

Inheritance Tax Review – second report: Simplifying the design of Inheritance Tax

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section 186(4)(b) of Finance Act 2016



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Foreword

In January 2018, the Chancellor asked the Office of Tax Simplification (OTS) to review a wide range of administrative and technical aspects of Inheritance Tax.

Following an unprecedented level of engagement, including nearly 3,000 responses to an online survey, 500 emails from members of the public and 100 written responses to a call for evidence, the OTS published its first report in November 2018, covering the administration of the tax.

We are now pleased to publish the OTS's second report on Inheritance Tax, which explores the main complexities and technical issues that arise from the way the tax works, making recommendations which could streamline gift exemptions, change the way the tax works in relation to lifetime gifts to make it both simpler and more intuitive, and address distortions in the operation and scope of reliefs such as those for business property and agricultural property.

Inheritance Tax is often said to be unpopular and raises strong emotions, not least because it affects people only occasionally, in sometimes significant and surprising ways, and at a sensitive time. We hope that consideration of the ideas explored in this report can help support fruitful dialogue about ways in which it can and should be improved.

The OTS would like to thank Daphna Jowell, who led the review, supported by Charlotte Alderman, Michael Govind, Simon Jackson, Zoë Judd, Bethan Kay, Nigel Mellor and Andy Richens, guided by OTS Head of Office David Halsey. We are also very grateful to our HM Treasury and HM Revenue & Customs colleagues, our Consultative Committee and all those who have willingly given time, ideas, challenge and support.



Kathryn Cearns, OBE

OTS Chair



Bill Dodwell

OTS Tax Director

Executive summary

Introduction

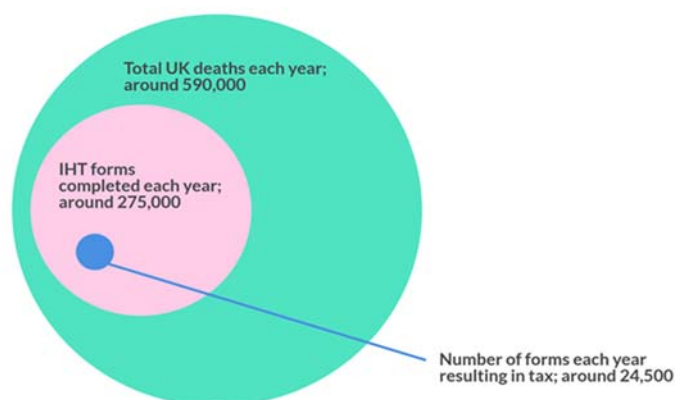
The Office of Tax Simplification (OTS) is the independent adviser to government on simplifying the tax system. The work of the OTS is rooted in improving the experience of all who interact with the tax system. The OTS aims to improve the administrative processes, which is what people actually encounter in practice, as well as simplifying the rules. These are often of equal importance to taxpayers and HM Revenue & Customs (HMRC).

In January 2018, the Chancellor asked the OTS to carry out a review of Inheritance Tax (see Annex A). In the wide-ranging consultation exercise which followed, the OTS received valuable contributions from representative bodies, professional advisers, academics and others, as well as from the Consultative Committee (see Annex B) and an online survey through which nearly 3,000 members of the general public submitted their views. A full list of organisations consulted, or which responded to the call for evidence, is in Annex C.

In November 2018, the OTS published the first part of its review,¹ which made recommendations on the administrative aspects of Inheritance Tax.

In its first report the OTS highlighted the fact that very few people are currently within the scope of Inheritance Tax, with fewer than 25,000 estates being liable each year. This is less than 5% of all deaths, even though ten times as many estates need to complete and submit forms.

Chart A: Number of Inheritance forms resulting in tax being paid



Source: HMRC data – see Annex E

¹ <https://www.gov.uk/government/publications/office-of-tax-simplification-inheritance-tax-review>.

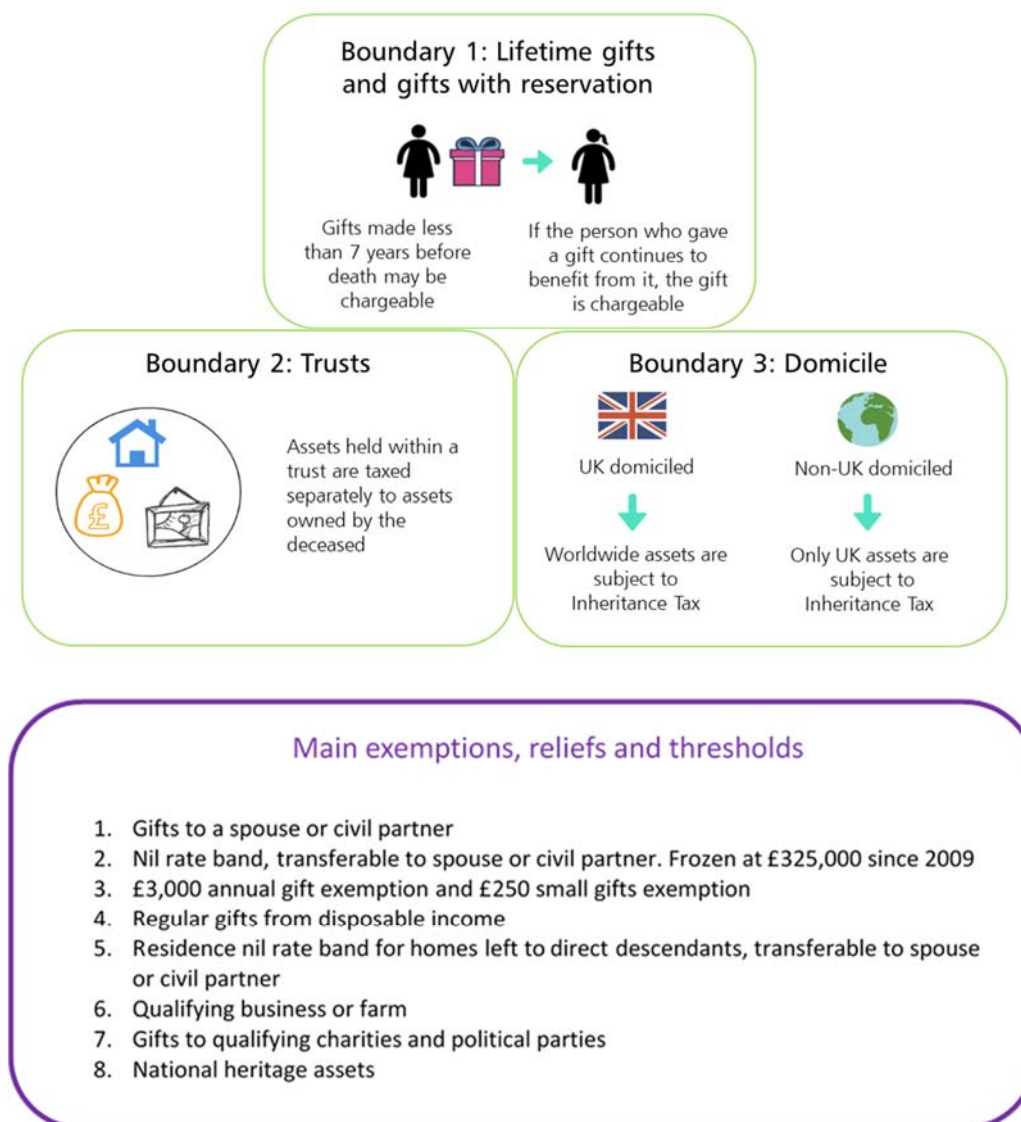
In this second report, the OTS has turned to substantive aspects of the design of Inheritance Tax, leading to recommendations which the OTS considers would make the tax easier to understand and more intuitive and simpler to operate.

Scope of Inheritance Tax

Inheritance Tax is primarily a tax levied on the value of the assets of someone who has died, after all their liabilities, such as any money owing on a mortgage, have been settled.

As well as being charged on the value of assets transferred on death, Inheritance Tax is also charged on some lifetime gifts and in relation to trusts. An outline of some main features of the tax is provided in Chart B below. A glossary of technical terms and acronyms is provided in Annex D.

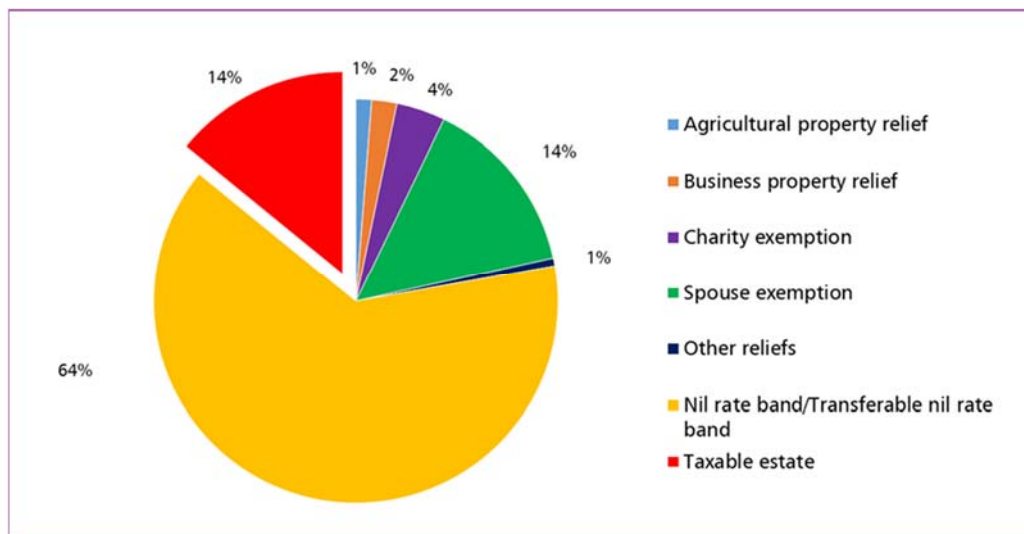
Chart B: Features of the scope of Inheritance Tax



Source: OTS

Chart C below provides a breakdown of the net value of estates in 2015-16 showing the extent to which this value is covered by the various major exemptions and reliefs.

Chart C: Breakdown of net capital value of estates for 2015-16



Source: HMRC data – see Annex E

Is there a better way to tax transfers of wealth?

During the OTS’s consultation, many respondents expressed views about the fairness or otherwise of taxing inter-generational transfers or made big picture suggestions about whether and how transfers of wealth ought to be taxed. Some discussed whether Inheritance Tax ought to be abolished and replaced by a gift tax, or by Capital Gains Tax on death.

These are policy, rather than simplification, issues, on which this report does not make recommendations. However, where possible, the OTS has sought to publish data obtained in the course of its work that will inform this important wider debate.

Simplifying the design of Inheritance Tax

It is surely a fundamental requirement for the legitimacy of a tax that its framework should be reasonably clear to the majority of those potentially liable to it.

The OTS’s extensive consultation exercise revealed many areas where Inheritance Tax is either poorly understood, counter-intuitive, requires substantial record keeping, creates distortions, or where the application of the law is simply unclear.

Main findings

The OTS makes 11 recommendations in this report. These are concentrated on three key areas of Inheritance Tax:

- 1 Lifetime gifts, including liability for paying any tax due on such gifts
- 2 Interaction with Capital Gains Tax
- 3 Businesses and Farms

Many of the problems identified are connected, so solving one in isolation would simply create knock-on issues in other areas. That is why some of the

recommendations consist of packages of changes that would need to be implemented together.

Key area 1: Lifetime gifts (Chapters 1-3)

This part of the report is about the treatment of gifts made during a person's life and the interaction of such gifts with those made on death under a will.

Exemptions

The OTS heard that the present array of gift exemptions is complex and creates confusion. There are several monetary thresholds to be considered and each applies in a slightly different way.

The exemption for regular gifts from disposable income (known as 'normal expenditure out of income') can require extensive record keeping and the scope of the exemption is disputed.

Recommendation 1

The government should, as a package:

- replace the annual gift exemption and the exemption for gifts in consideration of marriage or civil partnership with an overall personal gifts allowance
- consider the level of this allowance and reconsider the level of the small gifts exemption
- reform the exemption for normal expenditure out of income or replace it with a higher personal gift allowance

Gifting period and taper

Consultation responses indicated that the current 7 year period during which a lifetime gift may become subject to Inheritance Tax is too long. It can be difficult for executors to obtain records going back that far and the latter part of the 7 year period raises little tax. The record keeping problem is even greater for a small number of individuals who have made gifts into trust, where the relevant period may be up to 14 years.

The 7 year period requires a large amount of record keeping but raises little tax.

The rate of Inheritance Tax for gifts made more than three years before death is reduced by way of a taper relief.

The OTS heard that the way this works is widely misunderstood. In particular, many people do not appreciate that taper relief is only relevant to people who make very large lifetime gifts totalling more than the nil rate band.

Recommendation 2

The government should, as a package:

- reduce the 7 year period to 5 years, so that gifts to individuals made more than 5 years before death are exempt from Inheritance Tax, and
- abolish taper relief

Recommendation 3

The government should remove the need to take account of gifts made outside of the 7 year period² when calculating the Inheritance Tax due (under what is known as the '14 year rule').

Payment of Inheritance Tax on gifts and the nil rate band

In the relatively unusual situation where the value of gifts made prior to death is large enough to use all the available nil rate band, the calculation of Inheritance Tax can be complex, and it may be difficult to understand who ultimately bears the tax.

Many people are not aware that that the recipient of a lifetime gift is liable for any Inheritance Tax payable on that gift. Nor do they know that the nil rate band is allocated to lifetime gifts in the order in which they are made, and applied to the death estate only to the extent it hasn't already been allocated to lifetime gifts.

This may lead to differences in the amounts ultimately received by beneficiaries that were not intended (or understood) by the person making the gifts.

Case Study A

Sarah gives £325,000 to her son James in 2015 and in the following year she gives the same amount to her daughter Claire. Sarah dies in 2018. Sarah has made no other gifts.

Both gifts are made within 7 years of Sarah's death, so the position is:

	James (£)	Claire (£)
Gift	325,000	325,000
Nil rate band available	(325,000)	(0)
	0	325,000
Inheritance Tax @ 40%	0	130,000

The NRB of £325,000 is offset against the gift to James as this is the first gift Sarah made. There is **no Inheritance Tax for James to pay** on the gift he received.

Claire must pay Inheritance Tax of £130,000 on her gift.

Sarah could have specified in her will that Inheritance Tax on the gift to Claire should be paid from her estate. However, she may not have thought about this or presumed that she would live long enough for the gift to become free of Inheritance Tax. Sarah could also have removed the inequality between her children by giving the gifts on the same day – but this may not always be possible.

² This would reduce to 5 years if the government were to make the changes suggested in the package above.

In Chapter 3, the OTS sets out two alternative ways of changing the way the tax operates on lifetime gifts to individuals, and chargeable lifetime transfers such as gifts into trusts. These two very different alternatives would either reform or amend the rules, to address the issues described above where it is possible that lifetime gifts may exceed the person's nil rate band.

Reform option:

- any Inheritance Tax due in relation to lifetime gifts to individuals should be payable by the estate, and
- the nil rate band should no longer be allocated to lifetime gifts in chronological order but, rather, first be allocated proportionately across the total value of all the lifetime gifts, with any remainder then being available to the death estate

Amendment option:

- for executors to be liable to pay Inheritance Tax relating to lifetime gifts only out of assets they handle, and which are due to be distributed to the gift recipient in question, and if it has not proved possible for HMRC to collect the money directly from the gift recipient

Recommendation 4

The government should explore options for simplifying and clarifying the rules on liability for the payment of tax on lifetime gifts to individuals and the allocation of the nil rate band.

Key area 2: Interaction with Capital Gains Tax (Chapter 4)

The scope of this review specifically included looking at the interaction with Capital Gains Tax, and any distortions to decision making.³ The OTS has concluded that the interaction between Inheritance Tax and Capital Gains Tax is complex and can distort decision making.

It is generally the case that there is no Capital Gains Tax on death.

For Capital Gains Tax purposes, the person inheriting an asset is treated as acquiring it at its market value on the date of death, rather than the amount originally paid for it. This is known as the 'capital gains uplift' and it means the asset can be sold shortly after death without Capital Gains Tax being due.

Where an asset is exempted or relieved from Inheritance Tax (for example, certain business property or farmland, or where the spouse exemption applies), the capital gains uplift means the asset can be sold shortly after death without either Inheritance Tax or Capital Gains Tax being payable.

This can put people off passing on assets to the next generation during their lifetime. It distorts and can complicate the decision making process around passing on assets to the next generation. The OTS has concluded that this distortion would be best addressed by amending the Capital Gains Tax rules rather than changing Inheritance Tax.

³ Inheritance Tax Review Scoping document, set out in Annex A.

Recommendation 5

Where a relief or exemption from Inheritance Tax applies, the government should consider removing the capital gains uplift and instead provide that the recipient is treated as acquiring the assets at the historic base cost of the person who has died.

Key area 3: Businesses and Farms (Chapter 5)

Trading businesses and farming assets may qualify for full relief from Inheritance Tax under business property relief (BPR) and agricultural property relief (APR). BPR also extends to certain companies traded on the Alternative Investment Market.

It is generally understood that the main policy rationale for BPR and APR is to prevent the sale or break up of businesses or farms to finance Inheritance Tax payments following the death of the owner.

The requirements about the level of trading activity needed to qualify for BPR are different to the comparable conditions of two of the main business reliefs for Capital Gains Tax. It is unclear why there are different tests for different tax reliefs relating to the same business, potentially distorting decision making in choosing between transferring a business during one's lifetime or on death. It could simplify decision making about when to hand assets on to the next generation if the tests were standardised.

Indirect non-controlling shareholdings in trading companies were another area where complexities in the application of BPR were identified.

Furnished holiday lets are not treated consistently because, unlike other sources of income relating to property, they are deemed to be trading for Income Tax and Capital Gains Tax purposes but are not generally regarded as a trading activity for Inheritance Tax purposes.

Recommendation 6

The government should, as a package:

- consider whether it continues to be appropriate for the level of trading activity for BPR to be set at a lower level than that for gift holdover relief or entrepreneurs' relief
- review the treatment of indirect non-controlling holdings in trading companies, and
- consider whether to align the Inheritance Tax treatment of furnished holiday lets with that of Income Tax and Capital Gains Tax, where they are treated as trading providing that certain conditions are met

The OTS has also identified further complexities in this area around the treatment of limited liability partnerships and the treatment of farmhouses when the farmer has left the farmhouse to go into care. It has also identified a lack of clarity on when a valuation is required.

Recommendation 7

The government should review the treatment of limited liability partnerships to ensure they are treated appropriately for the purposes of the BPR trading requirement.

Recommendation 8

HMRC should review their current approach around the eligibility of farmhouses for APR in sensitive cases, such as where a farmer needs to leave the farmhouse for medical treatment or to go into care.

Recommendation 9

HMRC should be clear in their guidance as to when a valuation of a business or farm is required and, if it is required, whether this needs to be a formal valuation or an estimate.

