The Investment COACH

Pensions, death and taxes: the retirement anomaly

There is an interesting lesson to be learned from a think tank's pension criticism.

Think tanks come in many different guises, some more independent than others. Those without political links – overt or covert – can often provide a valuable, spin-free insight into government policy. One of the best known in this category is the Institute for Fiscal Studies (IFS) whose director, Paul Johnson, is near ubiquitous in the media at Budget time.

As its names suggests, the focus of the IFS is taxation, but it covers many other related economic areas from student finance, through savings and investment to health and social care. In a recent report, *Death and taxes and pensions*, the IFS took a close look at those three topics. The report's findings included:

- **Pensions are being increasingly used as a vehicle for bequests.** The IFS view is that the current tax system, which dates back to the introduction of pension flexibility in 2015, "results in the bizarre situation where pensions are treated more favourably … as a vehicle for bequests than they are as a retirement income vehicle."
- **Basic-rate income tax could straightforwardly be levied on all funds that remain in pensions at death.** At present, any payments to beneficiaries of pension death benefits are subject to income tax, but only if the pension owner was aged 75 or over at death. Under today's rules that can mean benefits escape tax on death before age 75 or if the recipient in a non-taxpayer, e.g. a minor child.
- **Pension pots should be included in the value of estates at death for the purposes of inheritance tax (IHT).** With a few technical exceptions, there is no IHT on pension death benefits, regardless of age at death or the beneficiary.

The IFS recommends that reforms of the system should be announced "as swiftly as practical". In practice, any immediate change is unlikely, given that it was a Conservative Government that introduced the 2015 changes. It was also not so long ago that Rishi Sunak, in his then role of Chancellor, dismissed a raft of IHT reforms proposed by the Office of Tax Simplification.

All of which means that, for now at least, you may want to review the role your pension plans play in your retirement and ensure you have made the right choice(s) in nominating the beneficiaries of your pension death benefits.

Making Tax Digital for income tax deferred

During the non-news week before Christmas, there was a significant announcement on the Making Tax Digital (MTD) scheme for income tax.

In recent months, you could be forgiven for thinking that the infrastructure of UK plc was falling apart. One element of the general malaise that received less publicity than it arguably deserved was an announcement from the Treasury about HMRC's tax technology masterplan, MTD.

The idea of MTD started in 2015, when the then Financial Secretary to the Treasury promised that, "By 2020, HMRC will have moved to a fully digital tax system where bureaucratic form-filling is eradicated – taxpayers should never have to tell HMRC information it already knows." Three years beyond that target date, and six financial secretaries later, the plan has not quite lived up to expectation.

A key feature of MTD is that taxpayers are required to submit quarterly returns digitally to HMRC. As VAT was already subject to quarterly reporting, it was the first tax to come within MTD system in April 2019. Until the pre-Christmas announcement, MTD had been due to be extended from April 2024 to landlords and self-employed individuals with gross annual income of more than £10,000. Most general partnerships with income over £10,000 were due to join a year later.

On 19 December, two days before the House of Commons went into recess, the current Financial Secretary to the Treasury issued a written statement announcing that:

