Technical Briefing

Alternatives in tax efficient pension drawdown & as long-term growth driver / inflation beater

INTRO

INTRODUCTION

March's Spring Statement offered little direct comment on the tax efficient alternatives universe, unlike the October 2024 budget which saw some significant changes to Business Relief by way of an upcoming £1 million limit on 100% IHT relief on BR qualifying assets, with any excess only qualifying for 50% relief and all AIM shares fixed at the same level.

We're left with a changed landscape featuring a faltering economy, public spending cuts and big drivers for changes to retirement and estate and other tax planning.

This is a context in which the use of the Enterprise Investment Scheme (EIS), Venture Capital Trusts (VCT) and Business Relief (BR) could offer excellent solutions as part of a diversified portfolio and tax planning approach. That diversification of planning methods is only going to be driven by the increasing size of taxable estates as unused pension capital is likely to become a part of the deceased estate for IHT purposes in 2027.

To help advisers and professionals to understand some of the scenarios in which tax efficient alternative investments can potentially play a role in minimizing additional tax liabilities, this Technical Briefing explores two linked case studies featuring how EIS/VCT can help tackle the big income tax implications of pension drawdowns outside the lump sum allowance, and BR as a home for that drawn down capital that is both IHT efficient and combats inflation.

1 CASE STUDY | EIS & VTCs

EIS and VCTs offer the potential of tax-free growth, which could be useful in retirement. Until the October 2024 budget, many planners saw pensions as the best place to accumulate capital, because of the tax efficiency of pension investments, but also because no IHT was due on unused pension capital.

Now, those same planners may well be looking for a method to reduce pension pots to prevent possible IHT exposure and this is where both EIS and VCTs could prove useful; their 30% upfront income tax reliefs provide a way to reclaim some of the tax penalties that apply when withdrawing pension funds above the 25% tax-free allowance.

Kevin, 62 and in good health, has a £1.6m pension but does not need to touch it because he is living off capital and income from personal investments (and has withdrawn his tax-free lump sum). He has discussed the following with his daughter, Simone, and they have agreed they are happy to take the risks associated with VCT investing in order to make a tax saving of close to **£350,000** in *scenario 2*.

62
years old

£1.6m
pension

Scenario 1

Having used all his Nil rate band (NRB) and Residence nil rate band (RNRB), if he dies after 6 April 2027, Kevin's pension is likely to be taxable to IHT at 40% totaling £640,000 and then Simone will pay 45% income tax on the £960,000 remainder as her father is over the age of 75 when he eventually dies. As a result of that Simone has to pay her marginal tax rate on the withdrawal, leaving her with **£528,000 inheritance**.

Inheritance: **£528,000**

CASE STUDY

Scenario 2*

Instead of leaving these assets to be eroded by IHT and income tax Kevin decides to withdraw money from his pension and invest the money into VCTs as follows to recoup some of the income tax payable on the drawdowns.

1. For ten years he takes £60,000 from his pension to take his income up to £90,000 annually (*this creates marginal income tax of £23,431.40*)

Tax Band		Rate of tax	Tax
Personal Allowance	Up to £12,570	0%	£0.00
Basic rate	£12,571 to £50,270	20%	£7,539.80
Higher rate	£50,271 to £125,140	40%	£15,891.60
Total			**£23,431.40**

2. Each year, Kevin then uses this to make a £60,000 VCT investment (*which gives rise to 30% or £18,000 income tax relief*).

3. He intends to hold all the VCT shares for a minimum of five years and then to exit the VCT by selling the shares and using the proceeds to acquire BR qualifying shares for the IHT efficiency.

4. £600,000 is removed from the pension at an income tax cost of £234,314. That is offset by £180,000 of VCT income tax relief, to leave an overall tax cost of £54,314.

5. If the shares simply keep their value, then on Kevin's death 15 years after 6 April 2027, Simone will inherit:

+ **£600,000 Business Relief** qualifying shares benefitting from 100% IHT relief

+ **£330,000 pension.**
(Having used all his NRB and RNRB the £1,000,000 remaining pension is taxable to IHT at 40% totaling £400,000 and then his daughter, Simone, will pay 45% income tax on the £600,000 remainder, leaving her with £330,000).