Other areas of Inheritance Tax (Chapters 6 – 12)

Life assurance and pensions

The OTS observes that whether a term life insurance policy is written in trust can make a major difference to its Inheritance Tax status. However, few such policies are written in trust.

Recommendation 10

The government should consider ensuring that death benefit payments from term life insurance are Inheritance Tax free on the death of the life assured without the need for them to be written in trust.

Pre-owned asset tax

The pre-owned asset tax (POAT) rules are complex and not widely known about or well understood. It is an Income Tax charge that was introduced to combat certain Inheritance Tax avoidance, which, in itself, adds complexity.

Recommendation 11

The government should review the POAT rules and their interaction with other Inheritance Tax anti-avoidance legislation to consider whether they function as intended and whether they are still necessary.

Residence nil rate band

The residence nil rate band gives an additional nil rate band to those leaving a residence to their direct descendants. Many respondents to the OTS's call for evidence raised concerns about the perceived unfairness of the policy intent and the complexity of rules. The most complicated aspects of the residence nil rate band are the downsizing provisions. The residence nil rate band is one of the most complex areas of Inheritance Tax and generated a large proportion of the correspondence received by the OTS.

Since the residence nil rate band is still relatively new, more time is needed to evaluate its effectiveness before recommendations can be made on how best to simplify it. Chapter 10 sets out respondents' suggestions for simplification, which the OTS invites the government to consider when reviewing this area of policy.

Trusts

The OTS is aware that HMRC has recently been consulting on changes to the taxation of trusts.

The OTS has received comments suggesting that the Inheritance Tax regime for trusts is too complicated. These are set out in Chapter 11 for the government to consider in the context of that broader consultation.

Charities

Since 2012, where a person leaves 10% or more of their net estate to a charity, the rate of Inheritance Tax payable on their estate is reduced to 36%.

The OTS has heard that this recently introduced relief is not well understood and that it is complicated to establish whether the reduced rate applies. HMRC data indicates that it has not yet been widely taken up. However, this relief will take time to fully embed itself because, unless someone is already planning to leave a large amount to charity, it requires a change to their will. For this reason, no recommendations have been made on the 36% rate.

Implementation

The OTS acknowledges that some of the recommendations made in this report will lead to changes that could prompt some people to change their wills. This is not considered to be a bar to changes being made, as other recent changes to Inheritance Tax (such as the transferable nil rate band and the residence nil rate band) have also had this consequence. However, the OTS considers that such changes would need to be legislated sufficiently far ahead of coming into operation for people to have time to take account of the new regime and consider any impact on their affairs. The OTS considers that changes would best be implemented in relation to deaths on or after a certain date, rather than there being a transitional period, which would simply add to complexity.

Summary of Recommendations:

Key area 1: Lifetime gifts

Gift exemptions package

- 1 The government should, as a package:
 - replace the annual gift exemption and the exemption for gifts in consideration of marriage or civil partnership with an overall personal gifts allowance
 - consider the level of this allowance and reconsider the level of the small gifts exemption
 - reform the exemption for normal expenditure out of income or replace it with a higher personal gift allowance

Gifting period and taper package

- 2 The government should, as a package:
 - reduce the 7 year period to 5 years, so that gifts to individuals made more than 5 years before death are exempt from Inheritance Tax, and
 - abolish taper relief
- 3 The government should remove the need to take account of gifts made outside of the 7 year period⁴ when calculating the Inheritance Tax due (under what is known as the '14 year rule').

Liability for payment and the nil rate band

- 4 The government should explore options for simplifying and clarifying the rules on liability for the payment of tax on lifetime gifts to individuals and the allocation of the nil rate band.

Key area 2: Interactions with Capital Gains Tax

- 5 Where a relief or exemption from Inheritance Tax applies, the government should consider removing the capital gains uplift and instead provide that the recipient is treated as acquiring the assets at the historic base cost of the person who has died.

Key area 3: Businesses and Farms APR/BPR

- 6 The government should, as a package:
 - consider whether it continues to be appropriate for the level of trading activity for BPR to be set at a lower level than that for gift holdover relief or entrepreneurs' relief
 - review the treatment of indirect non-controlling holdings in trading companies, and

- consider whether to align the Inheritance Tax treatment of furnished holiday lets with that of Income Tax and Capital Gains Tax, where they are treated as trading providing that certain conditions are met
- 7 The government should review the treatment of limited liability partnerships to ensure that they are treated appropriately for the purposes of the BPR trading requirement.
 - 8 HMRC should review their current approach around the eligibility of farmhouses for APR in sensitive cases, such as where a farmer needs to leave the farmhouse for medical treatment or go into care.
 - 9 HMRC should be clearer in their guidance as to when a valuation of a business or farm is required and, if it is required, whether this needs to be a formal valuation or an estimate.

Other areas of Inheritance Tax

- 10 The government should consider ensuring that death benefit payments from term life insurance are Inheritance Tax free on the death of the life assured without the need for them to be written in trust.
- 11 The government should review the POAT rules and their interaction with other Inheritance Tax anti-avoidance legislation to consider whether they function as intended and whether they are still necessary.

⁴ This would reduce to 5 years if the government were to make the changes suggested in the package above.

Chapter 1

Lifetime gifts: exemptions

Background

- 1.1 Inheritance Tax was designed with a view to encourage lifetime giving and that aspect represented a major change when it was introduced in 1986 to replace Capital Transfer Tax.
- 1.2 When an individual gives a gift to another individual, there is no Inheritance Tax payable at the time.
- 1.3 If the person giving the gift to another individual lives for more than 7 years after the gift is made, the gift is exempt from Inheritance Tax and no tax will be payable, subject to certain anti-avoidance rules. Making such lifetime gifts is a simple way for individuals to reduce the amount of Inheritance Tax payable when they die.
- 1.4 If the individual giving the gift dies within 7 years of making the gift, then Inheritance Tax may become payable on the gift at the time of death. However, there are a number of exemptions that may apply to the gift to reduce or eliminate any Inheritance Tax liability.
- 1.5 After taking account of any exemptions, the value of the gifts is reduced by the nil rate band, which is the threshold amount of £325,000 below which Inheritance Tax is charged at 0%. It is possible to transfer any unused nil rate band to your spouse or civil partner and so the value of gifts can be reduced by up to £650,000.
- 1.6 No Inheritance Tax is payable on any lifetime gifts which are within the available nil rate band. However, the amount of Inheritance Tax payable on the death estate may be increased as the nil rate band is used up by lifetime gifts.

Exemptions and thresholds

- 1.7 The main exemptions and thresholds relevant in relation to lifetime gifts are summarised in Chart 1.A. For gifts to individuals, these are relevant only in relation to gifts made within 7 years of death.

Chart 1.A: Summary of exemptions and thresholds available for lifetime giving

 <p>Nil rate band</p> <ul style="list-style-type: none"> chargeable lifetime gifts covered by the nil rate band are charged at 0% remaining nil rate band can be offset against the estate any unused nil rate band can be transferred to a spouse or civil partner 	<ul style="list-style-type: none"> no limit  <p>Gifts to charities</p>
 <p>Small gifts</p> <ul style="list-style-type: none"> up to £250 to each recipient per year cannot be combined with annual gift exemption 	<ul style="list-style-type: none"> no limit exempt if payments are made to provide maintenance of spouses or civil partners, or for the maintenance, education or training of children under 18  <p>Family maintenance</p>
 <p>Annual gifts</p> <ul style="list-style-type: none"> up to £3,000 per year can be carried forward one year 	<ul style="list-style-type: none"> assets of foreign armed forces situated in the UK because of their military service, are exempt  <p>Foreign armed forces pay and moveable property</p>
 <p>Gifts on consideration of marriage</p> <ul style="list-style-type: none"> £5,000 from parents £2,500 from grandparents £1,000 from anyone else 	<ul style="list-style-type: none"> all gifts to named bodies to preserve the national heritage, national institutions, universities, government departments, health service bodies, local authorities and certain libraries are exempt  <p>Gifts for national purposes</p>
 <p>Gifts which are normal expenditure out of income</p> <ul style="list-style-type: none"> no limit must be regular gifts exempt if gift is made out of income must be able to maintain their standard of living 	<ul style="list-style-type: none"> all gifts of land to UK housing associations and registered social landlords are exempt  <p>Gifts of land to housing associations</p>
 <p>Gifts to political parties</p> <ul style="list-style-type: none"> no limit must be a qualifying political party 	<ul style="list-style-type: none"> all gifts to a spouse or civil partner are exempt from Inheritance Tax there is one exception, where a spouse or civil partner is from outside the UK. In this situation their estate will not be subject to UK Inheritance Tax and the relief is restricted to £325,000  <p>Spouse exemption</p>

Source: OTS

Observations

OTS Inheritance Tax Survey

1.8 The OTS Inheritance Tax online survey¹ asked questions to assess the level of understanding of the gift exemptions and asked if the respondents had used any of the exemptions. The survey was undertaken by nearly 3,000 people and revealed a wide range of views. It is important to highlight that the survey was open to all who wished to take part and, as the respondents were only those who chose to complete the survey, it did not form a representative sample of society.

1.9 The following is a snapshot of the responses:

- respondents had good knowledge of some of the gift exemptions but not others. The majority were aware of the exemption for gifts made more than 7 years before death but only a quarter were aware of the exemption for family maintenance

¹ More information on the survey can be found in the first OTS report on Inheritance Tax: <https://www.gov.uk/government/publications/office-of-tax-simplification-inheritance-tax-review>.

- a majority of respondents answered that the gift rules are either complex or very complex
- three quarters of the respondents who thought that the gift rules are complex, answered that this complexity is a barrier to lifetime giving

HMRC's gifting research

1.10 HMRC have published research into lifetime gifting which they commissioned to improve understanding of gifting behaviours among the British population.²

1.11 Some outputs from the research are that:

- overall, 13% of the general population were identified as gifters, having given a single gift of £1,000 or more in the two years prior to the interview, or multiple gifts of at least £250 totalling £3,000 or more
- when also including any single gift worth £1,000 or more (in today's money) given more than two years ago, the proportion of the population identified as gifters increased to 27%
- those who were more likely to be gifters were older people, wealthier people, those with higher incomes, people who are married and people with children
- the majority of those surveyed gave relatively small amounts, with a smaller proportion giving substantially more: for the majority (65%) the total value of gifts they had given in the previous two years was less than £5,000 with 7% of gifters reporting giving £20,000 or more
- knowledge of the Inheritance Tax rules was low among those who give gifts

Number and interaction of gift exemptions and thresholds

1.12 The OTS has heard that the exemptions and thresholds are not always well understood and that they interact in ways which are counterintuitive. There are many limits and exemptions which can be complex and confusing.

1.13 One frequent criticism the OTS heard is that the interaction between the £3,000 annual gift exemption and the £250 small gifts exemption is confusing. The limits cannot be combined and are calculated in different ways. The £3,000 annual exemption is a cumulative total whereas the £250 limit is per person which cannot be used to reduce larger gifts, so individuals can make countless gifts of £250 so long as they are each to different recipients.

1.14 Any part of the £3,000 annual gift exemption which is unused can be carried forward (rolled over) into the following year. Any unused amount can only be carried forward for one year. The logic behind the roll over rules is unclear but may be to prevent a cliff edge (so that if an annual exemption is missed by a day, the estate is not disproportionately affected).

² <https://www.gov.uk/government/publications/lifetime-gifting-reliefs-exemptions-and-behaviours-research>.

Case Study 1.A

Sarah dies in 2018. Sarah made a gift in 2017, described below. She made no gifts in 2016. The NRB has been used up.

- £6,250 gift to Claire in 2017 to help buy a house – **partially exempt**

Sarah has a £3,000 limit to use in 2017 and as she made no gifts in the previous year, she can also make use of the £3,000 annual limit from 2016.

The gift to Claire is above the annual limit available but the small gifts limit and the annual limit cannot be combined. The gift is reduced by £6,000.

Inheritance Tax is then potentially chargeable on £250.

- 1.15 The existence of a £3,000 annual limit, along with the way it rolls over for only one year, creates confusion as some incorrectly assume that some Inheritance Tax is payable once the limit is exceeded. This may not be the case as the nil rate band is applied after the annual exemption.
- 1.16 The exemption for normal expenditure out of income and the exemption for family maintenance can apply in a wide range of circumstances and respondents said that it is not clear how these interact with the small limits and exemptions. The OTS has heard from respondents to the call for evidence that these two larger exemptions are in effect regarded as a last resort, generally considered when no other exemptions are available.

The level of the exemptions has been frozen for a long time

- 1.17 The nil rate band, the annual gifts exemption, the small gift exemption and the exemption for gifts on marriage or civil partnership have not kept pace with inflation.

Quote from a response to the call for evidence:

“We think all of the exemptions should be increased to more meaningful amounts and this is long overdue.”

- 1.18 The nil rate band has been frozen at £325,000 since 6 April 2009,³ the annual exemption has been frozen at £3,000 since 1981,⁴ the small gifts exemption has been set at £250 since 1980⁵ and the three monetary exemptions for gifts on marriage or civil partnership have not changed since the introduction of Capital Transfer Tax in 1975.⁶

³ <https://www.gov.uk/government/publications/rates-and-allowances-inheritance-tax-thresholds-and-interest-rates/inheritance-tax-thresholds-and-interest-rates>.

⁴ Inheritance Tax Act 1984 s22.

⁵ Inheritance Tax Act 1984 s20.

⁶ See Finance Act 1975 Sch 6.

Table 1.A: Level of nil rate band and gift exemptions if increased to reflect inflation

	Current Limit	Limit in 2019-20 if increased to reflect inflation
Nil rate band	£325,000	£423,000
Annual gift exemption	£3,000	£11,900
Small gifts exemption	£250	£1,010

Source: HMRC data – see Annex E

The scope of the normal expenditure out of income exemption is disputed

- 1.19 There is no statutory definition of ‘normal expenditure’ or of ‘expenditure out of income’. The interpretation of the terms ‘income’ and ‘normal’⁷ is open to debate. For example, there is disagreement as to whether annual withdrawals from a life policy should be treated as income.
- 1.20 The OTS has heard that some people believe Inheritance Tax should be a tax on capital or accumulated wealth and that this justifies the existence of the normal expenditure out of income exemption. However, such a distinction is not used for other Inheritance Tax purposes, which makes the exemption appear anomalous. (Generally, Inheritance Tax is charged on the value of any assets owned by the deceased at the date of death, whether it is a house owned for many years or cash representing employment income received by the deceased in the month before death.)
- 1.21 The limit for the normal expenditure out of income exemption depends on the amount of surplus income available, which varies widely both over time and from person to person, so it can be difficult to establish.

Quote from a response to the call for evidence:

“The description of what constitutes ‘a regular gift made out of a person’s disposable income’ needs to be clearly defined (the ‘normal expenditure out of income’ rules) so you know what is definitely exempt rather than ‘may be exempt’.”

- 1.22 The OTS has heard from a few respondents that the exemption has on occasion been used to exempt gifts worth more than £1 million for individuals with a very high annual income.

⁷ In *Bennett v IRC*, the High Court held that normal expenditure out of income should have a ‘settled pattern’ and that this should be ‘a pattern established by proof of the existence of a prior commitment or resolution or by reference only to a sequence of payments’. Taxpayers should also be ‘left with sufficient income to maintain [their] usual standard of living.’ (Inheritance Tax Act 1984, s21).

Table 1.B: Normal expenditure out of income exemption claims made in 2015-16

HMRC data shows that of the 579 estates which claimed the exemption for the 2015-16 tax year, 55% made claims under £25,000 and 14% made claims of £100,000 or more. These figures do not take account of lifetime gifts made into trust.

Value of gifts (£)	Number of claims	Proportion
<25,000	321	55%
25,000 – 49,999	90	16%
50,000 – 74,999	52	9%
75,000 – 99,999	36	6%
>99,999	80	14%
Total	579	100%

Value of gifts is the value of the gifts after any reliefs and exemptions such as the annual exemption.

Source: HMRC data – see Annex E

The exemption for normal expenditure is difficult to claim and often not planned for

- 1.23 The OTS has heard that the exemption for normal expenditure out of income is often not considered during lifetime and it only becomes apparent to the deceased's executors after death that it may be available. An exception to this may be those who obtain professional advice during their lifetime.
- 1.24 When a claim is made, HMRC requires evidence to show that the gifts were normal expenditure and that they have been made from surplus income. This creates an administrative hurdle which is not faced when claiming other exemptions.
- 1.25 Where the exemption has been actively considered during someone's lifetime, maintaining suitable records can be straightforward. However, it can be difficult if it is necessary to reconstruct records, which the OTS understands is quite common.

Conclusions

The landscape of gift exemptions creates confusion

- 1.26 Some taxpayers think that the Inheritance Tax rules for lifetime gifts are complex and it is not hard to see why. There are many factors to consider before being able to establish whether or not Inheritance Tax is payable on a gift and this creates uncertainty. For most people Inheritance Tax will not be payable on gifts given during their lifetime and it should be possible to provide this majority with some certainty.

- 1.27 Confusion arises from the large number of exemptions and thresholds for gifts. One stakeholder suggested that the mere existence of a £3,000 annual exemption is a source of anxiety and complexity as some incorrectly assume that Inheritance Tax is payable once the limit is exceeded. £3,000 is a low threshold in comparison to the value of the estates actually claiming the exemption.
- 1.28 The normal expenditure out of income exemption is anomalous, confusing and can be difficult to document.
- 1.29 This landscape is confusing and consolidation and streamlining of the exemptions would be very desirable. The OTS proposes combining the following two approaches to simplify the gift exemptions:
- one annual gift allowance for donors
 - replacement or reform of the exemption for normal expenditure out of income

One annual gift allowance

- 1.30 A single personal gift allowance which allows an individual to give up to a fixed amount each year, with no rollover of unused limits, would be a simplification. The personal gift allowance should be used to cover all gifts other than those covered by a de minimis rule (which prevents the need to keep track of very small gifts to work out whether they exceed the annual exemption).
- 1.31 It is not for the OTS to suggest the specific amount of such a personal gift allowance and it will depend in part on which current exemptions it replaces (although there may be merit in acknowledging the impact of inflation since the original limits were set, alongside the cost implications for the Exchequer).
- 1.32 The driver behind introducing a single personal gift allowance would be to remove the complexities introduced by the number and interaction of many different exemptions and thresholds. It would therefore be desirable to replace as many of the existing exemptions as possible with this new allowance. Abolishing some exemptions and increasing the annual exemption available should reduce the impact on tax receipts.
- 1.33 The OTS suggests that the following exemptions are replaced by the personal gift allowance:
- annual gift exemption with rollover (£3,000)
 - gifts in consideration of marriage (£5,000, £2,500, £1,000)

Is there a simpler way to exclude small transactions?

- 1.34 The small gifts exemption prevents the need to account for small transactions and removing the exemption could introduce complexity. This is because it would require all gifts, however small, to be taken into account when considering if the annual exemption had been exceeded. The current interaction between the small gifts exemption and the annual exemption is

confusing but it is not clear how any alternative would improve or simplify the position.

- 1.35 In addition, as noted above, if this figure were increased to reflect inflation it would now be £1,010. Such an increase would not have a material Exchequer effect.