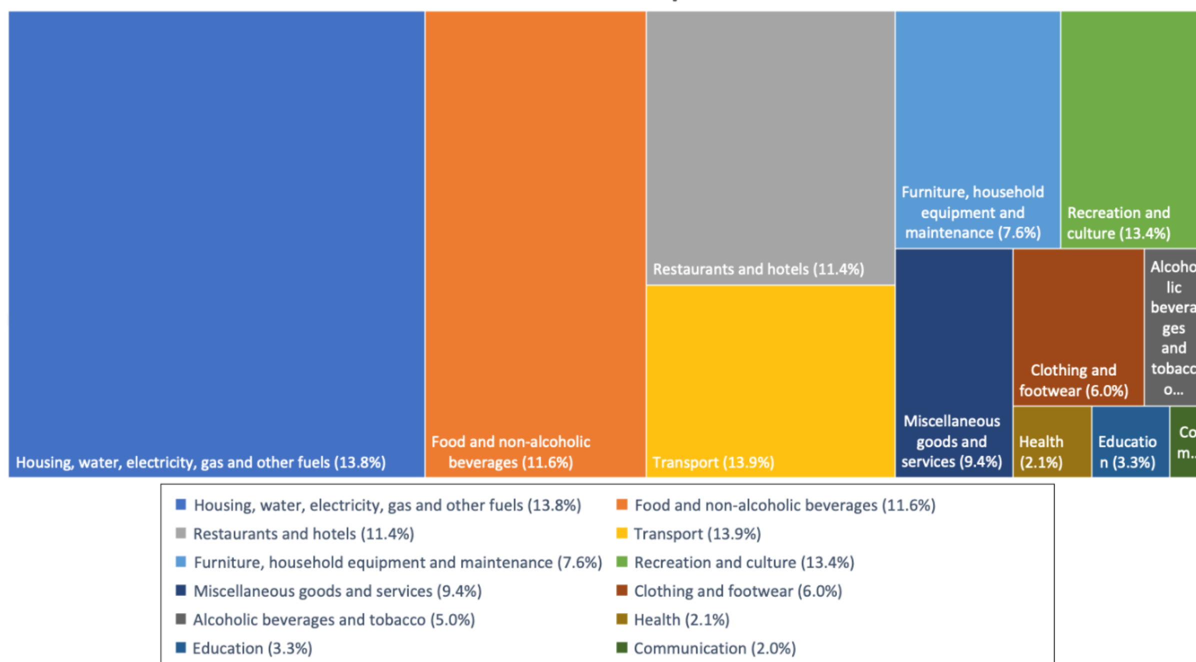
- For landlords and the self-employed with gross income of over £50,000 a year, MTD would become mandatory from April 2026.
- Landlords and the self-employed with gross income of over £30,000 a year would enter MTD from April 2027.
- The government will "review the needs of smaller businesses, and particularly those under the £30,000 threshold".
- General partnerships will now become subject to MTD "at a later date" than April 2025.

The Institute of Chartered Accounts of England and Wales echoed the view of most tax professionals when it said "over the last several months it had become clear that a deferral was inevitable…"

Before you breathe a sigh of relief, nobody expects MTD to disappear. As the Autumn Statement showed, the Treasury will not miss any opportunity to raise more revenue.

The inflation puzzle of 2022

Annual inflation in 2022 was 10.5%, but not all components rose by double digits.



Source: ONS.

Annual inflation, as measured by the Consumer Prices Index (CPI), was 10.5% in 2022 against 5.4% in 2021. The official CPI calculator, the Office for National Statistics (ONS), says that the last time inflation was as high was in 1981. But what drove the inflation indices to four-decade highs last year? As is often the case, a simple economic question does not lead to a straightforward answer.

The hierarchy graph above offers a visual response:

- The ONS CPI inflation 'basket' contains 12 categories, each with different weights (see figures in brackets) based on typical household expenditure. In 2022, the second largest category of spending, Housing, Water, Electricity, Gas and Other Fuels, recorded an increase of 26.6%. Unsurprisingly, the star performer was gas prices, which rose 128.9% across 2022. That alone was worth a 1.8% rise in the CPI. Electricity prices jumped by 65.4%, adding another 1.3% to the CPI.
- The next largest contributor to inflation, with a slightly smaller weighting in the basket, was Food and Non-Alcoholic Beverages, which rose by 16.8% over the year. The ONS says this category's annual inflation has increased for 17 consecutive months (from -0.6% in July 2021) and is now at 1977 levels. It accounted for 1.95% of CPI inflation.

- In 2022, the category with the largest weighting in the CPI basket, Transport, played a less significant role in terms of overall inflation (0.9% on the CPI) than it did last year. Over the year, the category's inflation was 6.5%. In June, annual transport inflation was nearly 15%, driven by the rise in petrol and diesel prices. As these fell back, so too did the transport inflation rate.
- The category with the lowest inflation (2.0%) was also the one with the second lowest basket weighting – Communications – so did little to counter the sharp rises elsewhere.

The two main causes of 2022 inflation – food and gas prices – help to explain why inflation is expected to drop sharply in 2023. Both rose in response to the war in Ukraine and as that is now a year ago, prices should start to stabilise – indeed wholesale gas prices have fallen from their peaks.

