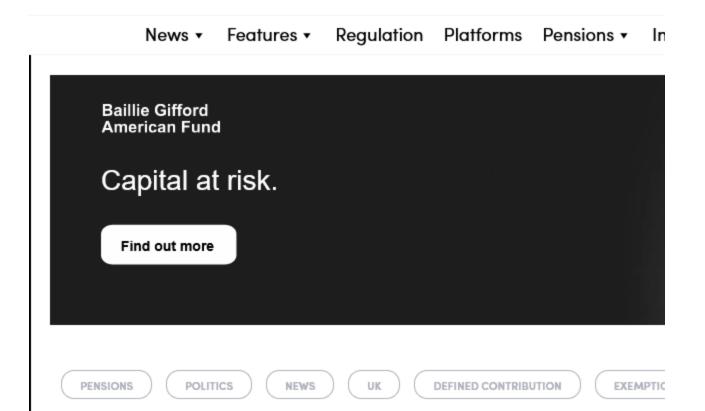
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## Ros Altmann: The disaster of removing IHT exemptions for unused pension funds





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There has been surprisingly little fuss about the shock Budget announcement to remove inheritance tax (IHT) exemptions for unused pension funds. But the changes – due to start in 2027 – could be disastrous for Defined Contribution (DC) pensions.

The lack of opposition to this potentially damaging decision is horribly reminiscent of 1997, when Gordon Brown's removal of dividend tax credits from UK pension funds attracted little industry criticism. The harm to traditional final-salary-type (DB) pensions was only recognised years later.



likely impact of removing IHT exemption is more early withdrawals, lower contributions, less pension investment in long-term higher-expected-return assets and more pensioners reliant on state benefits.

This decision unravels the sensible behavioural incentives of the pension freedoms introduced just ten years ago. Freedoms helped people take control of their own pension. It was suddenly safe to keep money in your fund for later life, continuing to invest for the long-term and spending ISAs or other savings first, while keeping funds for your 80s and 90s, which is surely what pensions are for.

Imposing 40% inheritance tax on unused pension funds on death may not sound so disastrous, but the reality is far worse.

If the proposals proceed as currently planned (and I truly hope they don't, so do reply to the Consultation that closes in March) those inheriting pensions from someone dying over age 75 face not only losing 40% of the remaining fund in IHT, but must also pay income tax on withdrawals at their marginal rate too. So HMRC effectively takes 52%, 64% or 67% of an inherited

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fund, depending on tax brackets.

## "The likely impact of removing IHT exemption is more early withdrawals, lower contributions and less pension investment"

The previous rules, which required most DC pension funds to buy unpopular and potentially unsuitable annuities (unless the funds were tiny or huge) often left nothing to pass onto loved ones. And the old 55% death charge on unused drawdown funds incentivised people to take more out before their 80s, to avoid losing over half their pension to HMRC. These new proposals may take us back to those bad old days.

Removing the IHT exemption basically destroys the tax incentives that encouraged more money into pensions while working and more money to stay in pensions through retirement. It will also mean fewer people in their 60s investing for the longer term in assets that can boost British growth, such as infrastructure, real estate or small companies, which is supposedly a key Government aim.

The proposed measures will also vastly increase the administrative burdens and complexity of calculating the tax due, resulting inevitably in delays for loved ones who might need the money quickly. It is all very well to say spouses and civil partners will be unaffected, but dependent children, for example, will have to wait far longer.

Of course, there is little sympathy for people who have well over £1m in their pension fund, but those will not be the biggest losers. People around the middle are the most likely to strip their pension fund quickly, leaving nothing to live on apart from state benefits if they survive to a ripe old age.

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As most people normally underestimate their life expectancy, the new regime will mean pension-holders will worry about losing the majority of their hard-earned pension fund to the taxman. The rational response, therefore, seems taking as much as possible quickly, especially when it can be at a 20% tax rate.

Consider someone with a £500,000 pension fund (which could buy about £20,000 annual index-linked pension annuity income), after taking tax-free cash.

## "It's time to wake up before it's too late. Don't destroy DC pensions – harness them to boost growth instead"

The remaining £375,000 could be withdrawn at 20% tax, by keeping total annual income below £50,271 (the 40% threshold). With a £12,000 State Pension, they can withdraw £38,000 a year at basic rate tax – emptying their fund within ten years, and a £400,000 fund in under eight years. People on average incomes starting withdrawals from age 55 could take all their funds much sooner.

Instead, a 4% annual withdrawal from the fund could give £15,000 a year and the potential of future investment growth.

And that's not all. IHT will be levied on death-in-service benefits too. This will cause significant delays in paying bereaved families, with massively reduced payouts from levels expected when set up. This kind of retrospective taxation undermines accepted norms of pension policy.

The industry may relish the prospect of selling new life-insurance products or expensive annuities, but they should have been focusing on helping people understand the benefits of managing money for the long term and keeping some for their later years. Opposition to these measures is important.

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There are alternative proposals that are much more benign. A 20% specific death charge could mitigate these pitfalls, making administration simple, and treating pre- and post-75 rules would also raise revenue without these major risks to DC pensions.

It's time to wake up before it's too late. Don't destroy DC pensions – harness them to boost growth instead.

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