Increasing the small gifts exemption to **£1,000** would reduce Inheritance Tax receipts by less than **£100,000 per annum**

Source: HMRC data – see Annex E

Reform or replacement of the exemption for normal expenditure out of income

- 1.36 The exemption for normal expenditure out of income can cause some complexity. It is too difficult to claim unless the donor has made plans during lifetime. There is a need for reform.
- 1.37 The OTS suggests the following options are considered for simplification:
- remove the need for expenditure to be 'regular' and introduce a limit
 - replace the exemption with a higher personal gift allowance

Option 1 – remove the requirement for expenditure to be regular and introduce a percentage limit

- 1.38 The exemption for normal expenditure out of income is intended to allow individuals to make gifts from their income without those gifts being subject to Inheritance Tax, which is primarily a tax on wealth transfers. The exemption achieves this with restrictions placed on what type of gifts or expenses are exempt.
- 1.39 Removing the need for expenditure to be regular would simplify the exemption and would make it more accessible to a wider range of taxpaying estates. A change to the criteria of this sort would also make the exemption more intuitive and would reduce the record keeping and form filling required to claim the exemption.
- 1.40 Extending the exemptions to cover all expenditure from surplus income could, however, have a significant cost impact for the Exchequer.
- 1.41 Limiting the amount of income covered by the exemption to a fixed percentage of income, which could be based on the most recent tax return if available, could enable the existing complex criteria for a gift to be 'regular' and out of excess income to be removed. This would reduce the time spent by HMRC and executors on claims for the exemption. It would create a clearly defined boundary to the exemption which would provide clarity to advisers and executors.

Option 2 - replace the exemption with a higher personal gift allowance

- 1.42 The exemption for normal expenditure out of income creates great complexity and the taxation of lifetime gifts would, naturally, be simpler if

the exemption were abolished. There would be no need to maintain detailed records and the lack of clarity about what is covered by the exemption would no longer be an issue. However, it is very valuable to those who use it and removing the exemption could increase the amount of Inheritance Tax paid.

- 1.43 If the exemption were abolished, it could be replaced by a higher annual personal gift allowance. The personal gift allowance would be available to use against all gifts and it would not matter if gifts were made from income or capital.

A personal gift allowance of £25,000 would cover the value of 55% of all normal expenditure out of income claims.

Source: HMRC data – see Annex E

- 1.44 There would clearly be winners and losers from such a change. The very small number of people currently using the exemption in relation to large gifts could pay more Inheritance Tax, subject to those gifts falling within other exemptions. Consequently, it is difficult to fully assess the impact of this change.

Recommendation 1

The government should, as a package:

- replace the annual gift exemption and the exemption for gifts in consideration of marriage or civil partnership with an overall personal gifts allowance
- consider the level of this allowance and reconsider the level of the small gifts exemption
- reform the exemption for normal expenditure out of income or replace it with a higher personal gift allowance

Chapter 2

Lifetime gifts: time limits and taper

Background

- 2.1 A lifetime gift to an individual will result in Inheritance Tax being payable if all the following criteria are met:
- the gift was made less than 7 years before the death of the person who gave the gift
 - the gift is not covered by any of the gift exemptions
 - the value of the gift, combined with the value of other lifetime gifts within the 7 years not covered by exemptions, exceeds the available nil rate band
- 2.2 Once it has been established that tax is payable on a gift, the amount of tax must be calculated. The rate of Inheritance Tax is reduced on a sliding scale dependent on the amount of time between the date of the gift and the death of the person who gave the gift. This is known as taper relief.

Taper relief

- 2.3 For lifetime gifts on which Inheritance Tax is payable, taper relief reduces the rate of tax on the gift on a sliding scale depending on the time that has elapsed between the relevant gift¹ being made and the date of death.

Table 2.A: Tapered rates of Inheritance Tax

Time between gift and donor's death	Tapered rate of Inheritance Tax
Fewer than 3 years	40%
Between 3 and 4 years	32%
Between 4 and 5 years	24%
Between 5 and 6 years	16%
Between 6 and 7 years	8%
More than 7 years	Exempt

¹ Relevant gifts, or relevant lifetime gifts, are lifetime gifts that use up any available nil rate band or are subject to Inheritance Tax.

Observations

It is difficult to identify gifts made many years before death

- 2.4 Executors can find it difficult to find records of gifts given by the deceased. This is particularly difficult for earlier gifts as the records may have been lost. The OTS has heard that it can be difficult and time consuming for executors to obtain bank statements and other financial records more than 6 years old. Clearly, the longer the period over which records of gifts must be maintained, the more onerous the record keeping requirements are for individuals and for executors.
- 2.5 It is reasonable to presume that some gifts made many years before death are not reported to HMRC because they have not been recorded and executors are unable to identify them.

Quote from BDB Pitmans LLP:

“It is often not possible to obtain bank statements going back more than 6 years: gifts made within 7 years of death are potentially taxable.”

- 2.6 In 2015-16, 4,860 estates (about 20% of the total number of taxpaying estates) recorded lifetime gifts being made less than 7 years before death with a total value of £870m. 54% of gifts were made were within 3 years of death. Around 24% of gifts were made 5 or more years before death. See Table 2.B.

Table 2.B: Lifetime gifts to individuals by year between gift and death

Years	Number of gifts	Net Value of gifts (£m)	Net tax chargeable (£m)	Average gift value (£)	Median gift value (£)
0-1	1,590	160	15	98,000	31,000
1-2	1,120	140	18	124,000	41,000
2-3	980	110	11	115,000	50,000
3-4	830	120	12	144,000	64,000
4-5	740	110	8	152,000	72,000
5-6	700	120	6	172,000	100,000
6-7	770	110	1	144,000	94,000
7-14	160	20	0	133,000	77,000
Total	6,890	890	71	129,000	53,000

Table Notes:

Number of gifts is different from number of estates. One estate may have made multiple gifts.

Gifts in years 7-14 relate to those where transfers into trusts are involved.

Source: HMRC data – see Annex E

A small proportion of Inheritance Tax relates to gifts made more than 5 years before death

- 2.7 Perhaps unsurprisingly, given the difficulties in retaining or obtaining records, and the fact that taper relief reduces the tax rate where the gifts exceed the nil rate band, little Inheritance Tax is paid on gifts given more than 5 years before death.

In 2015-16, only **£7 million** out of total Inheritance Tax of **£4.38 billion** related to gifts to individuals made more than 5 years before death.

This is **less than 10%** of the **£71 million** of Inheritance Tax in 2015-16 relating to all taxable lifetime gifts to individuals.

However, it is important to recognise, for example, that such gifts reduce the nil rate band available to the estate, which in turn, increases the Inheritance Tax paid by the estate.

Source: HMRC data – see Annex E

Taper relief is complicated and not well understood

- 2.8 The tapered rate of Inheritance Tax on lifetime gifts is poorly understood. The OTS has heard that advisers find it difficult to explain taper relief to clients and that many individuals intuitively expect or understand the relief to work in an entirely different way.
- 2.9 One very common misconception is that taper relief applies to all gifts. The OTS has heard that many individuals do not understand that taper relief will apply only to those later gifts which take the total of the gifts over the nil rate band.
- 2.10 It has been suggested that an alternative, and more intuitive, approach could be to taper the value of the relevant gift rather than the rate of tax. This would mean applying taper to all such gifts, not just those that exceed the nil rate band. This approach could reduce the anomalies introduced by the allocation of the nil rate band.

The existence of a '14 year rule' is surprising

- 2.11 It is quite well understood that Inheritance Tax may be payable on gifts made within 7 years of death. However, it is not generally understood that to allow executors to identify the gifts on which tax may be payable, they may need to consider gifts made up to 14 years before death.
- 2.12 It becomes necessary to look back up to 14 years before death when, for example, there has been a lifetime gift made into trust followed by a lifetime gift to an individual, after which the person who has made the gift dies within 7 years. This is because in considering the amount of nil rate band available at the date of the gift, regard must be made to the amount already

utilised against chargeable lifetime transfers² in the 7 years before the date of the gift concerned.

Case Study 2.A

December 2009 – Ellen makes a gift of £325,000 into trust

January 2013 – Ellen made a gift of £20,000 to Trisha

March 2018 – Ellen dies

To calculate the Inheritance Tax on the gift made to Trisha in January 2013, any gifts into trust made in the preceding 7 years must be considered.

The gift into trust made in December 2009 uses all of the nil rate band and so Inheritance Tax of £8,000 is payable on the gift to Trisha (ignoring taper relief).

- 2.13 All respondents to the OTS's call for evidence who mentioned this subject agreed that the need to look back up to 14 years from death is confusing.

Quote from the Saffery Champness:

"Even where individuals are aware of the general 7 year rule they can often assume that this is all that needs to be considered, and miss the potential implications of the 14 year clock."

Conclusions

The taxation of gifts needs simplification

- 2.14 The current period during which lifetime gifts are taken into account for Inheritance Tax purposes is too long and is not justified by the amount of Inheritance Tax raised. The rules on taper relief are poorly understood and confusing. These rules need simplification in order to clarify how they operate in practice and ease the administration of an estate.
- 2.15 The OTS proposes a package of two changes to simplify the taxation of lifetime gifts on death:
- gifts to individuals made more than 5 years before death should be exempt from Inheritance Tax
 - taper relief should be abolished
- 2.16 Additionally, the OTS suggests that the confusing '14 year rule' should be removed.

² A chargeable lifetime transfer is a gift that is immediately taxable if the amount transferred exceeds the available nil rate band (and no relief is available such as normal expenditure out of income, BPR or APR). Transfers to trusts or gifts to a company may be chargeable lifetime transfers.

- 2.17 These changes would have an effect on the taxation of chargeable lifetime transfers during an individual's lifetime, as a person would have to consider other chargeable lifetime transfers within 5 years rather than the current 7 years when calculating if there is any tax due.

The 7 year period should be reduced to 5 years

- 2.18 It would clearly be a simplification if executors only needed to account for gifts made within 5 years of death rather than 7 years. The 5 year period has been chosen in order to balance easing the administrative burden for executors and limiting the loss of revenue to the Exchequer.
- 2.19 This would come at a cost to the Exchequer, not least because it would also lead to an ability to give away (to individuals or into trust) an amount equal to a person's nil rate band every 5 years without a charge to Inheritance Tax, rather than every 7 years. Even though the tax receipts for gifts made in years 6 and 7 is low, such gifts reduce the nil rate band available to the estate which increases Inheritance Tax receipts paid by estates.

Taper relief should be abolished

- 2.20 The OTS considers that taper relief is a source of complexity and that alternative approaches introduce their own complexities. The best way to make the taxation of lifetime gifts simpler would be for taper relief to be abolished. This would increase the amount of Inheritance Tax payable overall.
- 2.21 It is recognised that this will introduce a cliff edge as gifts made 5 years before death would be exempt and gifts made 5 years less one day before death could be subject to 40% Inheritance Tax. However, the OTS considers that the merits of the shorter period in relation to which gifts have to be identified outweighs the drawbacks of creating this cliff edge, provided the 7 year period is reduced to a 5 year period.
- 2.22 Gifts made less than 5 years before death would then be subject to Inheritance Tax at the same rate as the assets held by the deceased at the time of death.

The 14 year rule should be abolished

- 2.23 All gifts made more than 5 years before death should be ignored when calculating the Inheritance Tax on death, which would remove the current anomaly of the '14 year rule'. Although this rule is rarely pertinent, the OTS considers that it would be desirable to remove this confusing feature of the system even if the other aspects of the recommendations package are not taken forward.

Recommendation 2

The government should, as a package:

- reduce the 7 year period to 5 years, so that gifts to individuals made more than 5 years before death are exempt from Inheritance Tax, and
- abolish taper relief

Recommendation 3

The government should remove the need to take into account gifts made outside of the 7 year period³ when considering the Inheritance Tax due (under what is known as the '14 year rule').

³ This would reduce to 5 years if the government were to make the changes suggested in the package above.

Chapter 3

Lifetime gifts: payment of Inheritance Tax and the nil rate band

Background

- 3.1 This chapter relates to the relatively unusual situation where the value of relevant lifetime gifts¹ is so high that the applicable nil rate band has been used up on death so there is some Inheritance Tax to pay in respect of lifetime gifts.

The recipient of the gift is liable for any Inheritance Tax

- 3.2 Unless the deceased has specified otherwise in their will, individual gift recipients are liable for any Inheritance Tax due on a lifetime gift.
- 3.3 However, if the recipient does not pay the tax within 12 months of the death, then the deceased's estate² becomes liable for any unpaid tax together with the gift recipients. Where the estate pays the Inheritance Tax on a lifetime gift, it has limited statutory rights of redress against the gift recipient but does have some equitable rights of reimbursement.
- 3.4 It is possible for an individual to provide for all Inheritance Tax due on the lifetime gifts they make to be paid by their estate, by specifying this in their will.

Nil rate band allocation

- 3.5 The nil rate band³ is allocated to lifetime gifts given in the 7 years before death before assets remaining in the estate and is allocated in chronological order, so that the earliest gift receives the nil rate band first.
- 3.6 Unless the total value of all lifetime gifts given during the 7 year period exceeds the nil rate band,⁴ no Inheritance Tax is payable on any such gift. However, the lifetime gifts use up the nil rate band, so that the amount available to offset against the deceased's remaining assets is reduced.

¹ Relevant lifetime gifts are lifetime gifts that use up any available nil rate band or are subject to Inheritance Tax.

² Legally it is the executors or personal representatives who become jointly liable to pay the tax, but in practice this means that the obligation to pay the tax falls jointly on the assets of the estate and the gift recipients.

³ For ease of understanding, references to the nil rate band in this chapter include references to the transferable nil rate band.

⁴ The nil rate band is set at £325,000 in 2019.

Immediately Chargeable Lifetime Transfers

- 3.7 Some lifetime gifts, for example a transfer into trust (other than a disabled trust), are immediately taxable, if the amount transferred exceeds the available nil rate band (and no relief is available such as normal expenditure out of income, APR or BPR). These are called immediately chargeable lifetime transfers. The person making the gift is primarily liable for the Inheritance Tax on immediately chargeable lifetime transfers.
- 3.8 The nil rate band is allocated to relevant gifts, including chargeable lifetime transfers, in chronological order. In addition, the nil rate band is used for other purposes in relation to transfers into trusts, to calculate any '10 year charge' or 'exit charge' to Inheritance Tax. The amount of nil rate band used for these purposes is the amount that was allocated to the transfer into trust at the time of the transfer. Unsurprisingly, advisers are well aware of the value of using the nil rate band for transfers into trust.

Observations

Taxing the gift recipient is counter intuitive

- 3.9 The OTS has heard that many people who make large lifetime gifts to individuals, and many recipients of such gifts, assume that the gift is for the recipients to spend, without considering that:
- the recipient may have to pay Inheritance Tax if the donor dies within 7 years
 - if the recipient does not pay any such Inheritance Tax within 12 months (which is common) the estate becomes jointly liable
- 3.10 A wide range of comments have been made on this topic by those who responded to the OTS's call for evidence. Some felt strongly that it is unfair to chase after the recipient of a gift for an Inheritance Tax payment when they may have received it some years ago and may have spent the money. Others felt no less strongly that it would be unfair for the burden of the tax to fall onto the estate if gift recipients do not pay.

The allocation of the nil rate band to the earliest gift first can cause inequalities

- 3.11 The OTS has heard that the allocation of the nil rate band to lifetime gifts in preference to the death estate, and to the earliest gifts first, is one of the most widely misunderstood aspects of Inheritance Tax.
- 3.12 It can cause inequalities between gift recipients in situations where someone has given lifetime gifts that have used up their nil rate band. Individuals who have not taken advice may not be aware that the nil rate band is allocated to the earliest gift first and it can mean some beneficiaries unexpectedly benefit from the nil rate band while others do not.
- 3.13 As well as creating inequality between recipients that may have not been intended by the donor, this can lead to situations where gift recipients have spent the funds given to them but then find themselves liable for Inheritance Tax.

3.14 The nature of the rules is illustrated in Case Study 3.A:

Case Study 3.A

Sarah gives £325,000 to her son James in 2015 and in the following year she gives the same amount to her daughter Claire. James and Claire both spend the money on purchasing flats. Sarah dies in 2018 having made no other gifts. Her estate is worth £1 million.

Both gifts are within 7 years of Sarah's death, so the position is:

	James (£)	Claire (£)
Gift	325,000	325,000
Nil rate band available	(325,000)	(0)
	0	325,000
Inheritance Tax @ 40%	0	130,000

The nil rate band of £325,000 is offset against the gift to James as this is the first gift Sarah made. There is no Inheritance Tax for James to pay on the gift he received.

Claire must pay Inheritance Tax of £130,000 on her gift. If Claire does not pay the Inheritance Tax within 12 months of Sarah's death (perhaps because she has spent the money and does not have other funds) then the estate becomes jointly liable for the unpaid tax.

The nil rate band has been used on a lifetime gift and so none is available to set off against the value of the estate. Unless further reliefs and thresholds are available, the estate will be taxed at 40%, and be liable to pay £400,000 of Inheritance Tax.

Sarah could have specified in her will that Inheritance Tax on the gift to Claire should be paid from her estate. However, she may not have thought about this or presumed that she would live long enough for the gift to become free of Inheritance Tax. Sarah could also have removed the inequality between her children by giving the gifts on the same day – but this may not always be possible.

- 3.15 While some respondents have told the OTS that the chronological allocation of the nil rate band is confusing and misunderstood, others have pointed out the advantages of this approach, particularly for those taking advice. In particular, chronological allocation means that the amount of nil rate band available for a specific gift (such the gift made to James in the example above, or gifts made into trust if they are made first) can be known at the time when the gift is made. It is not dependent on future gifts.

Allocating liability when the gift recipient does not pay the tax due is problematic

- 3.16 If Inheritance Tax is payable on a lifetime gift and the gift recipient does not pay within 12 months, the executors of the estate become concurrently liable to pay the tax out of the estate assets.
- 3.17 The OTS has heard that these rules can be difficult for both HMRC and executors to administer. Raising separate tax demands for each gift recipient, in those cases where this is required, creates an administrative burden.
- 3.18 In the past there have been practical issues such as finding the names and addresses of the gift recipients and ensuring that separate tax demands have been sent. Recent changes to Inheritance Tax forms should help ensure that these problems are resolved for the future so that HMRC can get in touch with the recipients of the gift directly, unless they have been notified that the executor is dealing with the matter.
- 3.19 Executors are personally liable for any unpaid Inheritance Tax up to the value of the estate that has come into their hands. This can be worrying, particularly for executors who are not beneficiaries of the will, despite the available HMRC guidance on their general approach.⁵ They may be reluctant to distribute the estate if there is a risk that substantial lifetime gifts had been made on which tax may be due and they may become personally liable.
- 3.20 In some cases, lifetime gifts outweigh the amount in the estate on death to the extent that there is not enough remaining to pay the Inheritance Tax if the gift recipients do not pay. Where the beneficiaries of the estate are different from those who received lifetime gifts, there can be an unfairness, especially where the gift recipients are overseas making it more difficult to collect any tax due from them.
- 3.21 In some situations, for example where there have been a number of marriages or civil partnerships, it is not uncommon for the estate to be divided differently between those receiving lifetime gifts and those receiving part of the death estate. This can cause tensions if tax remains unpaid on those gifts given in lifetime.
- 3.22 The OTS has heard that executors sometimes pay the tax on lifetime gifts up front even while the gift recipient is still solely liable. This might be because they do not understand the rules or are concerned about being personally liable for the tax if the gift recipients do not pay, or it could be because they are under pressure from the beneficiaries to release funds from the estate.
- 3.23 There are limited statutory rights for the executors to recover any unpaid Inheritance Tax from the gift recipients. The OTS has heard that the lack of a well defined statutory right of recovery of the unpaid tax can result in executors not wishing to seek to recover the tax from gift recipients where the estate has paid the tax on a lifetime gift.
- 3.24 In other cases, the OTS has heard that it can mean that the executors delay distributing the estate because they are concerned that if a lifetime gift

⁵ <https://www.gov.uk/hmrc-internal-manuals/inheritance-tax-manual/ihtm30044>.

emerges after they have distributed, it will be difficult for them to pursue the gift recipients for the tax due.