The consensus is for the annual CPI number to end the year around 5%, less than half of 2022's level but still enough to mean any long-term financial plans need to build in the value-eroding effects of inflation.

Value for money: State pension vs. NICs

Recent research has compared the value of personal national insurance contributions (NICs) with the value of state pension received. The results may surprise you.

NICs are not well understood, a fact exploited by Chancellors past and present. Many people mistakenly believe that NICs accumulate in a government fund to pay future benefits, in a similar way to how the traditional pension scheme operates. This is not the case. In practice, NICs are just another form of tax on earned income and one that successive governments have found easier to increase than income tax itself.

Up until recently, the government has allowed people to fill historic gaps in their NIC record up to six years after the year in question, but on 6 April, this will come to an end.

An individual's NIC record determines how much state pension they will receive. The question of whether NICs provide value for money in terms of the pension benefits is thus a valid one and has attracted the attention of the number crunchers at the Pension Policy Institute (PPI).

The PPI modelled the employee NICs payable and pension outcomes for men and women at current ages of 20, 40 and 60 with earnings in the bottom 10%, middle and top 10% of earnings.

Interestingly, the PPI assumed that while the middle earners would have a life expectancy that matched the principal projection from the Office for National Statistics (ONS), the low earners would live three years less and the high earners three years longer. That six-year socio-economic gap has been noted by the ONS in the past and is a reminder of the differences that are hidden with population-wide life expectancy figures.

The PPI produced a series of tables showing what proportion of each individual's state pension was funded by their NICs (excluding employer's contributions), meaning anything less than 100% implied more coming out in pension than what went in as NICs.

	Men			**Women**		
Income level	**Bottom 10%**	**Average 50%**	**Top 10%**	**Bottom 10%**	**Average 50%**	**Top 10%**
Age 20	28%	56%	86%	18%	39%	71%
Age 40	31%	65%	101%	20%	43%	81%
Age 60	36%	60%	79%	22%	42%	68%

Source: Pension Policy Institute January 2023.

As shown in the table, women do better than men due to living longer, while the lower paid win over the higher paid because under the new state pension regime that has operated since 2016, pension accrual is at a flat rate, regardless of earnings.

Now is a good time to check your own NIC record as the opportunity to pick up missed payments beyond six years ago will disappear from 6 April.

Don't forget the other student loan

When it comes to student loans, the media focus is usually on tuition fees (outside Scotland), but there's another loan that shouldn't be overlooked – and that includes Scotland.

In January 2023, the Department for Education (DfE) issued a press release headlined *Cost of living boost for students*. However, the 'boost' was more akin to a damp squib:

- There was a reannouncement of a statement made in February 2022 that tuition fees in England would be frozen at £9,250 for the 2023/24 and 2024/25 academic years. This was a quid pro quo for cutting the earnings threshold at which new students from the 2023/24 academic year onwards must start repaying their loans.
- Maintenance loans will increase by 2.8% for 2023/24, taking the maximum for a student living away from home and studying in London to just over £13,000 (just under £10,000 elsewhere). The Office for Budget Responsibility currently projects Consumer Prices Index inflation in September 2023 at around 7%.

Two days after the DfE press release, the House of Commons Library issued a research note entitled, *The value of student maintenance support*. The parliamentary researchers observed that once the 2.3% increase to the maintenance loan in 2022/23 was taken into account, "the real cut in the maximum value of support in between 2021/22 and 2023/24 is 11% or around £1,100".

That is not the end of the bad news on student loans. Part of the maintenance loan is means-tested in England, with only students whose parental household income is no more than £25,000 being eligible for the full loan. Above that income threshold, which has remained frozen since 2008, the loan entitlement is reduced by £1 for around £7.00 of income to a minimum of about 45–50% of the full amount, depending on where the student is living and attending university. The reduction is classed as a 'parental contribution', often a contentious point with both parent and student.

Scotland, Northern Ireland and Wales have slightly different systems for student maintenance, but all suffer from low maximum levels and some form of means testing (although in Wales this applies only in the determining mix between loan and grant rather than the total sum).

If you have children (or grandchildren) heading for university, maintenance costs are becoming an increasingly significant element of any funding plans. While there is government loan to cover the full tuition fees, on the maintenance front, the government loan will all too often be far from adequate.