# The pension Lifetime Allowance (LTA) & legacy planning

## When should any excess be crystallised?

We are often asked "When is the best time to crystallise pension funds to minimise the LTA tax?"  But if the goal is efficient wealth transfer, then paying the lowest possible LTA charge doesn't automatically deliver the greatest legacy.

The arguments are broadly:

1. Crystallise the whole fund at the earliest opportunity and take out 'tax free' cash only (e.g. 25% of the fund up to the LTA). The second LTA test at 75 will only be based on the growth on the remaining fund which will also have been reduced by the initial LTA charge, or

2. Leave everything in the pension and face the LTA charge on the excess at 75, in the hope that this will maximise growth and provide a large pot for beneficiaries to inherit, despite a higher LTA charge

However, the LTA charge is just one element to consider when trying to secure the greatest legacy. Tax on the funds withdrawn, including any IHT on assets which are removed from the pension wrapper, will typically a have greater bearing on what beneficiaries may receive.

Getting the IHT planning wrong will normally have much more impact on the size of the eventual legacy than saving LTA tax. So IHT planning comes first, then the LTA.

We all are different, so there's no 'one size fits all' solution to the 'when to crystallise' and 'extract or retain in pension' dilemmas. However, we've developed some broad rules of thumb and strategies which can be used as a starting point to build a plan:

It can make sense to consider the pension as two separate pots – one within the LTA (with tax-free cash and no LTA tax) and one the excess (with LTA tax and no tax-free cash).

## When to crystallise?

1. **The excess**: In general, don't crystallise funds in excess of the LTA unless you have to
2. **Within the LTA**: Delaying all crystallisation until 75 will generally deliver the largest legacy (unless you die before age 75 of course!)

### Extract funds or retain in the pension?

1. **IHT**: If withdrawn funds are likely to attract IHT, within either your or your beneficiary's estate, it normally makes sense to leave them inside the pension wrapper

2. **Income tax**: If funds can be kept free of IHT, it normally makes sense to withdraw them from the pension if they can be extracted tax-free (or at lower rates than future beneficiaries are likely to pay)

**Mitigating IHT normally impacts much more on the size of the eventual legacy than saving LTA tax**. This might mean that funds need to be crystallised before 75 to allow sufficient time to get them outside the estate.

Starting from these rules of thumb will mean you're not just focusing on LTA tax, but considering the wider picture around what can be passed on after taking account of all taxes. This should mean more of your wealth is available for future generations.

We've reached these conclusions for the following reasons:

**Crystallisation strategies**

The 'all or nothing' approach to crystallisation is not the only option. Funds don't have to be crystallised all at once, and you may be better served by adopting a solution between these two extremes.

There are four potential crystallisation strategies:

1. Fully crystallise everything, including the LTA excess, as soon as possible
2. Crystallise up to the available LTA as soon as possible, but delay crystallising the excess until 75
3. Crystallise in stages (phasing)
4. Delay crystallising everything until 75

Remember, you also need to think about the second LTA test on drawdown funds at (currently) age 75 and how fund growth in the interim might impact on it.

There are simply too many moving parts to plan with absolute certainty as all our circumstances are different!

In general, delaying crystallisation (particularly LTA tax) for as long as possible will create the largest legacy. This is because it leaves more funds in the gross roll-up, IHT-protected environment of the pension wrapper for longer. However, it will generally create the largest LTA tax charge too. This reinforces why a narrow focus on minimising LTA tax can drive a poor outcome.

There's an important exception to this general reasoning, death before 75. Then crystallising (at least up to the LTA) as early as possible is most likely to deliver the largest legacy. This is because there's no second LTA test on crystallised funds on death before 75, so any growth after the original crystallisation is completely sheltered from LTA tax.

All things being equal, crystallising the excess as early as possible is likely to mean the lowest LTA tax hit. And gives immediate access to the funds. But this will bring the tax charge forward, leaving a smaller pension fund to grow in future years and generally reducing the eventual pension legacy.

The most efficient wealth transfer strategy may ultimately depend more on the tax treatment of any withdrawn funds, particularly the IHT position, than on the timing of LTA crystallisations.

**Should funds be kept inside the pension or withdrawn?**

Where tax-efficient wealth transfer is the goal, IHT planning must sit at the heart of this decision. Getting the IHT planning wrong will normally more than wipe out any tax savings from LTA planning.

If funds withdrawn from the pension are likely to attract IHT, within either your or your beneficiary's estate, leaving them inside a modern flexible pension for loved ones to inherit as a drawdown pot will generally deliver a larger legacy.

This is because a 40% IHT charge, on top of any income tax paid to withdraw funds, will almost always add up to more than the effective rate of tax that beneficiaries will pay to take funds from the pension wrapper as needed. Plus anything left unused inside the pension remains sheltered from IHT for future generations.

Funds extracted from the pension and gifted will generally fall outside the estate after seven years. This means your state of health and life expectancy also need to be factored into the planning.

Here's how the average probability of surviving seven years reduces with age:

| Age | 55 | 60 | 65 | 70 | 75 | 80 |
|---|---|---|---|---|---|---|
| Probability of surviving 7 years* | 96% | 94% | 91% | 85% | 76% | 60% |

* Standard Life actuarial analysis of ONS English life tables (2011-2013)

At 65 only one in 11 people are expected to die within the next seven years but by age 75 this has gone up to almost one in four. If in poor health, the odds of course may be even shorter. This might mean that, to give a higher chance of getting withdrawn funds outside the estate, it may be worth considering bringing forward the timing of benefit crystallisations.

Assuming you can plan effectively to mitigate IHT outside the pension, it then comes down to whether you're likely to pay less tax to extract funds from the pension.

- If IHT can be avoided, it normally makes sense to extract the tax-free cash. This is because beneficiaries will be taxed on withdrawals if you die after 75 (which most people do)

- Even if IHT can be avoided, it only makes sense to extract and gift taxable pension if you expect to pay less tax on the income than your beneficiaries would to extract it on death

**The LTA legacy planning framework:**

There's no 'right' answer as to 'when to crystallise'? But it's dangerous to consider LTA tax in isolation, as it could potentially trigger other taxes that outweigh any LTA tax saving.

Factoring LTA tax into wider tax and legacy planning, and following our broad 'rules of thumb', can give you a framework to build a bespoke plan to deliver the right legacy.

**Do not act on this information alone! Always seek independent financial advice before taking any action.**

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