump sum plus some income (i.e. 25% of the payment will be tax free up to the PCLS being exhausted; you can also take up to 75% of the residual fund and this will be taxable at your marginal rate).

In all the above instances, it is likely that these will be classed as 'income' and therefore any gifts made from these amounts may meet the gifts out of normal expenditure exemption providing all three of the conditions above are met.

If those conditions are not met, then it may be possible to utilise other exemptions i.e. annual exempt amount (£3,000) or where the gift is made to an individual this would be classed as a PET.

Care: payments which are deemed income may not be considered income indefinitely. HMRC considers income as capital after a period of two years unless there is evidence to the contrary. This relates to all income payments and is not specific to pensions.

How do these different planning strategies work in practise?

Here are some examples of gift planning in action.

1. Gifts out of normal expenditure

Bethany aged 57 is married with four children she has the following assets:

- £1.8m pension with Fixed Protection 2012
- £1.5m house
- £500,000 investments

She has a salary of £150,000 each year (fluctuates depending upon bonus received).

Her bonus is payable in April each year.

Her salary provides her with sufficient income to cover her standard of living.

She is planning to retire in the next few years but would like to start some IHT planning. She is worried about the recent announcements that pension money left where the individual dies after 6 April 2027 will fall within the IHT net. Her four children are at university, and she would like to start to provide them with regular payments over the next five years.

Bethany's adviser suggests she may want to consider taking her pension commencement lump sum (PCLS) over the next five years – there in providing £90,000 a year to be divided between her children. Bethany's intention is that this payment will be made four times a year to allow her children to pay for their university fees and cost of living.

Each time a payment is made, her adviser suggests that she records each payment.

After 5 years, Bethany has not retired but has reduced her hours. She has begun to draw her pension and has excess income. So, she again decides to provide yearly gifts to her children. The value of these gifts will vary as Bethany has decided to use her bonus to provide those gifts.

Due to the nature of Bethany's gifting meeting all three conditions for gifts out of normal expenditure, on Bethany's death these gifts will not be included in her estate.

2. Gifting into a Lifestyle Trust

Carrie is keen to undertake some IHT planning following the news that pension pots will soon be subject to IHT. However, she is concerned that she has enough money for her later years. She has a healthy pension pot of £1.2 million (Individual Protection). She has taken her PCLS of £300,000 and now wants to do some IHT planning. Her adviser has recommended the Quilter Lifestyle Trust.

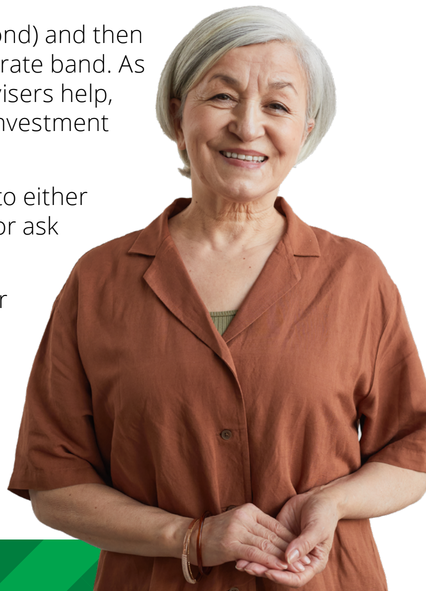
This trust allows Carrie to undertake IHT planning but on specified dates receive access to the value of some or all her investment.

Carrie places £300,000 into a Quilter onshore single premium bond (the Collective Investment Bond) and then assigns the bond into the Lifestyle Trust, there is no immediate IHT charge as this is below the nil rate band. As this is a discretionary trust, she does not need to name specific beneficiaries. Carrie, with her advisers help, specifies that she would like access to 100 policies a year for 10 years. This means (assuming no investment growth/loss) Carrie would have the right to access £30,000 a year if encashed.

The benefit of the Lifestyle Trust is that before the vesting date, Carrie is able to ask the trustees to either allow the polices to vest to her, defer the right to receive access to these policies to a future year or ask the trustees consider making an appointment in favour of a beneficiary.

In year one and two, Carrie doesn't need the additional funds so asks the trustees to defer to year five. In year three, the policy funds vest to Carrie and she encashes them. As she is a basic rate taxpayer, she has no income tax liability and spends the money on a new car.

See the ***Lifestyle Brochure*** for further information on the IHT treatment.



Summary

When considering IHT planning and excess wealth, there are three primary approaches: spending wealth, insuring the IHT liability with a life insurance policy (though this becomes more expensive with age), or gifting wealth during lifetime.

Interest in lifetime gifting and IHT exemptions has risen following the announcement that pensions will come within the scope of IHT from 6 April 2027. Lifetime gifting is a key area that can make a significant difference if planned correctly. Your advice will be crucial – this isn't considered a DIY option, and your clients will need your help.

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