Conclusions

3.25 The observations above have led the OTS to explore alternative methods for calculating and allocating the liability for Inheritance Tax. The OTS suggests the following very different alternatives are considered.

3.26 Reform the existing framework:

- any Inheritance Tax due in relation to lifetime gifts to individuals should be payable by the estate, and
- the nil rate band should no longer be allocated to lifetime gifts in chronological order but, rather, first be allocated proportionately across the total value of all the lifetime gifts, with any remainder then being available to the death estate

3.27 Amend the existing framework:

- for executors to be liable to pay Inheritance Tax relating to lifetime gifts only out of assets they handle, and which are due to be distributed to the gift recipient in question, and if it has not proved possible for HMRC to collect the money directly from the gift recipient

3.28 It is important to note that these suggested changes would only affect estates where the total value of taxable lifetime gifts exceeds the applicable nil rate band.

Reform the existing framework

Inheritance Tax on lifetime gifts to individuals to be paid by the estate

3.29 The current process under which Inheritance Tax on lifetime gifts to individuals may be payable by the recipient is complicated and can lead to uncertainty. Individuals giving a gift often do not realise some of that gift might be clawed back in tax. Similarly, recipients of gifts may not appreciate this and may spend the money without waiting to see whether Inheritance Tax becomes payable.

3.30 If the Inheritance Tax on lifetime gifts to individuals was payable by the estate, the Inheritance Tax system would be more intuitive and easier for most individuals to understand and comply with.

3.31 The collection of Inheritance Tax would generally be operationally simpler as, in most cases, HMRC would collect tax solely from the executors, without the need to seek tax from gift recipients who may well have spent their gift.

3.32 The OTS is aware that this would be quite a significant change to the way Inheritance Tax is calculated and paid. As well as the obvious implication that the residuary beneficiaries would bear the cost of any Inheritance Tax on lifetime gifts to individuals, there would be a number of other implications and knock on effects.

3.33 For example, the tax due on lifetime gifts would have to be taken into account in the calculation of the overall Inheritance Tax due from the estate

in a comparable way to the approach adopted in relation to specific gifts made in the will, potentially including the gifts being grossed up.⁶

- 3.34 Another impact of this change concerns the relatively rare situation where the tax to pay on lifetime gifts along with any additional tax to pay on chargeable lifetime transfers is so large that the assets left in the estate cannot cover it. In other words, the estate is insolvent. In these situations, as now, HMRC would need to be able to recover the tax from gift recipients.
- 3.35 Where the estate includes illiquid assets, HMRC might want to consider guidance or extending the instalment payment options to cover any Inheritance Tax on lifetime gifts. In addition, protection for executors would be needed to address the very unusual scenario of a lifetime gift coming to light after they have distributed the estate despite the executors having undertaken their best efforts to uncover all such gifts.
- 3.36 Any additional Inheritance Tax arising on death in relation to chargeable lifetime transfers (if the total amount of these and relevant lifetime gifts to individuals exceeded the nil rate band) would fall on the estate.
- 3.37 Finally, it is recognised that that this change would affect any testators who wanted lifetime gift recipients to bear any Inheritance Tax on those gifts. This may be the case especially in those situations where there have been a number of marriages in a family and someone wants to provide for some members of the family through a lifetime gift and others through the estate. They would have to plan for this either by adjusting the amount of any (separate) will gifts to that person, or by entering into arrangements with the recipient at the time the lifetime gift is made.

Allocate the nil rate band on death rather than in chronological order

- 3.38 Alongside making the estate liable for the tax on lifetime gifts to individuals, the OTS suggests the nil rate band be allocated proportionately on death across the total value of all relevant lifetime gifts, rather than from the earliest gift first.
- 3.39 This would prevent confusing inequalities between the tax paid by different gift recipients.
- 3.40 Such a change would have a particular impact on certain immediately chargeable lifetime transfers such as transfers into trust.
- 3.41 Under the present rules the nil rate band at the time of a transfer into trust is used to calculate the amount of Inheritance Tax payable on the initial transfer into trust as well as the amount of '10 year charges' and exit charges payable by the trust. Where the deceased person has made gifts into trust but has not used up their nil rate band at the time of death, these proposals should not impact on the taxation of the trust.
- 3.42 However, where this is not the case, the trustees of the trust will need to plan for the fact that the applicable nil rate band may not be certain at the

⁶ Grossing up is discussed in Chapter 8.

time that these tax charges arise. It will not be final until the settlor has died or the 7 years⁷ have passed (whichever is the earlier).

- 3.43 It is worth noting that one of the suggestions made to the OTS is that trusts should have their own de minimis threshold rather than sharing the nil rate band with lifetime gifts to individuals. This would simplify the interaction between gifts into trust and gifts made to individuals. This suggestion is discussed further in Chapter 11 (Trusts).

Case Study 3.B: Revisiting Case Study 3.A on the basis of the reform option

Sarah's estate is worth £1 million on her death. The value of the gifts would be added to the value of Sarah's estate, the Inheritance Tax calculated taking into account the nil rate band, and then payable out of the estate. As a result, the tax, and the overall estate, would be split equally between the two children.

	£	£
Lifetime gifts	650,000	
Less nil rate band	(325,000)	
Total		325,000
Estate		1,000,000
Total		1,325,000
Inheritance Tax @ 40%		(530,000)
Balance split 50:50 between children		795,000

Option to amend the existing framework

- 3.44 A less radical option than the reform option discussed above would be to amend the liability rules to better support executors. Some have suggested that this could be done by improving the statutory rights of recovery for the estate against recipients of lifetime gifts. However, the OTS's view is that a statutory right of recovery would not go far enough in protecting executors from the burden of having to chase gift recipients.
- 3.45 The OTS suggests that the government consider changing the liability for payment of tax on lifetime gifts. The executors would instead be liable to pay the tax only out of assets they handle and which are due to be distributed to the gift recipient in question. This would be the case only if it has not proved possible for HMRC to collect the money directly from the gift recipient.

Recommendation 4

The government should explore options for simplifying and clarifying the rules on liability for the payment of tax on lifetime gifts to individuals and the allocation of the nil rate band.

⁷ This would be 5 years if the OTS's recommendation is adopted.

Chapter 4

Interaction with Capital Gains Tax

Background

- 4.1 At a theoretical level, Inheritance Tax and Capital Gains Tax are quite different and are underpinned by separate policy rationales. Capital Gains Tax is charged on the increase in the value of an asset since its acquisition (the gain), whereas Inheritance Tax is generally levied by reference to the total value of assets transferred.
- 4.2 Despite the theoretical differences, there is, of course, a high degree of practical overlap between Capital Gains Tax and Inheritance Tax. Many of the assets on which Capital Gains Tax is levied also potentially attract Inheritance Tax. This is arguably one reason Capital Gains Tax is not levied on death.¹

Capital Gains Tax as an alternative to Inheritance Tax

- 4.3 As noted in the OTS's first report on the tax,² Inheritance Tax appears to be almost uniquely unpopular,³ and the OTS received many representations suggesting that it should be abolished. Reasons given included that it comprises double taxation and that it is a wealth transfer tax targeted at people who have worked hard to save for their old age.
- 4.4 This, and the fact that there are a number of countries which do not have inheritance taxes, raises a broader issue about the overall structure of the tax system and the interactions between different taxes. Some of those raising the idea that Inheritance Tax should be abolished suggested that it should be replaced with Capital Gains Tax on death.

Simplification aspects

- 4.5 It is tempting to suggest that it would be simpler in principle to apply Capital Gains Tax in life and on death, and to abolish Inheritance Tax.
- 4.6 There would then only be one tax for people to deal with and for HMRC to administer and such an approach could alleviate concerns around double taxation of wealth transfers.
- 4.7 It is also possible that Capital Gains Tax on death would be easier to apply than Inheritance Tax. Capital Gains tax on death could be a less unfamiliar

¹ Section 62 of the Taxation of Chargeable Gains Act 1992.

² Page 10, Inheritance Tax Review: first report <https://www.gov.uk/government/publications/office-of-tax-simplification-inheritance-tax-review>.

³ <https://yougov.co.uk/news/2015/03/19/inheritance-tax-most-unfair/>.

tax for some lay executors to deal with. Moreover, as is clear from this report, and notwithstanding the recommendations made, the lifetime giving regime is complex to understand and comply with, and there is at least a risk of intentional or unintentional non compliance. A tax that is better understood, has more public legitimacy and greater levels of compliance would be simpler and more straightforward.

- 4.8 However, from a simplification perspective there would also be disadvantages to imposing Capital Gains Tax on death. The main potential disadvantage is that, assuming there were no changes to existing Capital Gains Tax allowances, many more people would be brought into a charge to tax on death than are currently subject to Inheritance Tax.
- 4.9 It would also involve a substantial Exchequer cost as well as impacting a much larger number of people. Such a change goes beyond the scope of this review, but it is hoped that the HMRC data provided will help inform debate.

Table 4.A: Capital Gains Tax on death compared with Inheritance Tax

	Capital Gains Tax on death	Capital Gains Tax on death (if no PPR)	Inheritance Tax
Estimated annual number of taxpaying estates	55,000	182,000	24,500
Estimated tax raised per annum	£1.3 billion	£2.8 billion	£4.38 billion

Table note: PPR is the Capital Gains Tax exemption on the main home, known as principal private residence relief

Sources: HMRC data and Inheritance Tax receipts in 2015-16 – see Annex E

Interaction with Inheritance Tax

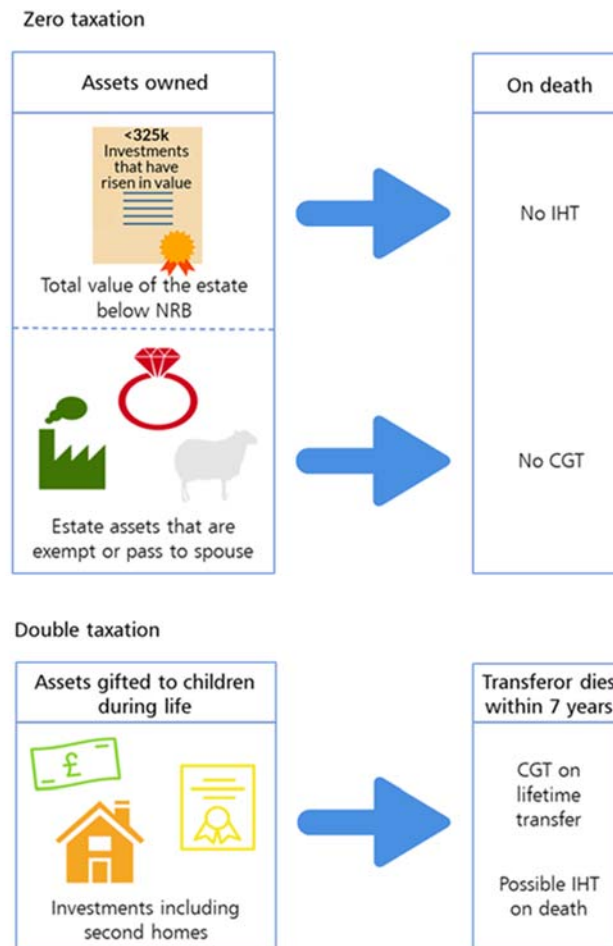
- 4.10 Capital Gains Tax exemption on death is intended to reflect the impact of Inheritance Tax. However, it does so in an imperfect manner. Both zero taxation and double taxation are possible under the current system. This is illustrated in Chart 4.A below.

Smooth interaction

- 4.11 In some situations, the interaction between Capital Gains Tax and Inheritance Tax is relatively smooth.
- 4.12 Investments such as listed shares are included in the value of the estate on death for Inheritance Tax purposes, but are not subject to Capital Gains Tax on death.
- 4.13 Principal private residence relief means taxpayers do not have to pay Capital Gains Tax when they dispose of their main residence. However, main residences (or their sale proceeds, if retained) are included in the value of the estate for Inheritance Tax purposes. Subject to the nil rate bands, their value is taxed on death.

- 4.14 By contrast, assets qualifying as national heritage assets can pass to their new owners with relief from both Inheritance Tax and Capital Gains Tax.⁴ (The OTS did not receive many comments on national heritage relief during the course of its work).

Chart 4.A: How zero and double taxation can arise with Capital Gains Tax and Inheritance Tax



Source: OTS

The capital gains uplift on death

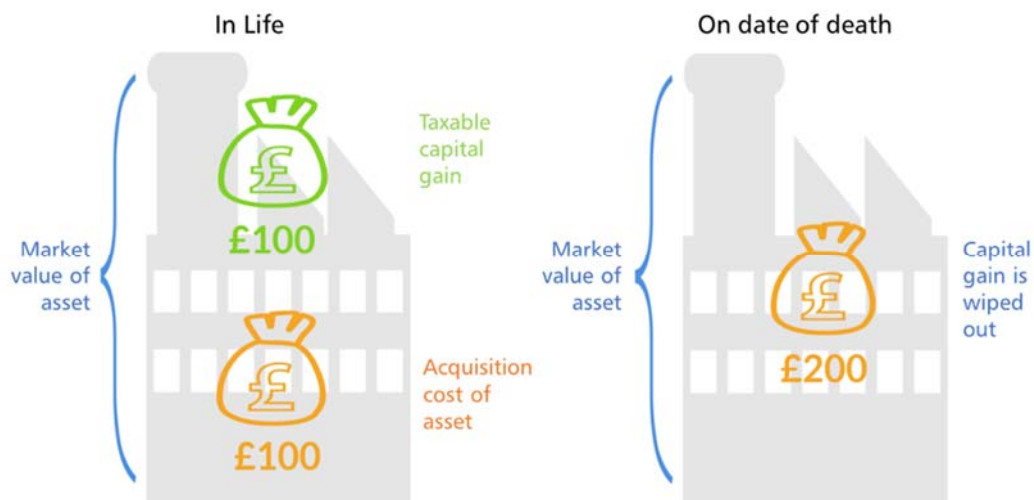
Background

- 4.15 When someone inherits assets, the acquisition value of the assets for capital gains purposes is the market value of those assets on the date of death.⁵ Any previous gains are wiped out. This is known as the 'capital gains uplift' on death. Of course, it is also possible that this rule could wipe out a loss, although this would be relatively unusual in a scenario where many assets gradually rise in value over time.
- 4.16 The capital gains uplift is illustrated in Chart 4.B. The capital gains uplift applies to all capital assets, including business property, farms, residential property, shares and other investments held at death.

⁴ <https://www.gov.uk/guidance/tax-relief-for-national-heritage-assets>.

⁵ S62 Taxation of Chargeable Gains Act 1992.

Chart 4.B: The capital gains tax uplift



Source: OTS

- 4.17 The capital gains uplift is not available for gifts made during life. However, there is one important relief from Capital Gains Tax that can apply to lifetime gifts, known as gift holdover relief.⁶
- 4.18 Subject to certain conditions being met, if a trading business or farm is given away during a person's life, either to an individual or to a trust, a claim to gift holdover relief may be made, so there is no immediate charge to Capital Gains Tax. Instead, the recipient is treated as acquiring the asset at the donor's historic acquisition cost and no gains arise until a subsequent disposal of the business or farm. At the same time, APR or BPR could apply for Inheritance Tax purposes.
- 4.19 Below are some case studies illustrating how the capital gains uplift works.

Case Study 4.A: Alternative Investment Market (AIM) – zero taxation on death

Sue is a successful accountant, who has retired with a large pot of cash savings which could be subject to Inheritance Tax on her death. Sue therefore decides to invest £100,000 in a portfolio of AIM-traded shares selected by her financial adviser. The shares have been selected because they are likely to attract BPR once Sue has held them for 2 years.

The shares do very well and on her death some years later, they are worth £250,000.

Sue dies, and her children inherit the shares. Sue's children sell the shares shortly after her death, when they are worth £300,000.

⁶ S165 Taxation of Chargeable Gains Act 1992.

Inheritance Tax	Capital Gains Tax
<ul style="list-style-type: none"> the shares qualify for BPR there is no Inheritance Tax to pay on the shares 	<ul style="list-style-type: none"> no Capital Gains Tax to pay on death gain of £150,000 is wiped out on Sue's death because of the capital gains uplift when Sue's children sell the shares, there is a capital gain of £50,000, as the value of the shares has increased by £50,000 since they were inherited

Case Study 4.B: Spouse exemption – zero taxation on death

Jim and Angela have been married for 20 years. During this time, Jim has spent £100,000 building up a portfolio of listed shares.

Jim dies and leaves his entire estate to Angela. At this point, the value of the share portfolio is £300,000.

Inheritance Tax	Capital Gains Tax
<ul style="list-style-type: none"> none, due to spouse exemption 	<ul style="list-style-type: none"> no Capital Gains Tax to pay on death capital gains of £200,000 wiped out because of the capital gains uplift

Case Study 4.C: Trading business – double taxation

Sam has set up a successful pet food supply business. Over the years, he has invested £100,000 in the business, but it is now worth £1 million. He has reached retirement age and decides to hand the business on to his children. A joint claim for gift holdover relief from Capital Gains Tax means that children take over the business at Sam's base cost of £100,000. They do not benefit from the capital gains uplift because Sam is still alive when he gives it to them.

The business does even better, and it is sold 3 years later for £1.1 million. The children realise a total capital gain of £1 million on which tax of £200,000 will be due (potentially £100,000 if entrepreneurs' relief applies).

Sam dies the following year, 4 years after giving the business away, so the gift was given within 7 years of his death.

