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Institute for Fiscal Studies on death, taxes and pensions

Synopsis: The Institute for Fiscal Studies has published a new report highly critical of the treatment of pension death benefits.

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The Institute for Fiscal Studies (IFS) has long been critical of the tax treatment of pension death benefits, usually making comments in papers that deal with tax or pensions more generally.

The IFS has now taken a more concentrated aim at the subject and issued a report, 'Death and Taxes and Pensions', part-sponsored by the abrdn Financial Fairness Trust.

The report's key findings are...

- **Pensions are being increasingly used as a vehicle for bequests.** The IFS says that the spread of DC pensions and introduction of 'pension freedoms' would have led to more pension wealth passing at death, even if there were no behavioural response to the 'strong tax incentives to use pensions for bequests'. It says that if nothing changes, more people will respond to the incentives created by the tax system.

- **Basic-rate income tax could be levied on all funds that remain in pensions at death.** As an alternative, the IFS suggest that the current income tax rules that apply on death benefits from age 75 could be extended to all deaths, regardless of age. The IFS goes on to propose this approach could be combined with a minimum rate of income tax on any withdrawals by a beneficiary, set at the basic rate of income tax. The logic here is to prevent funds withdrawn by non-income taxpayers, in particular children, entirely escaping income tax.

- **Pension pots should be included in the value of estates at death for the purposes of inheritance tax**. The IFS logic is that 'If we are to have an inheritance tax at all, it should apply evenly across all forms of wealth.' Where the funds held in pension pots are to be subsequently subject to income tax – reducing their effective value – it would be appropriate for 80% of these funds to be counted for inheritance tax purpose. That implies a total effective tax rate of 52% (100% – 80% x 60%) – not dissimilar to the 55% rate that applied before April 2015 to crystallised funds and also on death on or after age 75.

- **Subjecting pensions to inheritance tax would raise revenue and remove the perverse incentive to avoid using a pension to fund retirement.** The IFS calculates that if the generation benefiting from pension freedoms were to die with their full pension pots intact, the proposal would raise extra inheritance tax revenue of £1.9 billion a year (in 2022 terms) – over a quarter of the current IHT yield. However, the IFS

- accepts that the calculation is very sensitive to the extent to which pensions will be run down before death: were half of current pensions intact at death, the yield would fall correspondingly.

- **If the government did not want this change to increase the overall yield of inheritance tax, it could use the revenue to cut the inheritance tax rate and/or increase the threshold.** To give a sense of scale, the IFS says that £1.9 billion would be roughly enough to reduce the rate from 40% to 30%, while £0.9 billion would be roughly enough to reduce the rate to 35%.

- **Reforms should be announced as swiftly as is practical**. Making a statement as soon as possible would, in the IFS view, *'...reduce the extent to which individuals will have saved in a pension in the incorrect expectation that they will be able to bequeath these funds under the current generous arrangements.'* It accepts that, as with any wealth tax reform, some retrospective taxation would be inevitable. If thought necessary, the IFS suggests some transitional phasing of implementation, based on the date of death.

Comment

Mr Hunt has already shown that he is willing to impose more tax on wealth by the measures on CGT, dividend tax and the additional rate threshold in his Autumn Statement. In theory he could introduce the IFS changes in the Spring Budget, now confirmed for 15 March.

In practice any such move seems unlikely unless the Treasury discovers another large revenue shortfall. However, inaction may only represent a stay of execution. As Mr Hunt has already 'borrowed' some of Labour's ideas for taxing wealth, Rachel Reeves might find the IFS proposals a useful alternative.

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