The Taxing Wealth Report 2024

Every politician's guide to "How to pay for it"[1]

Inheritance tax reforms

Removing the inheritance tax exemption for funds retained in a pension fund on death

Brief summary

This note suggests that:

- The current inheritance tax provisions that exempt from charge to that tax sums left in personal pension arrangements that have been undrawn at the time of a person's death should be abolished.
- These arrangements have been abused with consequence for horizontal and vertical tax equity in the UK.
- This abuse is widely known about and advised upon by UK financial services providers.
- Despite forthcoming panned changes to pension tax laws, this arrangement is likely to offer continuing opportunity for abuse in the future.
- On the basis of reasonable estimates, abolishing this exemption could raise maybe £1.3 billion in additional tax revenue per annum.
- This change would be easy to implement.

[1] This note forms a part of 'The Taxing Wealth Report 2024' published by Finance for the Future LLP, which is UK LLP number OC329502, registered at 33 Kingsley Walk, Ely, Cambridgeshire, CB6 3BZ. See https://www.financeforthefuture.com/taxing-wealth/. This note was written by Richard Murphy FAcSS FCA FAIA (Hon), Professor of Accounting Practice, Sheffield University Management School, who is a director of Finance for the Future LLP. © Finance for the Future LLP 2023

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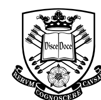
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The proposal	To remove the inheritance tax exemption for funds retained in a pension fund on death.
Reason for the proposal	1. To improve the horizontal equity of taxation, which is currently undermined by this exemption which removes from an inheritance tax charge a sum that was itself accumulated in a pension fund on a tax-free basis, creating considerable imbalance within the tax system between those able to take advantage of this arrangement and those who cannot. 2. To increase the prospect of vertical equity of taxation in the UK which is currently undermined by the ability of some people to take advantage of this opportunity, undermining the vertical tax equity of inheritance tax. 3. To reduce the tax spillover effect that this exemption creates by encouraging the accumulation and retention of funds in tax free pension arrangements. 4. To reduce the rate of tax avoidance in the UK which this exemption encourages. 5. To consequently improve the rate of tax compliance in the UK. 6. To raise additional tax revenues.
Estimated tax that might be raised as a result of the recommendation made	The behavioural response to this recommendation is hard to estimate because the extent to which the exemption is used is currently unknown because of a lack of data on the issue and some planned changed to pension rules might make it less attractive in the future for reasons unrelated to inheritance tax. Based on reasonable assumptions the exemption might cost more than £1.3 billion annum at present.

Ease of implementation	Relatively straightforward. The exemption was introduced with little fanfare and could be removed in much the same way.
Likely difficulties that might result from implementation	Few.
Likely time required to implement the change	Months in the year preceding the year of actual change.
Consultation period required.	Short, largely because few realistic objections are likely to be capable of being made.

Background

When George Osborne introduced significant changes to taxable pension arrangements in the UK during his time as Chancellor of the Exchequer[2], he introduced a particularly attractive quirk into those arrangements which has had a significant interaction with inheritance tax.

Broadly speaking, until Osborne changed the UK's pension tax regime, a person who had saved in a pension arrangement was required to purchase an annuity at the time that they took a pension from the fund to which they had contributed. That annuity then provided them with a guaranteed income for the remainder of their life.

The result of this was that the annuity provider took out a gamble with the retired person. They made that retiring person an offer of a pension that, based upon the that person's age, gender and health, they thought that they could afford to pay for the remainder of the annuitant's life. If the annuitant died early, then the annuity provider gained, and vice versa. What, however, was always the case was that the available funds at the time of retirement were always entirely used for the purposes of providing a pension payment. There was nothing left over on death.

Osborne removed this requirement that a person must acquire an annuity when they retired. Instead, he permitted a person who had made pension savings to draw down funds from the pension pot that they had accumulated over the remainder of their life. As a result the pensioner decided when such payments would be made, with them always being aware of the risk that there might be insufficient funds to provide them with an income for life if they took funds too early or lived beyond their anticipated life expectancy.

[2] https://www.professionalpensions.com/analysis/1014826/pension-tax-relief-cuts-brief-history

What these changes created was the possibility that a person might die with a part of their pension savings being left unused in their pension fund. Osborne's changes provided that this remaining capital sum did not then become the property of the pension provider but was, instead, available to the executors of the late pensioner to distribute to that person's heirs. No inheritance tax was, however, payable on the value of this distribution which was deemed to fall outside the estate of the deceased pensioner.

This arrangement is particularly egregious with regard to horizontal and vertical tax equity. The funds exempted from inheritance tax charge have already been subject to an income tax and national insurance (in some cases) exemption on the assumption that they will be subject to an exit tax charge from the pension fund in which they are saved, even if not of equivalent amount. This inheritance tax exemption does at least create the possibility that no tax charge of any sort might arise on the withdrawal of these funds from a pension savings arrangement, most especially if the person dying is under 75 years of age. This is deeply disruptive of horizontal tax equity and also disrupts the vertical tax equity of inheritance tax.

It is important to note that there have always been rules that, rather perversely, can make the receipt by a beneficiary of such a pension arrangement subject to income tax in the hands of the recipient if the person who died was of more than 75 years of age and that this note is being written with an awareness that further changes to pension rules should apply from 2024 which will, in most cases, reduce the likely value of these undistributed pension pots, particularly if the pensioner dies after reaching 75 years of age, but this does not mean that the opportunity for the abuse of inheritance tax that these arrangements has created will be eliminated. As a consequence, the advice now commonly provided by pension advisors to those with a choice as to how they will fund their earnings in retirement, which advice normally suggests that sums from a pension fund should be drawn-down last because any undrawn part of that fund will fall outside the scope of inheritance tax will, most likely, remain valid.

Analysis

There is no logic to this inheritance tax exemption. If it was meant to, for example, replicate the opportunity that any person has to withdraw up to 25% of their pension fund tax-free, then it fails to do so. That is because even if opportunity was taken to exploit that tax free drawn down those funds would still then fall within the scope of inheritance tax, meaning that a charge to inheritance tax would be due, which is not the case under the arrangement that George Osborne created. The exemption does in that case make no sense.

Proposal

This relief should be abolished. Any residual funds remaining in a pension saving arrangement that a person has at the time of the death should be brought within the scope of an inheritance tax charge on their estate and be distributed on that basis.

Potential sum that might be raised

Estimating the tax yield from this reform is hard for three reasons:

- Pension rules are changing in 2024 and these changes may well impact this yield by reducing the sums left in pension funds on death.
- There is no data published on the sums subject to these arrangements.
- The current rules, especially given their change when a person reaches 75 years of age, make it hard to know to what degree this opportunity is exploited.

That said, given that the possibility of making use of this exemption is widely known to UK based financial advisers it is likely that it is commonly used by those with wealth.

Presuming that half of the estates subject to inheritance tax did take advantage of this planning opportunity and that there was a modest (by the standards of wealthy person's pension funds) £250,000 residual value in such pension funds at the time of death then the tax saving per person taking advantage of this opportunity might be £100,000 at the 40% marginal income tax rate on such estates. In that case the cost of this exemption might amount to £1.35 billion[3 and 4].

[3] 27,000 estates were subject to inheritance tax charge in 2020, meaning that this estimate is for 13,500 estates at £100,000 per estate. No account is taken of the additional estates that would be brought into the scope of this tax as a result of this proposal, which might be significant in number.

[4] https://www.gov.uk/government/statistics/inheritance-tax-statistics-commentary/inheritance-tax-statistics-commentary