Inheritance Tax	Capital Gains Tax
<ul style="list-style-type: none"> • BPR does not apply because the children no longer own the business • Inheritance Tax is payable 	<ul style="list-style-type: none"> • Capital Gains Tax was paid on sale of business • Some relief is later available for the Inheritance Tax paid

Observations

The capital gains uplift distorts decision making

- 4.20 The OTS has heard from numerous advisers that the capital gains uplift on death distorts decision making relating to assets that benefit from an exemption from Inheritance Tax. Where a client holds such an asset that has risen in value, and is considering transferring it during life, they are often advised to retain it until death rather than giving it away during lifetime, because of the tax benefits.
- 4.21 The capital gains uplift is a distortive factor in decisions on the succession of businesses and farms which qualify for APR or BPR. Where such an asset is retained until death, any potential capital gains are wiped out and there is no Inheritance Tax to pay. This could lead to an asset being retained rather than being transferred to the next generation at the time that is right for the business.
- 4.22 The OTS has heard anecdotal evidence of businesses and farms suffering because the owner has remained in charge despite being too old to devote themselves to the business. Of course, this could happen for reasons unrelated to tax, but it is unhelpful that the tax system encourages such a situation.
- 4.23 A similar issue arises where the spouse exemption from Inheritance Tax applies. The capital gains uplift can apply when assets are transferred on death and are covered by the spouse exemption so that capital gains are wiped out and no Inheritance Tax is paid. However, lifetime transfers between spouses do not benefit from the uplift. This can also distort the decisions couples make about the timing of asset sales.
- 4.24 There may be other situations where this problem arises, such as where an asset is not chargeable to Inheritance Tax because its owner is not domiciled in the UK for Inheritance Tax purposes.
- 4.25 Respondents have also suggested that the capital gains uplift undermines the policy intent behind APR and BPR. As shown in the examples above, it is possible for the farm or business to be exempt from Inheritance Tax on death and sold immediately thereafter with no Capital Gains Tax payable either.
- 4.26 Some advisers suggested that it would simplify decision making around succession if there were no capital gains uplift for assets that are not subject to Inheritance Tax. Individuals would be able to focus on when the time is

right to pass on their assets without being influenced by the capital gains uplift.

A 'no gain, no loss' transfer on death

- 4.27 One option that has been considered to remove the distortion is replacing the capital gains uplift with a 'no gain, no loss' transfer, for certain assets.
- 4.28 A 'no gain, no loss' transfer means that there would be no capital gains uplift (but nor would capital gains be immediately payable upon death). Those to whom the business passes on death would instead acquire the assets at the historic base cost of the person who had died.
- 4.29 This would bring the treatment of transfers on death in line with gift holdover relief from Capital Gains Tax, which is the relief likely to be used for lifetime gifts of BPR or APR assets, and with the Capital Gains Tax treatment for lifetime transfers between spouses.
- 4.30 Parity between treatment in life and on death would eliminate the distortion caused by the capital gains uplift. For this reason, a transfer at the historic base cost is preferred to a Capital Gains Tax charge on death. A Capital Gains Tax charge on death could simply reverse the distortion in favour of lifetime transfers so that it would be preferable, from a tax perspective, to give away the asset during life.
- 4.31 An area that would require careful consideration is where a proportion of the estate is inherited by a spouse or civil partner without individual assets being identified. In this situation, there can be a choice of which assets pass to which beneficiaries and the legislation would need to ensure that all assets passing to a spouse or civil partner do so at a 'no gain no loss' value.
- 4.32 Another issue that would need to be considered is where the relevant asset is not given full relief from Inheritance Tax, or where it is transferred to two beneficiaries, one of whom is exempt and the other is not. In such cases, consideration would need to be given as to how a no gain, no loss transfer would apply. What proportion of the value would receive a capital gains uplift? This could raise tricky valuation issues.
- 4.33 The OTS has received three suggestions on how to approximate a sensible result here without creating unnecessary complexity. There may also be other approaches or government could adopt a combination of these:
- the proportion of an asset that does not qualify for Inheritance Tax relief is used to determine the proportion of the gain on any eventual disposal that would not be subject to Capital Gains Tax, or
 - where an asset is bequeathed partly to an exempt beneficiary and partly to a chargeable one, only the fractional interest received by the exempt beneficiary would receive no gain, no loss treatment
 - a monetary amount could be added to the base cost of the asset, calculated by reference to the value in respect of which Inheritance Tax is payable

Conclusions

The capital gains uplift is imperfect and distortive

- 4.34 Forgiveness of capital gains at death reflects the existence of Inheritance Tax. However, it is an imperfect way of eliminating double taxation and it can lead to zero taxation.
- 4.35 The key times where zero taxation occurs are where a relief or exemption from Inheritance Tax, such as the spouse exemption, BPR or APR, applies. In these cases, neither Capital Gains Tax nor Inheritance Tax is payable on death. The policy rationale for this is not clear.
- 4.36 The capital gains uplift provides an incentive for taxpayers to transfer their businesses or farms on death rather than in life. It also incentivises couples to wait until one spouse has died before selling an asset. This is a distortion as it can lead to these assets being transferred at a suboptimal time from a commercial or personal perspective. It complicates the decision making process for families as to how and when to pass on their wealth and would benefit from simplification.

A 'no gain, no loss' transfer would go a long way to eliminate the distortion

- 4.37 Replacing the capital gains uplift with a no gain, no loss transfer in situations where a relief or exemption from Inheritance Tax applies would help eliminate the distortion. It would come at an administrative cost to the people involved, because it could involve retaining records of acquisition costs,⁷ but would have no immediate tax impact on those who continued to hold the relevant assets.
- 4.38 The government would need to consider how this could be done in a way which minimised valuation complexities where assets are only partially exempt from Inheritance Tax. Some suggestions have been made in paragraph 4.33.

Recommendation 5

Where a relief or exemption from Inheritance Tax applies, the government should consider removing the capital gains uplift and instead provide that the recipient is treated as acquiring the assets at the historic base cost of the person who has died.

⁷ Note that there are some fixed valuations at specified dates inherent in Capital Gains Tax, which may apply instead of actual acquisition costs.

Chapter 5

Businesses and farms

Background

- 5.1 Inheritance Tax contains important reliefs for businesses and farms. Business property relief (BPR), and agricultural property relief (APR) combined are worth over £1 billion per year, and are important in determining Inheritance Tax liability.

Chart 5.A: Value of business and agricultural property reliefs



16,380 – number of estates expected to benefit from BPR or APR over the next five years

£5.85 billion – total cost to the Exchequer of BPR and APR over the next five years of both reliefs (compared with £30.4 billion – total Inheritance Tax yield expected over the next five years)

£357,000 – average benefit for each eligible estate of both reliefs over the next five years

Source: HMRC data – see Annex E

- 5.2 It is generally understood that the main policy rationale for APR and BPR is to remove the need for the sale or break up of businesses or farms to finance Inheritance Tax payments following the death of the owner.
- 5.3 These reliefs play an important role in ensuring that farms and businesses are able to continue from generation to generation, and in supporting the provision of investor finance to some small and medium sized businesses.

Business property relief

- 5.4 Where an estate includes a business that qualifies for relief, BPR reduces the amount of the value of the business chargeable to Inheritance Tax, either by 50% or 100%.
- 5.5 The property qualifying for relief is:
- a business, or an interest in a business (100% relief)
 - unquoted shares in a company (including shares traded on AIM) (100% relief)
 - quoted shares or securities where the owner had a controlling holding (50% relief)

- land or machinery owned personally and used in the trade of a company controlled by the owner, or a partnership in which that person was a partner (50% relief)
- 5.6 The property must have been held by the deceased for two years up to the date of death.
- 5.7 An important condition for relief is that the business must not consist wholly or mainly of holding investments. While 'wholly or mainly' is not defined in the legislation, it is thought of as a greater than 50% test. Where mixed activities are carried on, it is possible for the whole business to qualify for BPR provided that the investment activity is not the main part.

Agricultural property relief

- 5.8 While both APR and BPR might potentially apply to farms, APR can be wider than BPR in that it potentially applies to the farmhouse and to let land. Where a property qualifies for both APR and BPR, APR applies in priority. However, BPR can apply to farm property that does not qualify for APR as long as it meets the relevant conditions.
- 5.9 APR is available for the following types of property:
- agricultural land or pasture
 - woodland or buildings for the intensive rearing of livestock or fish, where occupied with and ancillary to the agricultural land or pasture
 - cottages, farm buildings and farmhouses which together with the land, are of a 'character appropriate' to the property
- 5.10 The agricultural property must be in the UK, Channel Islands, Isle of Man or an EEA state. This contrasts with BPR, which has no such restriction. To qualify, property must generally have been held and used for agricultural purposes for 2 years up to the date of death where the property is occupied by the owner, or 7 years where it is let.
- 5.11 The relief is 100% of the agricultural value if the owner farmed it themselves, or it was let on a tenancy that began on or after 1 September 1995. The relief is 50% in other cases. The agricultural value is the value if the property could only be used for agricultural purposes, which has relevance when valuing the farmhouse or development land, which may have a market value above this.

Woodland relief

- 5.12 This relief is for the value of trees only and does not include the value of the land on which they grow. The relief is used rarely in circumstances where the trees do not qualify for either APR or BPR.

Observations

Removing the reliefs and lowering the rate of Inheritance Tax

- 5.13 Some individuals who responded to the OTS's consultation suggested that the tax could be simplified by removing BPR and APR and reducing the rate of tax.

- 5.14 Some such respondents suggested that removing these reliefs might fund a halving of the main rate of Inheritance Tax. However, this is not the case. Such a change goes beyond the scope of this review, but some data is provided to help inform debate.

Abolishing APR and BPR entirely would fund a reduction of the main rate of Inheritance Tax from 40% to around 33.7%.

Source: HMRC data – see Annex E

Is the treatment of AIM shares within the policy intent of BPR?

- 5.15 BPR can be claimed on some shares that are traded on the Alternative Investment Market (AIM).
- 5.16 In addition, since 2013, AIM shares can be held in individual savings accounts (ISAs), which means AIM shares held in such ISAs can also benefit from BPR, unlike ISAs that include shares traded on other markets.
- 5.17 Generally, investment houses actively market the Inheritance Tax savings for qualifying shares purchased through AIM: BPR is seen by such firms as being important in supporting the AIM market.
- 5.18 The OTS notes that the government’s response to the Patient Capital Review consultation published in November 2017¹ stated the government’s commitment to protecting the important role that BPR plays in supporting family owned businesses and growth investment in AIM and other growth markets. In correspondence and meetings, the OTS has heard evidence of its importance in meeting that objective.
- 5.19 However, in particular in relation to third party investors in AIM traded shares, BPR is not necessary to prevent the business from being broken up or sold in order to fund the payment of Inheritance Tax. This raises a question about whether it is within the policy intent of BPR to extend the relief to such shares, in particular where they are no longer held by the family or individuals originally owning the business.

BPR: trading or investment?

- 5.20 If a business is wholly or mainly in the nature of investment, then it will not be eligible for BPR. This is not always straightforward to determine.
- 5.21 Many estates include both trading and non-trading business assets, and establishing whether this test is met can be difficult for both HMRC and the executor. The ‘wholly or mainly’ test (which is used in other parts of tax legislation) is generally considered to be a greater than 50% test. The test looks at the main activities of the business, and its assets and sources of income and profits over a reasonable period.

¹ Paragraph 3.24 of

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661398/Patient_Capital_Review_Consultation_response_web.pdf

- 5.22 For Capital Gains Tax purposes, where a business is given away as a gift or sold to a third party, gift holdover relief or entrepreneurs' relief may apply. For these reliefs, the test for eligibility in relation to companies is not the 'wholly or mainly' test but whether there is 'substantial' trading activity in the business. HMRC guidance suggests that this will generally involve an 80:20 split of trading vs investment, with several indicators to look at, including assets, income, expenses, time spent by officers or employees, and the history of the business.
- 5.23 The difference between the Capital Gains Tax rules and BPR can distort behaviour. This is due to gifts in life being treated differently under the Capital Gains Tax rules from bequests on death, to which the Inheritance Tax rules apply. This was noted in the OTS's business lifecycle report² and is discussed further in Chapter 4 of this report (Interaction with Capital Gains Tax).
- 5.24 More widely, in correspondence and discussions with stakeholders the OTS has heard views asking why there are different tests being applied to different tax reliefs. Some noted that it could simplify decision-making about when to hand these assets on to the next generation if the tests applied for Capital Gains Tax (if giving an asset away in life) and Inheritance Tax (if the asset is given away on death) were standardised.
- 5.25 Others however suggested that Inheritance Tax should continue to have a lower threshold for eligibility for relief than Capital Gains Tax, to reflect that it is more difficult to plan for death than for a disposal. This is because, unlike death, the timing of a lifetime disposal is within the control of the parties. Additionally, when an asset is sold, there will be funds available to pay any tax due. It was suggested that tightening the BPR test could lead to increased argument (and therefore delay in distributing the estate) between taxpayers and HMRC on the eligibility for relief but this is not a view shared by all.

BPR: non-controlling shares in trading companies

- 5.26 Another area of difficulty is the treatment of non-controlling holdings of 50% or less of the shares in trading companies, where the balance of the shares is held by a third party. This is a common ownership structure for modern joint ventures. Where such shares are held indirectly, for example through a holding company, such holdings in trading companies are likely to be treated as investments, even if comprising the major asset of a holding company. If the shareholding had been held directly by the individual, it would be eligible for BPR.

BPR: limited liability partnerships

- 5.27 The treatment of limited liability partnerships (LLPs) for BPR purposes is inconsistent with the treatment of LLPs more generally. LLPs are generally regarded as 'transparent' for tax purposes with each member or partner being assessed to tax on their share of the LLP's income or gains as if they

² Chapter 4 of <https://www.gov.uk/government/publications/simplifying-everyday-tax-for-smaller-businesses>.

were members of a 'normal' partnership. So, for example, if an LLP carries on a trade, each registered partner is taxable on the income they derive from the LLP as trading income.

- 5.28 Notwithstanding these general principles, the wording of the Inheritance Tax legislation³ currently suggests that a corporate trading group that has an LLP rather than a company as its holding vehicle, may not be treated as 'trading' for BPR purposes. This can produce a different outcome to the situation where the group is held by a company and relief is available.

BPR: furnished holiday lets

- 5.29 A further issue highlighted to the OTS surrounds furnished holiday lets, which do not, in the vast majority of cases, qualify for relief.
- 5.30 The treatment of furnished holiday lets under BPR has been subject to legal challenge, where taxpayers and HMRC have disagreed over the interpretation of the Inheritance Tax rules.
- 5.31 HMRC's guidance⁴ on this explains that 'furnished holiday lets will in general not qualify for BPR. The income derived from such businesses will largely consist of rent in return for the occupation of property. There may however be cases where the level of additional services provided is so high that the activity can be considered as not an investment, and each case needs to be treated on its own facts'.
- 5.32 Furnished holiday lets are not the only area where the distinction between trading and investment is a fine one which depends on the specific facts. However, it has been suggested to the OTS that particular confusion rises in relation to furnished holiday lets because, unlike other such areas, they are deemed to be trading for Income Tax and Capital Gains Tax purposes.

Valuations

- 5.33 The OTS has heard that obtaining a valuation can be time consuming for executors and others determining whether APR or BPR apply. HMRC's guidance is clear when a valuation is required in obtaining probate, but less clear in setting out where a formal valuation is likely to be needed for APR or BPR purposes.
- 5.34 For example, where it is clear that the business assets meet the criteria for eligibility for 100% relief under BPR, respondents were not sure whether undertaking a valuation of these assets is necessary and, if it is, whether this should be an informal estimate or a formal valuation (the latter being more expensive and time consuming).
- 5.35 HMRC have explained to the OTS that sometimes it is necessary to establish the gross estate value (for example in order to establish eligibility for the residence nil rate band). It would be helpful if HMRC guidance set out the situations where a formal valuation of a business or farm is required specifically for tax purposes.

³ Inheritance Tax Act 1984 S105(4)(b).

⁴ Inheritance Tax Manual at IHTM25278.

APR: illness or infirmity

- 5.36 In order to qualify for APR, the farmhouse or any farm cottage must be occupied for agricultural purposes. Complications can arise where the farmer moves out of the farmhouse to receive medical treatment, or leaves to go into care, and does not return. Currently, HMRC consider such circumstances on a case by case basis. Although the OTS has heard from HMRC that they seek to apply a common sense approach, the OTS believes that the tests for eligibility in such circumstances should be clearer and more transparent.

APR: the definition of agriculture

- 5.37 Some respondents have told the OTS that there is no common cross government definition of agriculture. The government should ensure that there is consistency as to what is considered agricultural use of land and HMRC should engage with the Department for Environment, Food & Rural Affairs on such matters, particularly in light of any changes following Brexit.

Conclusions

Trading requirements, non-controlling shareholdings and furnished holiday lets

- 5.38 As with the capital gains uplift, the trading and investment tests are an area where the interaction with Capital Gains Tax is very important, and where the OTS has heard that different definitions for Capital Gains Tax and Inheritance Tax may have a distortive effect on the process of deciding whether to transfer a business or farm during life or on death.
- 5.39 The OTS suggests that given the policy rationale for APR and BPR to grant relief to trading businesses, government should consider why the level of trading activity for BPR is set so much lower than the comparable reliefs from Capital Gains Tax. Aligning the BPR trading test with the tests for gift holdover relief and entrepreneurs' relief would be a simplification. Having one test would be easier for taxpayers to understand and would reduce distortions to decision making.
- 5.40 The OTS recognises that the distinction between trading and investment will come into sharper relief if the trading criteria for BPR are aligned with Capital Gains Tax. This could, in particular, affect non-controlling shareholdings and furnished holiday lets. The OTS therefore considers that these areas should be reviewed at the same time.
- 5.41 The OTS suggests that the government review the treatment of non-controlling shareholdings in trading companies when held indirectly, to ensure the use of a holding company structure does not inappropriately affect the scope of relief.
- 5.42 Furnished holiday lets are treated inconsistently between the taxes. The government should consider whether to align their Inheritance Tax treatment with that of Income Tax and Capital Gains Tax where they are treated as trading providing that certain conditions are met.

Recommendation 6

The government should, as a package:

- consider whether it continues to be appropriate for the level of trading activity for BPR to be set at a lower level than that for gift holdover relief or entrepreneurs' relief
- review the treatment of indirect non-controlling holdings in trading companies, and
- consider whether to align the Inheritance Tax treatment of furnished holiday lets with that of Income Tax and Capital Gains Tax, where they are treated as trading providing that certain conditions are met

Limited Liability Partnerships (LLPs)

5.43 Corporate trading groups may be treated differently for the purposes of BPR dependent on whether they have a company or an LLP as their holding vehicle. This adds complexity to the BPR rules and the OTS suggests that the government considers whether this difference in treatment is appropriate.

Recommendation 7

The government should review the treatment of limited liability partnerships to ensure they are treated appropriately for the purposes of the BPR trading requirement.

HMRC guidance

5.44 In addition, there are two areas of HMRC guidance or practice which would benefit from change, relating to sensitive cases where the farmer has had to leave the farmhouse for medical treatment or to go into care, and around valuations of businesses and farms. Questions of valuation will become particularly important if the government decides to increase the level of trading activity needed to qualify for BPR because more businesses would become subject to Inheritance Tax.

Recommendation 8

HMRC should review their current approach around the eligibility of farmhouses for APR in sensitive cases, such as where a farmer needs to leave the farmhouse for medical treatment or to go into care.