= **Total inheritance:**
£930,000 less £54,314 pension withdrawal income tax cost = **£875,686***

Inheritance: **£875,686***

Scenario 2*
£875,686*

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Scenario 1
£528,000

Outcome
= **£347,686**

EIS

The same 30% upfront income tax relief could be claimed by investing the withdrawn pension funds into EIS, however:

→ EIS shares tend to be less liquid than VCT shares so exit is likely to be harder, but it is probably not necessary as most EIS qualifying shares also qualify for BR. The minimum holding period to retain upfront tax relief gained from EIS qualifying shares is three years.

→ VCT shares could possibly attract tax free dividends, but exit will be required and redistribution into an IHT efficient solution would be required or the £600,000 of VCT shares would be taxed at 40% creating an additional £240,000 IHT liability. The minimum holding period to retain upfront tax relief gained from VCT shares is five years.

* For simplicity, EIS/VCT initial fees, annual management charges and exit fees have not been included in the calculations.

CASE STUDY

❷ CASE STUDY* | BUSINESS RELIEF

Business Relief could be a suitable IHT efficient solution for the £600,000 removed from the pension, rather than returning those funds to cash. Income earned through the BR offer while those funds are inside the BR wrapper could also significantly offset the impact of inflation over that period, even at the government's target inflation rate of 2% per annum.

Scenario 1

£600,000 in cash compounded inflationary reduction in buying power of 2% per year for the period during which Kevin is withdrawing funds from his pension:

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Withdrawn pension funds in cash	£60,000	£60,000	£60,000	£60,000	£60,000	£60,000	£60,000	£60,000	£60,000	£60,000
Impact of Inflation @ 2% p.a by year 10	£49,024	£50,024	£51,045	£52,087	£53,150	£54,235	£55,342	£56,471	£57,624	£58,800
Total capital										**£537,802**
Overall Loss buying power										**£62,198**

+ IHT payable at death if above NRBs: **£215,120**

= **£277,318 cost**

Inheritance: **£322,682**

£60k
per yeah widthdrawal

£600k
total widthdrawal

* For ease, these scenarios do not consider any tax penalties that may apply to withdrawing the £600,000 from Kevin's pension

CASE STUDY

Scenario 2

£600,000 invested into Business Relief at £60,000 per year, with annual 4% dividends reinvested (*dividends payable from year 3*):

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Investment into BR *(£60k – 2% initial fee)*	£58,800	£58,800	£58,800	£58,800	£58,800	£58,800	£58,800	£58,800	£58,800	£58,800
4 % Dividends*	£0	£0	£2,328	£4,634	£6,984	£9,371	£11,796	£14,259	£16,761	£19,302
Tax on dividends *(Kevin is a higher rate taxpayer)*	£0	£0	£617	£1,395	£2,188	£2,994	£3,812	£4,644	£5,488	£6,346
BR Annual management fee	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%
Value carried forward	£58,212	£115,842	£174,604	£234,276	£294,893	£356,470	£419,021	£482,562	£547,108	**£612,676**

Note, if exiting VCT investments, each will need to be held for a minimum of five years to retain any income tax relief claimed and when claiming BR, the shares must be held by the deceased's estate for at least two years prior to death and be held on death. This means using the VCT and BR solutions as described in these case studies would take a minimum of 17 years in total and Kevin's age and health is taken into account as part of the plan. In addition, the timing of exits from VCTs cannot be guaranteed.

\+ No IHT payable on death if within BR £1m 100% relief threshold
(assuming Kevin lives for at least two years while holding all of the shares within a BR wrapper).

= **£12, 676 gain, so a saving of £289,994 on the outcome of *scenario 1***

Inheritance: **£612,676**

Scenario 1: Inheritance

£612,676

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Scenario 2: Inheritance

£322,682

Outcome

= **£289,994**

Additional inheritance in scenario 2

* BR dividends are not guaranteed 1% annual management fee and 2% initial fees are assumed and actual fees may vary

KEY TAKEAWAYS

1. The risk profiles of EIS, VCT and BR are much higher than those typically associated with pensions.

2. EIS, VCT and BR are all classified as high risk, but both the Financial Conduct Authority and the government have emphasized the need for some higher risk-taking with a suitable proportion of assets to boost growth with higher returns within portfolios to meet financial objectives

3. Analysis shows that Venture Capital is a good diversifier for conventional portfolios

4. EIS, VCT and BR are not just for high net worth individuals. HMRC statistics show that in recent years over half of EIS investments and over a third of VCT investments made were of £10,000 or less, with the average VCT investment being £37,000. The average minimum entry level for unlisted (non-AIM) BR offers is £39,000 (MICAP)

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