Passing on your wealth through pensions

The abolition of the lifetime allowance could make pensions an even more attractive way of passing on wealth to the next generation.

Pensions can usually be passed on to your loved ones free from inheritance tax (IHT). Now that there is effectively no limit on the overall amount of money you can tax-efficiently build up in pensions over your lifetime, revisiting your estate plan could allow you to make a more meaningful difference to your children or grandchildren's financial future.

A financial adviser can help you create an estate plan that suits your needs and makes the most of your money. In the meantime, here are some of the key points to consider.

How are pensions taxed on death?

Pensions are one of the most tax-efficient ways of passing on money to the next generation. Unlike ISAs, pensions usually fall outside of your estate and so can be passed on to your beneficiaries free from IHT.

If you die before age 75, benefits left in a defined contribution (DC) pension can be paid as a lump sum, annuity or drawdown income to any beneficiary, with in most cases no tax to pay. If you die after age 75, they will be taxed at the beneficiaries' marginal rate of income tax.

As long as the funds stay in drawdown, they will remain IHT free. This means you could pass on your pension to your children, who could then pass it on to their children, who in turn could pass it to their offspring, raising the prospect of pension money cascading down the generations.

How could the LTA abolition affect estate planning?

Previously, there was a cap on the amount of money you could build up in pensions over your lifetime without triggering a tax charge when you came to access your pension benefits. In 2022/23, the lifetime allowance (LTA) was £1,073,100.

The government recently announced that the lifetime allowance is being scrapped. From 6 April 2023, savers no longer face a tax charge when accessing pension benefits in excess of the LTA. This offers the opportunity, where appropriate, to build up a larger pot and then pass on more wealth to the next generation free of IHT.

Are there any other limits to be aware of?

Although the lifetime allowance is being scrapped, there are still limits on the amount of money you can tax-efficiently save into pensions each year. The standard pension annual allowance is £60,000 (2023/24 tax year), although you can only receive tax relief on up to 100% of your UK relevant earnings. If you exceed the annual allowance, you'll have to pay a tax charge, which essentially claws back any excess tax relief you received at source.

Bear in mind that if you have a very high income or have already flexibly accessed your DC pensions, your annual allowance could be lower than this. For example, if you have an 'adjusted income' of £260,000 or more and your 'threshold income' exceeds £200,000, your annual allowance will be tapered by £1 for every £2 of adjusted income that exceeds £260,000, down to a minimum floor of £10,000. It's really important to understand what your annual allowance is and whether you're at risk of breaching it.

The abolition of the lifetime allowance also doesn't mean you can automatically draw 25% of your pension savings as a tax-free lump sum. From 6 April, the maximum tax-free lump sum that you can draw from pensions is capped at £268,275 (although yours may be higher if you have a form of lifetime allowance protection in place).

What else do I need to consider?

While pensions have become a more attractive estate planning tool, this doesn't necessarily mean that maxing out your annual allowance every year will be the right decision for you.

You can't access money in DC pensions until age 55 (rising to 57 from April 2028). If there's a chance you'll need the funds before then, ISAs or savings accounts will probably be a better option. ISAs can also be a useful way of building tax-efficient income in retirement, as you can draw as much money as you like, tax free. Other investment approaches could also be worth considering, such as venture capital trusts (VCTs) or Enterprise Investment Schemes (EISs), but these are specialist, high-risk investments that are not appropriate for all investors.

When it comes to estate planning, it may be the case that lifetime gifts better suit you and your family's needs. Gifting money is not only tax efficient, but it could have a transformative effect on the lives of the younger generation, perhaps enabling them to graduate debt-free or get a foot onto the property ladder. By making lifetime gifts, you'll be able to see your loved ones benefit from your wealth.

Next steps

Understanding how to pass on your assets securely and efficiently to your loved ones isn't straightforward, and that's where getting some smart advice comes in. A financial adviser can help you build an inheritance and estate plan that works for you, so you can feel confident you've laid the firmest foundations for your family's future.