Recommendation 9

HMRC should be clearer in their guidance as to when a valuation of a business or farm is required and, if it is required, whether this needs to be a formal valuation or an estimate.

Chapter 6

Life assurance products and pensions

Background

- 6.1 The OTS's discussions with stakeholders identified an uneven playing field in the Inheritance Tax treatment of distinct types of financial products.
- 6.2 In practice, this can lead to a difference in tax paid between those who have taken advice and the large number of people who have not taken financial advice.
- 6.3 In some cases, this applies generally (such as in relation to certain pensions) and in others it is dependent on whether the financial product, such as a life policy, has been written in trust. This is because whether or not assets are subject to Inheritance Tax depends on whether they form part of a deceased person's estate, rather than purely by reference to the nature of the asset.

Interaction with Inheritance Tax

- 6.4 The issues considered in this chapter arise as a result of general features of Inheritance Tax rather than in relation to specific products. This causes complexity for people purchasing these financial products because some products, which provide the same benefit for the beneficiary, can be subject to Inheritance Tax in some situations but not others.

Insurance

- 6.5 In the UK, the majority of life assurance policies are known as term life cover. These policies only make a payment if the person whose life is insured dies within the term of the policy which is typically a period of years. There is no material investment element to these policies. Other types of assurance (such as whole of life policies and investment bonds) are used for both insurance and investment purposes.
- 6.6 Trusts can provide a number of benefits for an individual who has purchased a life assurance product. There are two main advantages, namely:
 - life policies written in trust do not need to go through probate, so payment to beneficiaries can be completed in a much shorter period. This will generally reduce the stress and hardship after the death of a financial provider such as a parent or spouse
 - in the majority of cases, proceeds from policies written in trust do not form part of the deceased person's legal estate, so they are not liable to Inheritance Tax

Pensions

- 6.7 Government policy has been to encourage the use and flexibility of personal pension schemes. Changes to the rules relating to pensions mean that those with a defined contribution pension scheme have a wider range of options to access their pension savings from the age of 55. However, those with defined benefit pensions do not have the same range of options.
- 6.8 The OTS understands that greater access to defined contribution pension savings has led to a significant reduction in the number of people buying annuities, so the value remaining in pension schemes when people die has grown considerably. In certain situations, these pension savings can be passed on to the next generation free of Inheritance Tax (although in some cases the recipients will be liable to Income Tax on drawdown from the fund).

Observations

Term life insurance written in trust

- 6.9 Having a life insurance policy written in trust can be advantageous for a beneficiary as it can enable more speedy settlement of payments by insurance companies. In addition, the discretion for trustees to change who the beneficiaries are may, in certain circumstances, enable trustees to accommodate people's changing personal circumstances.
- 6.10 However, despite these advantages, the OTS understands that many life insurance policies are not written in trust. This means that many death benefit payments would be included within estates and so are potentially subject to Inheritance Tax. On the other hand, these death benefit payments will quite often be covered by the spouse exemption or the nil rate bands.
- 6.11 The OTS has heard that if there is a standard route to take, with regard to term life insurance, which means the asset is outside a deceased person's estate and as a result outside of Inheritance Tax, then it would generally be desirable for this to be the default result for tax purposes, without one having to jump through those hoops. This is especially relevant in light of a recent government consultation on the fifth money laundering directive,¹ which if implemented would require all trusts to be registered, adding an extra administrative burden.

Pensions with discretion

- 6.12 Pension savings can only be passed on free of Inheritance Tax if the pension provider can choose whether and to whom it is passed on to. It is this discretion which is the key factor rather than whether it is in trust. In practice, the operation of discretion by trustees, in relation to defined contribution pensions, creates an unwelcome operational administrative cost for the pension product provider. The OTS was told that currently, the main reason discretionary trusts are used is to keep such pension savings outside Inheritance Tax.

¹ <https://www.gov.uk/government/consultations/transposition-of-the-fifth-money-laundering-directive>.

Pension transfers

- 6.13 The OTS has heard that increasingly people are deciding to move money between different pension providers. The OTS understands that the primary drivers are likely to be lower fund management costs, consolidation of several pensions into one, to have a greater number of investment options or greater control of investments and the ability to access flexible drawdown. In most of these cases, the beneficiaries are unlikely to change.
- 6.14 A number of those the OTS consulted said that when a person makes such a pension transfer, perhaps between a defined benefit and a defined contribution scheme, within two years of their death, HMRC consider, in certain circumstances, that there has been a transfer of value and it is for the taxpayer to demonstrate that the transfer has been made without the intention to confer a gratuitous benefit. This means that in these cases an unexpected liability to Inheritance Tax can arise.
- 6.15 The OTS has heard that the operation of the two year rule regarding gratuitous benefits is causing a high degree of uncertainty for financial advisers because at the time of undertaking such transfers, there can be no certainty as to whether a transfer will be considered to be creating a gratuitous benefit.
- 6.16 The OTS understands that in practice, it is very unusual for HMRC to argue that there has been a transfer of value. HMRC will only argue that a transfer of value has arisen where there is evidence of an intention to confer a gratuitous benefit.
- 6.17 An example of such a case might be a person who has a final salary pension scheme who transfers it to a personal pension scheme thereby ensuring that there is a pot of money to be left to the deceased's beneficiaries. This frequently involves the beneficiary receiving six figure payments which they would not have received if the pension had remained in the final salary scheme.
- 6.18 There is currently a mismatch between the concern of financial advisers and the number of cases which HMRC actually pursue in these situations. It is also relevant that the guidance from HMRC in this area is not particularly clear. This issue has been subject to a recent decision of the Court of Appeal.² This provided some clarity on the issue and it is expected that HMRC will revise their published guidance in this area once the appeal process has been completed.

Conclusions

Insurance

- 6.19 The OTS has heard from many people that the financial services industry should have a more consistent approach when developing and marketing term life insurance policies.

² HMRC v Parry and ORS [2018] EWCA Civ 2266.

- 6.20 At present, the evidence indicates that most such policies are not written in trust even though it is very easy to do so when the policy is first purchased. Consequently, payments made under term life policies are included within some estates but not in others.
- 6.21 Accordingly, the OTS considers that it would be a simplification if all such death benefit payments were treated in the same way for Inheritance Tax purposes, whether or not one had the policy written in trust.
- 6.22 It is recognised that there would be a cost to the Exchequer in making such a change, depending on the extent to which such policies are not presently written in trust, but it has not been possible to cost this. It should be noted though that many death benefits are likely to pass to a surviving spouse and be exempt from Inheritance Tax.
- 6.23 As stated earlier in this report, the OTS is aware that HMRC have recently consulted on trusts, and the OTS suggests that these issues are given further consideration as HMRC take this forward.

Recommendation 10

The government should consider ensuring that death benefit payments from term life insurance are Inheritance Tax free on the death of the life assured without the need for them to be written in trust.

Pensions

- 6.24 As with life insurance policies, it appears anomalous that some pension policies can be included within an estate for Inheritance Tax purposes while other comparable pension savings are not. Changing this would simplify Inheritance Tax. It would remain a separate issue as to whether the use of discretionary trusts would be still appropriate for reasons that are not related to tax.
- 6.25 In relation to the gratuitous benefit pensions issue, the OTS considers that it would be helpful if HMRC were to provide further detailed guidance on the circumstances in which a gratuitous benefit may arise when making certain pension transfers, such as from a defined benefit scheme into a personal pension scheme shortly before death.
- 6.26 The interaction between Inheritance Tax and pensions is clearly a complex area but Inheritance Tax is only one of a number of taxes that apply to pensions. It may be appropriate, at some point in the future for the government to consider a wider review of the tax system and pensions, possibly carried out by the OTS.

Chapter 7

Anti-avoidance legislation

Background

- 7.1 There is a perception that many individuals avoid paying Inheritance Tax. This can be through legitimate tax planning or by illegitimate means.
- 7.2 The government have introduced two specific pieces of legislation (the gifts with a reservation of benefit rules and the pre-owned asset charge) to target abuse of the Inheritance Tax system.
- 7.3 In addition, the grossing up rules, discussed in Chapter 8, have a role in guarding against tax avoidance by ensuring that the correct amount of Inheritance Tax will be paid on an estate in circumstances where there may be exempt beneficiaries, gifts are left free of tax or relief is due.

Gifts with a reservation of benefit

- 7.4 A gift where the individual who made the gift retains a benefit for themselves is treated as a gift with reservation of benefit (GWR). When the person who made the gift dies and there has been a GWR prior to death, the rules allow HMRC to charge:
- the Inheritance Tax due on the gift if the gift was made within 7 years of the death
 - the Inheritance Tax due on death if there is still a reservation, or
 - the Inheritance Tax due as if the gift occurred on the date the reservation of benefit ceased, if the reservation ceased within 7 years of the death
- 7.5 An example of a GWR is when someone gives their home to their children but continues to live in the home rent free. This can arise where there is a desire for individuals to give away their family home to their children, either to reduce the Inheritance Tax payable on their death or to reduce their obligations to pay care home fees in the future.

Pre-owned asset charge to Income Tax

- 7.6 Following the introduction of the GWR legislation, schemes were devised to circumvent the legislation and create a similar outcome without the gift being a GWR. To ensure taxpayers were not able to avoid paying tax in these circumstances, the Pre-owned asset charge to Income Tax (commonly referred to as POAT) was introduced in 2005.

- 7.7 If an individual gives away a gift¹ and continues to enjoy a benefit but the gift does not fall within the GWR legislation, then the POAT legislation imposes an annual Income Tax charge on the value of the benefit received.

Observations

The anti-avoidance rules are complex

- 7.8 Some respondents have stated that the GWR rules, and the related POAT are not well understood and known by the public.
- 7.9 They can be complicated to apply, even by experienced advisors as it can be unclear what a reservation of benefit is. The liability for tax on reserved benefit property can be complex especially in cases where the gift is into trust or the reservation has ceased within the 7 years before death.

There is disagreement about whether POAT needs to be abolished, reformed or left alone

- 7.10 Some respondents to the OTS's call for evidence have questioned whether POAT is still necessary given the other anti-avoidance measures introduced by HMRC since the introduction of the POAT legislation in Finance Act 2004.

Quote from a response to the call for evidence:

"Since the POAT legislation was brought in, the General anti-avoidance rule (GAAR) and Disclosure of Tax Avoidance Schemes (DOTAS) rules for IHT provisions have been introduced and it is hard to think of a scenario that would not be within the GWR rules and then not be caught by either GAAR or DOTAS that the POAT legislation would apply to. A major simplification would be to remove the POAT tax rules in respect of transactions undertaken in the future."

- 7.11 However, this is not a view shared by all. The OTS has also received strong objections from some advisers to the idea of the POAT legislation being abolished because it could enable some taxpayers to engage in abusive tax arrangements without either Inheritance Tax or a POAT charge being imposed.
- 7.12 Some respondents have suggested that the POAT rules need to be reformed, as they apply in some circumstances where there is no reservation of benefit.

Conclusions

Anti-avoidance rules

- 7.13 Across all taxes, anti-avoidance legislation is becoming more complex, far reaching and inaccessible to most taxpayers.
- 7.14 This is a concern to both taxpayers and advisors who are confused by the amount of legislation and are afraid to make plans as they fear they will fall

¹ The type of gifts covered by the POAT legislation are gifts of chattels, intangibles or property.

within the anti-avoidance legislation. However, there is clearly a need to protect public funds from tax avoidance.

POAT

7.15 POAT is complex and not well known, it is an Income Tax charge that was introduced to combat Inheritance Tax avoidance, which in itself adds complexity.

Recommendation 11

The government should review the POAT rules and their interaction with other Inheritance Tax anti-avoidance legislation to consider whether they function as intended and whether they are still necessary.

Chapter 8

Grossing up

Background

- 8.1 The calculation of the Inheritance Tax payable, and its allocation, can vary if:
- any of the beneficiaries are exempt, such as a spouse or a charity
 - specific gifts provided for in the will are to be received 'free of tax', such as the gift of a painting or an exact sum of money
 - any of the assets in the deceased's estate attract relief, such as business property relief
- 8.2 The Inheritance Tax calculation is particularly complex if any of the beneficiaries of the residue¹ of the estate are exempt from tax (such as charities or a spouse). This is because the calculation can involve adjusting the amount of the estate allocated to anyone in receipt of a gift paid free of tax (under a process known as 'grossing up') to reflect the tax the estate is bearing in respect of those gifts.
- 8.3 In such a case, the amount of the residue left to the exempt beneficiary cannot be established until specific gifts have been grossed up at the correct rate of tax.
- 8.4 Another situation where grossing up is required is if the will provides for Inheritance Tax to be paid before the residue is divided. In such a case, the share of the residue left to chargeable beneficiaries will need to be grossed up to calculate the tax payable. However, the correct rate of tax cannot be calculated until the amount of exempt residue has been established.
- 8.5 The steps to follow to handle these situations are set out in legislation² or explained in HMRC guidance.³ A simple example is provided in Case Study 8.A below.

¹ The residue of an estate is what is left over after all gifts specified in the will have been paid out and Inheritance Tax and debts have been paid.

² <https://www.legislation.gov.uk/ukpga/1984/51/section/38>.

³ <https://www.gov.uk/hmrc-internal-manuals/inheritance-tax-manual/ihtm26152>.

Observations

Grossing up is complicated

- 8.6 The OTS has heard that the calculation of Inheritance Tax, particularly where 'grossing up' is required is complex and poorly understood, both among practitioners and taxpayers.
- 8.7 For executors completing the forms without professional advice, it is not helpful that the form does not indicate that grossing up may be required. It should however be noted that where forms are being completed without professional assistance, HMRC offer to do the calculation and a calculator is provided on GOV.UK.⁴

Residues split between chargeable and exempt beneficiaries can have unexpected outcomes

- 8.8 Where the residue is split equally between a mixture of chargeable and exempt beneficiaries, it could reasonably be expected that the beneficiaries would receive an equal amount, but this is not the case unless the deceased has specified that this is their wish and achieving that outcome always involves more tax being paid overall than would otherwise be the case.
- 8.9 Some respondents have suggested that the legislation should provide for the residue to be allocated after Inheritance Tax has been paid from the estate.

Sometimes grossing up is not done correctly or not done at all

- 8.10 It was suggested that there are instances where executors, including professional advisors, have incorrectly deducted Inheritance Tax from legacies due to charities.

Quote from Cancer Research UK:

"We believe that these mistakes are commonplace and may have led to a financial detriment to many charitable beneficiaries."

- 8.11 Some charities are concerned about reputational impact if they are seen to be repeatedly correcting errors. The OTS heard the desire expressed for these rules to be simplified.

Grossing up prevents the amount of Inheritance Tax payable from being manipulated

- 8.12 The following examples show the application of grossing up under the current rules and how the amount of Inheritance Tax payable on an estate could be manipulated if it were to be removed.
- 8.13 Case Study 8.A illustrates how grossing up works under present law.

⁴ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/730319/IHT400_Notes_0618_online.pdf.

Case Study 8.A

Vina gifts £325,000 to her son Ravi in 2015. She dies in 2017 with a remaining estate of £1 million. In her will, Vina makes a specific gift of £325,000 to her daughter, Anju, and the residue to her civil partner Natalia.

The gift to Anju is to be paid free of tax.

The gift to Ravi was within 7 years of Vina's death, and is therefore chargeable. The nil rate band of £325,000 is offset against this gift, and there is therefore no Inheritance Tax for Ravi to pay on the gift he received.

The nil rate band has now been used up, and no other reliefs are available.

The residue that is left to Natalia will be free of tax, because she is an exempt beneficiary. The gift to Anju needs to be grossed up, in order to calculate how much tax is due. Anju needs to receive £325,000. As the tax rate is 40%, the grossed up value of her gift will be £541,666.67. This is the value of the net gift (£325,000) plus the value of the tax (£216,666.67).

Of Vina's £1 million estate, £541,666.67 is chargeable to IHT and £458,333.33 is exempt.

Natalia, an exempt beneficiary, will receive £458,333.33.

- 8.14 Case studies 8.B to 8.D demonstrate how it would be possible for the Inheritance Tax payable to be manipulated if grossing up were removed (this example does not take into account the reduced rate of Inheritance Tax for gifts to charity).

Case Study 8.B

John left his entire estate of £1m to his son Alexander.

After accounting for the nil rate band of £325,000, Inheritance tax of £270,000 is payable at 40% on the balance of £675,000, and Alexander receives £730,000.

No grossing is required.

Case Study 8.C

As above, except John left a specific gift of £730,000 to Alexander and the residue to a charity.

Current position

- Inheritance Tax of £270,000 is payable, on the grossed up value of Alexander's gift (which is £1m)
- Alexander receives £730,000
- the charity receives £nil

Grossing removed

- Inheritance Tax of £162,000 is payable on the balance of the £730,000 gift that is not covered by the nil rate band
- Alexander receives £730,000
- of the £1m estate, £270,000 is exempt from Inheritance Tax, but
- the charity receives £108,000 (£270,000 less the tax of £162,000)
- so the gift to charity has reduced the Inheritance Tax payable but Alexander still receives the same amount

Case Study 8.D

As above, except John left a specific gift of £807,143 to Alexander and the residue to a charity.

Grossing removed

- Inheritance Tax of £192,857 is payable on the gift of £807,143 to Alexander
- Alexander receives £807,143
- of the £1m estate, £192,857 is exempt from Inheritance Tax, but
- the charity receives £0 because all of its entitlement is used to pay the tax
- so, by creating an appropriately calculated residual gift to a charity, Alexander's inheritance is increased by £77,143 and the Inheritance Tax is reduced but the charity does not in fact receive any distribution from the estate

Conclusions

- 8.15 The OTS has considered ways to simplify or remove the 'grossing up' calculation.
- 8.16 One possibility might be to require the tax to come out of the gift itself, but this would go against the presumption that specific gifts in wills are tax free and constrain the freedom of people to make such provision in their wills as they may wish.
- 8.17 Alternatively, if grossing up were simply removed, it would become possible to manipulate the amount of Inheritance Tax payable, as illustrated above.
- 8.18 Accordingly, the OTS does not recommend removing grossing up.

Chapter 9

Spouse exemption

Spouse or Civil Partner Exemption

- 9.1 In almost all cases, there is no Inheritance Tax to pay on assets inherited by a spouse or civil partner. The only exception to this rule is when the deceased was domiciled in the UK, and the surviving spouse has an overseas domicile.

Observations

- 9.2 It has been suggested to the OTS that the current system fails to take account of family relationships that are not based on a marriage or civil partnership, such as cohabiting couples. From 1996 to 2017 the number of cohabiting couple families increased from 1.5 million to 3.3 million.¹

Quote from The Royal London Mutual Insurance Society Limited:

“While cohabitation was once seen as a precursor to marriage, in an increasing number of cases couples are opting not to marry at all.”

- 9.3 Cohabiting couples and siblings cannot make use of the spouse exemption. This means that in a small number of unfortunate cases, the survivor may have to sell the joint home to pay Inheritance Tax. This would be the case if the value of the deceased’s estate is higher than their remaining nil rate band, and if the survivor is unable to make use of the facility to pay by instalments over ten years.

Conclusions

- 9.4 The OTS considers that any change to the definition of spouse to include a cohabiting partner or sibling would be far reaching. This would most naturally form part of a wider response to social change considered across government rather than being driven primarily by Inheritance Tax considerations.

¹ <https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/families/bulletins/familiesandhouseholds/2017>.

Chapter 10

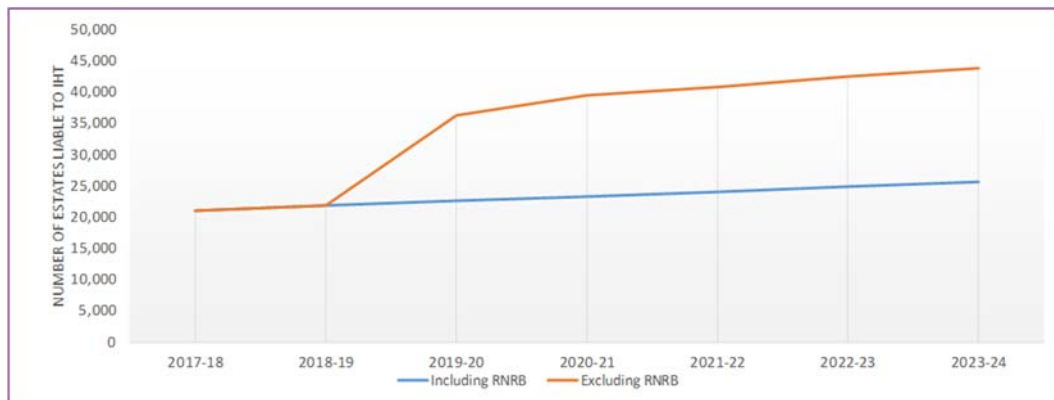
Residence nil rate band

Background

- 10.1 The OTS has received many comments from members of the public and tax professionals expressing concern about the residence nil rate band and transferable residence nil rate band.
- 10.2 The residence nil rate band was introduced in April 2017, at a level of £100,000, with the aim of making it easier to pass on the family home to direct descendants without an Inheritance Tax charge. It is being phased in over a 4 year period, increasing by £25,000 each tax year until 2020-21 when the full allowance will reach £175,000.¹
- 10.3 The residence nil rate band can be used in addition to an individual's nil rate band and is conditional on the following:
- the deceased must hold an interest in the residential property
 - the property is included in the deceased's estate
 - the property must have been the deceased's residence, at some point
 - the property is left to one or more direct descendants (direct descendants do not include nieces, nephews or the children of an unmarried partner but include adopted, foster, step children and those under legal guardianship)
 - the net value of the estate after liabilities but before any exemptions are applied is less than £2m (above this, a tapered reduction applies)
- 10.4 The residence nil rate band is capped at the lower of the value of the interest in the property and the available residence nil rate band in a given year. Any unused residence nil rate band cannot be used against other assets in the estate, but it can be transferred to the deceased's spouse or civil partner's estate. This is known as transferable residence nil rate band.
- 10.5 The residence nil rate band will take many people out of the scope of Inheritance Tax. The graph below shows the projected effect of the residence nil rate band on the number of estates that pay Inheritance Tax.

¹ <https://www.gov.uk/government/publications/rates-and-allowances-inheritance-tax-thresholds-and-interest-rates/inheritance-tax-thresholds-and-interest-rates>.

Chart 10.A: The projected effect of the residence nil rate band (RNRB) on the number of estates that pay Inheritance Tax



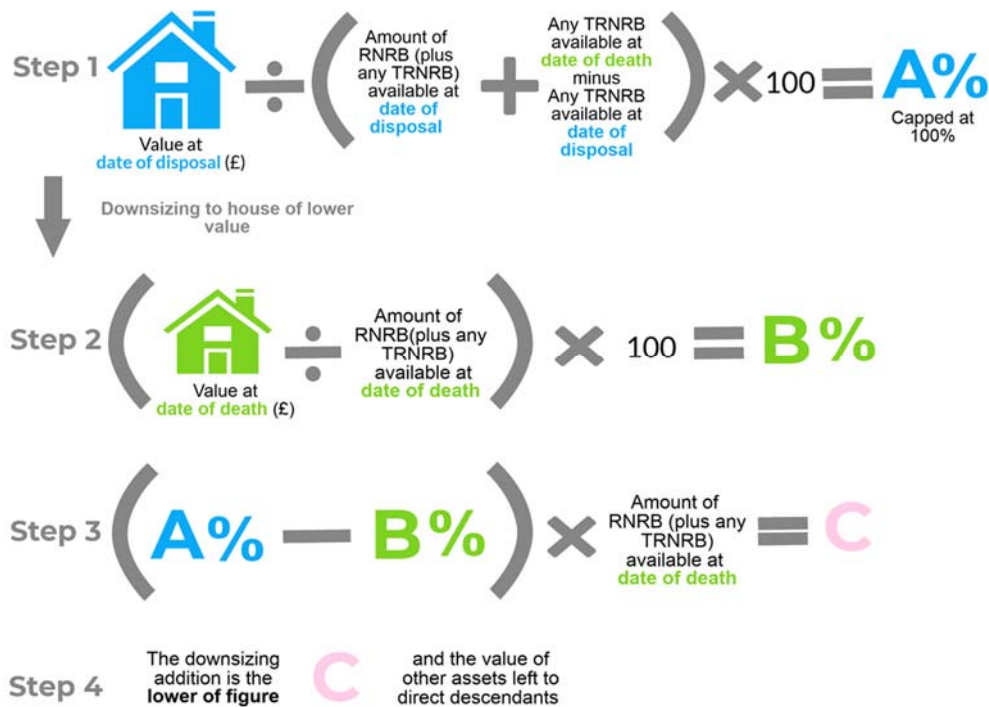
Source: HMRC data – see Annex E

The downsizing addition

- 10.6 The downsizing rules were introduced to ensure that people are not disadvantaged or disincentivised from moving ('downsizing') to a smaller or more suitable residence, or into residential care, in the latter stages of life.
- 10.7 The downsizing rules cater for situations where an interest in property which would otherwise have qualified for the residence nil rate band has been sold or given way and, as a result, there is no longer a sufficiently valuable residence in the estate at death to qualify for the full amount of residence nil rate band.
- 10.8 Downsizing can also apply when the deceased has disposed of their former home, without purchasing another property, so that there is no residential property in the estate. In both cases the downsizing rules apply providing that other assets in the estate have been left to direct descendants.
- 10.9 In such situations, the amount of residence nil rate band available may be increased by a 'downsizing addition' if:
- any entitlement has been lost due to the sale or disposal of a more valuable residence after 8 July 2015²
 - direct descendants inherit any other assets on death
- 10.10 The amount of the downsizing addition will usually be the same value as the proportion of the residence nil rate band that was lost as a result of the disposal of the property, but it will depend on the value of other assets being left to the direct descendants. The downsizing addition is the lower of the residence nil rate band (RNRB) that was lost due to downsizing and the value of other assets left to direct descendants.
- 10.11 The downsizing rules are the most complicated aspect of the residence nil rate band. An illustration showing all the steps required to calculate the downsizing addition, taking into account the transferable residence nil rate band (TRNRB), is shown below.

² The date on which the policy was announced.

Chart 10.B: Illustration of downsizing addition calculation



Source: OTS

10.12 If the home was sold before 8 July 2015 when the policy was announced, and there is no other residence in the estate, then the residence nil rate band and the downsizing rules will not apply.

Observations

The residence nil rate band will mean that many estates do not have to pay Inheritance Tax

10.13 The residence nil rate band was introduced with the specific aim of helping parents to pass on the family home to their children.

The residence nil rate band will, on average, take an estimated 16,450 estates per year out of Inheritance Tax over the next five years.

Source: HMRC data – see Annex E

Policy concerns

10.14 The residence nil rate band was the most common topic of correspondence that the OTS has received during the work on this review from both members of the public and professionals. There was strong feeling that rules place the following groups of people at a disadvantage:

- those who cannot or do not have children, but who wanted to be able to leave their property to nieces, nephews and god children to help them get on the property ladder
- elderly siblings who own a home and live together often for many years and who want to be able to leave the property to the surviving sibling on

the death of the first without the surviving sibling being forced to sell their home to meet the Inheritance Tax due

- those who do not own a home

Quote from member of the public:

"I understand recent changes have allowed greater exemptions to apply to direct descendants which discriminates against those of us without children...I also feel that it discriminates against siblings. My identical twin sister and I are now 62 years old and have worked incredibly hard all our lives in order to live in a beautiful house of our dreams. If something happens to one or the other of us...then the remaining sister would be forced to sell the property in order to fund major Inheritance Tax on the house..."

- 10.15 These points challenge the underlying policy rather than simplification as such, and addressing them could have a significant Exchequer cost.
- 10.16 For those concerned about the need to sell the family home to pay any Inheritance Tax due, payment of any Inheritance Tax due can be made in equal annual instalments plus interest, paid over a 10 year period. This does not apply to all assets, but does apply to houses, helping some people keep the house they inherited rather than having to sell it, whether they live in it or not.

The residence nil rate band is too complex and people struggle to understand it

- 10.17 The OTS has heard that some people who could qualify for residence nil rate band have missed out or are uncertain what they need to do because they do not understand it. The OTS has even heard that some solicitors choose not to advise clients about the residence nil rate band because it is so complicated.
- 10.18 The following are some of the areas raised with the OTS as possible areas of misunderstanding or complexity:
- not understanding that it is the value of the deceased's interest in the property that is relevant (for example if a property is held jointly)
 - gifting property during lifetime on the assumption that residence nil rate band works like the nil rate band, rather than applying only to the death estate
 - the need for direct descendants actually to inherit, in particular in cases where the property has been held subject to trusts which mean a child does not inherit outright
 - the operation of the taper rules
 - the need to reconsider wills written before the introduction of residence nil rate band to check if the qualifying criteria will be met, and the costs of seeking additional professional advice

- 10.19 While the nil rate band can apply to lifetime gifts and is 'refreshed' every 7 years, the residence nil rate band can be applied only to the death estate. In addition, as well as having one's own entitlement to residence nil rate band there may also be transferable residence nil rate band available if the residence nil rate band arising on the death of a spouse or civil partner was not used at that time.
- 10.20 HMRC's online calculator³ addresses some of the complexity of the rules by enabling an individual to enter the figures required without necessarily needing to understand all the complexities around the calculation to work out how much residence nil rate band they are entitled to.

The residence nil rate band taper and its impacts

- 10.21 The residence nil rate band taper progressively removes full residence nil rate band availability from estates over £2million at a rate of £1 for every £2 over £2million. In tax year 2019-20 this means that there would be no residence nil rate band available for estates over £2.3million (or £2.6million if full transferable residence nil rate band is available). The taper can be confusing, not least because the way it works is at odds with other aspects of Inheritance Tax, in particular, the transferable nil rate band.
- 10.22 For example, if a surviving spouse or civil partner inherits enough from their spouse or civil partner to push the value of their own estate above the £2m taper threshold it is possible to lose not only the benefit of the unused transferable residence nil rate band from the death of the first spouse, but also the benefit of their own residence nil rate band as well.
- 10.23 The situation can potentially be mitigated by the first spouse leaving their share of the property to one or more direct descendants on death and using their residence nil rate band entitlement at this point in time. However, clearly the wider impact of such actions would need to be carefully considered. These are the sort of issues that used to arise in relation to the nil rate band before the introduction of the transferable nil rate band removed them. The way the residence nil rate band rules work is now allowing these issues to arise again.

Downsizing

- 10.24 The OTS has heard from many sources that the downsizing provisions are the most complicated aspect of the residence nil rate band. Many have said that that they themselves find it difficult to calculate and expect that the majority of people would either have to resort to paying for professional advice, or need to obtain assistance from HMRC, to deal with it accurately. In fact, HMRC's own online guidance on downsizing acknowledges that 'the downsizing rules are complicated'.
- 10.25 Comments received from tax professionals on the calculating of the downsizing addition echo this opinion.

³ <https://www.tax.service.gov.uk/calculate-additional-inheritance-tax-threshold>.

Quote from Wedlake Bell LLP:

“This adds a further layer of complexity and it is in our experience nearly always impossible for a lay taxpayer to understand and calculate without professional advice...The result of the complex way in which the relief has been structured is that clients do not understand the rules.”

- 10.26 In recognition of this HMRC have produced an online calculator to help take people through the process and work out what they are entitled to. HMRC report that in practice they see few cases of difficulty in calculating and applying residence nil rate band and the downsizing addition and believe that this is due to people making use of the online calculator. It may also be that people are paying for professional advice before submitting their information to HMRC.

Possible alternatives

Abolish the residence nil rate band and increase the nil rate band

- 10.27 The OTS has heard from a number of respondents who have suggested that it would be simpler if the residence nil rate band were abolished, and the nil rate band threshold increased to £500,000 (the current amount of the nil rate band plus residence nil rate band of £175,000). However, such changes would have a variety of impacts. The following estimates illustrate what could happen if residence nil rate band was removed:

Box 10.1 Illustrations of the effects of changes to the residence nil rate band from 2019-20



Scrapping the residence nil rate band and using the cost savings to increase the nil rate band for all estates would increase the nil rate band by around £51,000 to £376,000.

Simply abolishing the residence nil rate band would lead to a 68% increase of the number of estates paying Inheritance Tax by 2023-24 and would raise approximately £5.6 billion in additional Inheritance Tax over the same period.

If the residence nil rate band was abolished and the Exchequer savings were used to increase the nil rate band, it would be possible to increase the nil rate band to £376,000. By tax year 2023-24 however, this would still mean that

an estimated 5,370 more estates would have paid Inheritance Tax than would otherwise be the case.

If the residence nil rate band was abolished, and the nil rate band increased to £500,000, then by 2023-24 an estimated 34,400 fewer estates would have paid Inheritance Tax than would otherwise be the case. However, this would cost the Exchequer around £7.5 billion during the same period.

Source: HMRC data – see Annex E

- 10.28 One long term option would be to allow the nil rate band to rise gradually, through regular indexation (and to reduce the residence nil rate band by the same amount, keeping the total the same, until the nil rate band absorbed all of the residence nil rate band). However, if such indexation started now, from the existing level of the nil rate band, this would take around 20 years.
- 10.29 Another suggestion that has been made to the OTS is to fund the abolition of the residence nil rate band by creating a new taper of the main nil rate band for larger estates.

Reform the downsizing provisions

- 10.30 Another suggestion made to the OTS is to tackle the downsizing complexity, by making the full residence nil rate band available to direct descendants of anyone who has owned and lived in a residential property during their lifetime. This would be irrespective of the property's value at time of sale, providing that the deceased's estate does not exceed the £2 million threshold.
- 10.31 This could remove the need to perform the complex downsizing calculations where downsizing has occurred and would maintain the key link between home ownership, direct descendants, and the threshold. However, this could also result in a disparity of treatment between those who retain a lower value property at death and those who dispose of a similar value property before death, distorting the playing field rather than levelling it.
- 10.32 What is clear is that downsizing will continue to confuse and cause problems unless a more straightforward way to achieve broadly the same policy outcome is achieved, or a wider reform, is considered.

Conclusions

- 10.33 The OTS has heard many comments about both the policy and the implementation of the residence nil rate band. While encouraging and facilitating the passing on of the family home to children and grandchildren is a government policy decision, the way the present rules work is complex.
- 10.34 However, the residence nil rate band is still very new, and more time is needed to evaluate its effectiveness before recommendations can be made on how to simplify it. The OTS suggests that the possible alternatives set out above are considered when the government reviews the residence nil rate band.

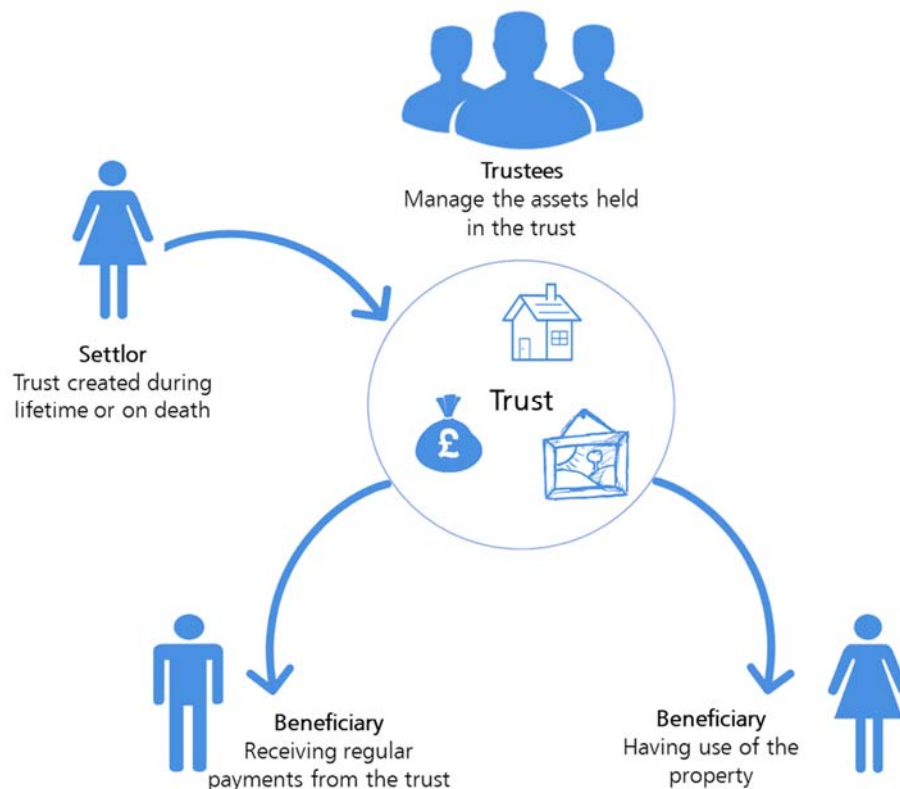
Chapter 11

Trusts

Background

11.1 Trusts are a legal arrangement where assets are held and looked after for the benefit of someone else. A person, called a settlor, can set up a trust during their lifetime. Once you put assets into a trust, they no longer belong to you. The person who owns the assets and manages the trust is known as the trustee, and the person for whom they are held and looked after, and who can receive a benefit from the assets is called the beneficiary.

Chart 11.A: What is a Trust?



Source: OTS

Why set up a trust?

11.2 There are many reasons why people may wish to set up a trust, to allow someone else to benefit from an asset, while not giving them full ownership of it. Examples include:

- on divorce, where, for instance, a former spouse might be given the right to occupy the family home during lifetime but on death the home must pass to the children

- a person who is young or incapacitated needs to benefit from the asset but they are not able to take full control of it
- where a family group owns an asset such as a business and they do not wish family members to be able to sell their interest in the business to third parties

11.3 Of course, in such cases Inheritance Tax and other taxes will be a factor (and may be the deciding factor) in deciding whether or not to set up a trust.

11.4 Some trusts are also set up expressly for Inheritance Tax mitigation. For example, arrangements known as nil rate band trusts or discounted gift trusts¹ are set up expressly to maximise or reuse the nil rate band. They are marketed as such by Independent Financial Advisers (IFAs) and Life Companies.

11.5 These products have been around for so long that they could now be described as being mainstream. Their widespread marketing is indicative of the complexity surrounding Inheritance Tax.

How does Inheritance Tax apply to trusts?

11.6 Following significant changes to the taxation of certain types of trusts in the Finance Act 2006, there are now only a limited range of circumstances where any property in a trust is included in the estate of the settlor, or a beneficiary. The majority of trusts that are subject to Inheritance Tax are instead subject to what is called the 'relevant property regime' under which Inheritance Tax is charged on certain occasions.

11.7 The way this works is that if a settlor has made transfers into trust in the previous 7 years that (together with other relevant gifts the settlor has made) add up to more than the nil rate band, then (unless an exemption such as APR or BPR applies) there will be an Inheritance Tax charge when the transfer is made into the trust. This is known as an 'entry charge', payable by the settlor. See Case Study 11.A.

Case Study 11.A

Jo decides to transfer some money into a trust. She makes the following cash transfers:

2012 - £300,000

2016 - £200,000

There is no Inheritance Tax to pay on the transfer in 2012 because this would be covered by the available nil rate band of £325,000.

However, for the second transfer in 2016 there is an Inheritance Tax charge. This is because the second transfer is within 7 years of the first and so needs

¹ Definition provided in Annex D.

to be considered. As £300,000 of the £325,000 nil rate band has already been used, there is only £25,000 available to be set off against the second transfer.

Inheritance Tax will be charged at 20% (the lifetime rate) for the remaining £175,000 not covered by the nil rate band.

- 11.8 There is then a charge to Inheritance Tax on each 10 year anniversary of the date the trust was established, paid by the trustees. Finally, there may be an Inheritance Tax exit charge, also payable by the trustees when assets are taken out of a trust, for example when they are distributed to beneficiaries or when the trust comes to an end.

Observations

HMRC have conducted a consultation on the taxation of trusts

- 11.9 In November 2018, HMRC published a consultation on the taxation of trusts.² In the consultation document, HMRC outline three underlying principles which underpin the taxation of trusts: transparency, fairness and simplicity. The consultation asked for views on the principles and the application of the principles in practice. The consultation is now closed and HMRC are reviewing the responses received.
- 11.10 While there is some overlap between the OTS review of Inheritance Tax and the trust consultation, the OTS's focus is on simplification to the Inheritance Tax rules rather than assessing the underlying principles of the taxation of trusts. In addition, the HMRC consultation related to the Income Tax and Capital Gains Tax treatment of trusts as well as to Inheritance Tax.

A small proportion of Inheritance Tax relates to settling assets into trust

- 11.11 The OTS has heard it is rare for the entry charge to be payable.

In the past 5 years of available data, average Inheritance Tax receipts from transfers into discretionary trust were around **£17.2 million per year**.

Source: HMRC data – see Annex E

- 11.12 It was anticipated when the 2006 measures were brought in that only a relatively small amount of revenue would be raised.

Quote from HMRC Guidance Note to the Finance Bill 2006:

"...the Government's estimate of the amount this measure will raise is only £15 million a year in revenues and will affect only a very small number of very wealthy people."

² <https://www.gov.uk/government/consultations/the-of-taxation-of-trusts-a-review>.

- 11.13 Outside the insurance and pensions industry, new trusts are often set up in situations where the entry charge will not be payable. For example, where the person setting up the trust has assets that are relieved from Inheritance Tax, such as business assets; where the relevant assets attract the nil rate band; or where another exemption, such as normal expenditure out of income, applies.
- 11.14 If a trust is set up with assets, such as cash, which are not exempt from Inheritance Tax, the OTS has heard that the Inheritance Tax costs associated with the trust may outweigh the benefits of using a trust even if there is a strong desire to protect assets for future generations.

Complexity arises from the interaction between lifetime giving to individuals and to trusts

- 11.15 The OTS has heard that where a person has both settled assets into trust and made lifetime gifts to individuals, this can cause complexity and uncertainty. Both of these can use up the nil rate band, but in the case of gifts into trust the available nil rate band may have to be recalculated if the settlor dies within 7 years and has made other gifts before settling assets into trust. This can create uncertainty for trustees.
- 11.16 Some have suggested that giving trusts a de minimis Inheritance Tax threshold instead of, and separate from, the nil rate band could help eliminate the complexity in this area. This suggestion would, in particular, help reduce complexity if the OTS's suggestions on the allocation of the nil rate band, set out in Chapter 3, are taken up by government.

The 10 yearly charge calculation is too complex

- 11.17 The mechanism for calculating the Inheritance Tax charges is too complex and the cost of employing an adviser to complete the calculations may often be more than the amount of the charge.
- 11.18 The OTS has heard that some trustees avoid the complex calculation by applying the maximum rate of 6% rather than calculating the correct rate of tax. This will result in more Inheritance Tax paid to HMRC but reduces the costs spent on advisers to calculate the correct charge.
- 11.19 The calculation is time consuming and the amounts of tax involved are often very small. Some respondents have suggested that the entry, ten yearly and exit charges for relevant property trusts be replaced with an annual trust tax charge which would be calculated as a fixed percentage of the trust assets. Others have suggested that simplification could be achieved by allowing individuals to establish interest in possession³ trusts during their lifetime.

³ HMRC guidance <https://www.gov.uk/trusts-taxes/types-of-trust>.

Quote from STEP:

“The way in which trusts are treated for IHT purposes is a significant area of complexity where there is definite scope for simplification.”

Trusts for children and other vulnerable people

- 11.20 For Inheritance Tax, there are three types of trust which can be used for different types of vulnerable people:
- 1 disabled persons trust (can be set up in lifetime or on death)
 - 2 bereaved minors trust (can only be set up on death)
 - 3 18 to 25 trust (can only be set up on death)
- 11.21 It would be a simplification to have a single type of trust for children and other vulnerable people which could be set up in the settlor’s lifetime or on death. However, there are different considerations for disabled people and for bereaved children (where the use of a trust may only be necessary until they reach a certain age), so different types of trust may be appropriate to cater for these different needs.
- 11.22 It has been suggested to the OTS that these types of trust should be outside the relevant property regime and the interest in possession regime, and that in the case of bereaved children this treatment would continue until the beneficiaries reach a given age (such as 18 or 25).

The definition of a disabled person is too restrictive

- 11.23 The OTS has heard that it is difficult to fall within the strict criteria for a disabled person’s trust.⁴ In most situations where an individual wants to use a trust to protect the beneficiary, a different type of trust is used because the definition of a disabled beneficiary is too restrictive.

The criteria for a disabled trust for Inheritance Tax differ from those for trusts for vulnerable persons for Capital Gains Tax and Income Tax

- 11.24 A disabled person’s trust for Inheritance Tax purposes is not the same as a trust for a vulnerable person for Capital Gains Tax and Income Tax. This is unnecessarily complex and it is difficult for advisors to navigate the different rules. It would be simpler and more straightforward if the requirements for disabled beneficiary trusts were simplified and the same across all taxes.

Conclusions

- 11.25 The Inheritance Tax rules applicable to trusts are not straightforward. Most individuals do not understand how trusts are used and have no knowledge of how they are taxed. It is not uncommon for experienced advisors to make errors as the Inheritance Tax charged on trusts is difficult to calculate.

⁴ HMRC guidance <https://www.gov.uk/trusts-taxes/trusts-for-vulnerable-people>.

The HMRC trust consultation has a wider remit than this review

- 11.26 The OTS Inheritance Tax review is covering all areas of Inheritance Tax, including the taxation of trusts in this regard; however, it does not cover the Income Tax or Capital Gains Tax paid by trusts.
- 11.27 The HMRC trust consultation has a wider remit which covers all taxes and all aspects of trust taxation. The OTS considers that the Inheritance Tax treatment of trusts should be addressed in the round alongside other taxes and for this reason no recommendations on trusts have been made as part of this review. When conducting this review, the OTS hopes the issues highlighted above will be helpful to HMRC as part of the ongoing trust consultation.

Chapter 12

Charities

Background

- 12.1 If a person gives to a charity, Community Amateur Sports Club (CASC), or a qualifying political party in their will or during their lifetime, there is no Inheritance Tax due on the gift. In the discussion below this is referred to as the general exemption for gifts to charity.
- 12.2 In addition, since 2012, if 10% or more of a person's net estate is given to charity or to a CASC, any Inheritance Tax payable on the estate can be reduced to a lower rate of 36%. In the discussion below this is referred to as the reduced rate for gifts to charity.
- 12.3 The OTS heard that legacy giving is a significant source of income on which charities rely.

Quote from Remember a Charity, the Institute of Fundraising, and the National Council for Voluntary Organisations:

"Two out of three guide dogs and six out of ten life boat launches are paid for by gifts in Wills, as is over a third of Cancer Research UK's life saving work."

The value of legacy giving in 2015-16 was over **£3 billion**.

Source: HMRC Data – see Annex E

Observations

The general exemption for gifts to charity

- 12.4 The OTS heard that the general exemption for gifts to charity is well understood by the public and by advisors.
- 12.5 Indeed, responses suggested that the existence of this relief encourages legacy giving. The OTS has heard that a major effect of charitable exemptions is that they present opportunities for professional advisors to discuss legacy giving with their clients.

- 12.6 Research suggests that when will writers ask the question “would you like to leave any money to charity in your will?” the number of legacy gifts can double.¹

Quote from The Economist:²

‘Some charities even offer free will writing services, in the hope that they might get a mention.’

- 12.7 Given the number of adults who die in the UK without making a will, there are significant opportunities for information campaigns about the importance of making a will and the possibility of including charitable gifts.

The reduced rate for gifts to charity

- 12.8 The OTS was concerned to hear that some advisers avoid talking about the reduced rate with clients because of its perceived complexity. The OTS hopes that over time, greater professional and public awareness and understanding of this relief will make these conversations easier.

The reduced rate – extra care is needed

- 12.9 It was anticipated during the development of the reduced rate that it would create extra complexity.

Quote from A new incentive for charitable legacies: A lower rate of Inheritance Tax when leaving 10% of an estate to charity (Consultation document):

“So the introduction of the reduced rate will, in some cases, mean that HMRC and personal representatives have to invest a greater amount of time and care in establishing and agreeing the value of assets left to charity.”

- 12.10 The OTS received comments about the difficulties involved in drafting a will to ensure that an estate benefits from the relief. A model clause ensuring that a specific legacy to charity will always meet the 10% test has been supplied by STEP and is available within HMRC guidance.³ However, it has been suggested that inserting this clause adds to complexity in drafting.
- 12.11 It is perhaps for this reason that the OTS has heard that there has been an increase in the number of cases in which charitable legacies were made or adjusted through an Instrument of Variation (IoV). This was also an anticipated outcome of the introduction of the reduced rate.⁴

¹ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/203286/BIT_Charity_Giving_Paper.pdf.

² “Charities try new tactics to be remembered in wills”, *The Economist*, 10 January 2019.

³ <https://www.gov.uk/hmrc-internal-manuals/inheritance-tax-manual/ihtm45008>.

⁴ A new incentive for charitable legacies: A lower rate of inheritance tax when leaving 10% of an estate to charity, HMRC Consultation Document, June 2011.

The reduced rate – complex calculations

- 12.12 Determining if the reduced rate applies is complicated. To do so, the estate must be split into three separate components: those where the assets pass outside probate by survivorship; property that is held in trust at the date of death; and everything else.⁵ A 'baseline amount', for each component, is calculated using steps set out in statute.⁶
- 12.13 The charitable giving condition is met for a component of the estate if at least 10% of the baseline amount of that component is donated to charity. There is an online calculator available to assist with determining this.⁷
- 12.14 The different components of the estate can be merged to share the benefit of the lower rate of Inheritance Tax across more of the estate if a suitable election is made. The OTS heard that some practitioners consider these rules and the associated guidance to be unclear. It was suggested that this is perhaps the main area of misunderstanding in relation to the reduced rate. The result is that some executors, including professionals, are not aware when this rate applies.
- 12.15 It was also suggested that the requirement to break the estate into separate components has led to the rule being misunderstood and not well publicised. The ability to merge the parts of the estate has been described simultaneously as both an added benefit and a further complication.

Low public awareness?

- 12.16 Some respondents suggested that there was low public awareness of the reduced rate. On the other hand, the OTS heard from others who said that the existence of this rate helped to generate initial interest from people making a will who might otherwise have dismissed a charitable legacy as being unaffordable. Although some questioned whether the reduced rate gave rise to any greater level of charitable donations, others acknowledged that it could help increase the level of charitable giving.

⁵ Inheritance Tax Act 1984, Schedule 1A, Paragraph 3.

⁶ Inheritance Tax Act 1984, Schedule 1A, Paragraph 5.

⁷ <https://www.gov.uk/inheritance-tax-reduced-rate-calculator>.

Chart 12.A: Level of charitable giving on death

Data shows 2.1% of estates applying for probate gift more than 10% of their net assets to charity on average and this relatively small number of estates are responsible for most legacy gifts.



Source: HMRC data – see Annex E

Suggestions for simplification of the reduced rate

- 12.17 The OTS received different suggestions for simplification.
- 12.18 One suggestion was to amend the rules so that it would no longer be necessary for an estate to be divided into components in order to calculate whether the reduced rate applies. It was suggested that this would encourage greater use of the relief as it would be simpler to understand.
- 12.19 However, it is possible that it could have the opposite effect. This is because more would need to be left to charity in order to reach 10% of the gross estate than would be needed to reach 10% of a component.
- 12.20 Other respondents suggested that the complexity created by the charitable rate of Inheritance Tax was so great that it ought to be replaced by another form of relief for charitable donations.
- 12.21 One idea was that the Inheritance Tax chargeable should be reduced by a given proportion of the amount donated to charity. A twenty pence reduction in Inheritance Tax for every pound gifted to charity was given as an example, subject to an overall cap. This would avoid the need to work out baseline amounts, or work out 10% of these.
- 12.22 This suggestion might encourage smaller donations to charity, but it might not achieve the current policy aim of the reduced rate. It may also create the need for more precise valuations where assets other than cash are left to charity, introducing an administration burden on executors and HMRC.

Conclusions

- 12.23 The policy aim of the reduced rate is stated to be to encourage people to leave 10% of their estate to charity.⁸ It is currently only a very low percentage of estates in which such a large proportion of assets are left to charitable causes. The OTS heard that legacy giving is a vital resource which funds the work of many charities, and that most of this resource comes from the small number of estates who gift more than 10% of their net assets.
- 12.24 It is perhaps unsurprising that there is no data that can show whether the introduction of the reduced rate has yet had any material impact on the level of legacy giving to charity. An individual would need to consider the relief at the time they are making or revising their will. There will then generally be a period of some years until the death of the individual, and a further period of six months by which any Inheritance Tax must be paid.
- 12.25 The OTS accordingly considers that it is still very early days for the reduced rate. More time is needed before it will be possible to evaluate its effectiveness and therefore no recommendations on it are made in this report.

⁸ A new incentive for charitable legacies: A lower rate of Inheritance Tax when leaving 10% of an estate to charity, paragraph 2.11, HMRC Consultation Document, June 2011.

Annex A

Scoping document

This scoping document was published on 15 February 2018.

IHT General Simplification Review

Inheritance Tax (IHT) in its current form was introduced in 1986, replacing Capital Transfer Tax.

Since then, it has been subject to a continuous process of evolution and change. In addition, the economic and social landscape has changed. While fewer than 5% of estates are liable to IHT, there has been an increase in the number of people that think they may be within the scope of the tax. This is partly driven by increases in residential property prices, especially in London and the South East of England.

The Chancellor and the Financial Secretary to the Treasury have requested that the Office of Tax Simplification (OTS) carry out a review of a range of aspects of IHT and how it functions today, including its economic incidence, to identify simplification opportunities. The review will be consistent with the OTS's remit to provide advice on simplifying the tax system, with the Chancellor responsible for final decisions on tax policy.

The overall aim of the review will be to identify opportunities and develop recommendations for simplifying IHT from both a tax technical and an administrative standpoint. The OTS will work alongside HMRC's project on administrative changes for the clear majority of estates where there is no tax to pay.

The OTS will publish a report in the autumn of 2018 that:

- provides an initial evaluation of aspects of the current IHT regime, and what they mean for taxpayers, HMRC and the Exchequer
- identifies opportunities for simplification of IHT supported by analysis and evidence; and
- offers specific simplification recommendations for government to consider

The OTS will provide a call for evidence early in 2018.

Scope of Review

The review will consider how key aspects of the current IHT system work and whether and how they might be simplified. This will include a combination of administrative and technical questions such as:

- the process around submitting IHT returns and paying any tax, including cases where it is clear from the outset that there will be no tax to pay

- the various gifts rules including the annual threshold for gifts, small gifts and normal expenditure out of income as well as their interaction with each other and the wider IHT framework
- other administrative and practical issues around routine estate planning, compliance and disclosure, including relevant aspects of probate procedure, in particular in relation to situations which commonly arise
- complexities arising from the reliefs and their interaction with the wider tax framework
- the scale and impact of any distortions to taxpayers' decisions, investments, asset prices or the timing of transactions because of the IHT rules, relevant aspects of the taxation of trusts, or interactions with other taxes such as Capital Gains Tax; and
- the perception of the complexity of the IHT rules amongst taxpayers, practitioners and industry bodies

Further guidance for this review

In carrying out its review and developing its recommendations, the OTS should:

- research widely among all stakeholders
- engage with HMRC's Administrative Burdens Advisory Board
- consider whether devolution of tax powers within the UK has implications and especially whether the Scottish legal system impacts any recommendations
- take account of relevant international experience
- consider the likely Exchequer implications of recommendations; and
- be consistent with the principles for a good tax system, including fairness and efficiency

A Consultative Committee will provide support and challenge.

Annex B

Consultative Committee

We are very grateful for the time and support of our Consultative Committee members.

Individual	Organisation
Stuart Adam	Institute for Fiscal Studies
Emma Chamberlain OBE	Pump Court Tax Chambers
Anne Fairpo	Temple Tax Chambers, Low Incomes Tax Reform Group, Judge in the First Tier Tax Tribunal
Zahra Kanani	Thackray Williams LLP
Sarah Kelsey	HM Revenue & Customs
Sue Moore	The Institute of Chartered Accountants in England and Wales
Jane Page	HM Treasury
Stephanie Parker	Haysmacintyre LLP
Gill Steel	LawSkills Ltd
Anjula Thiru	HM Revenue & Customs

Annex C

Organisations consulted

The OTS has listed below the wide range of organisations who gave their time to provide evidence to this review. The OTS are grateful to these organisations and the large number of individuals who gave their time to provide evidence. Individual names have not been published here.

Apologies are given to any organisations that have been inadvertently omitted.

1825 Financial Planning	Cancer Research UK
Aegon	Carswell Group
Age UK	Central Association of Agricultural Valuers
Agricultural Law Association	Charity Tax Group
AJ Bell	Chaverys
All Party Parliamentary Group on Inheritance and Intergenerational Fairness	Cheviot Holiday Cottages
Art Fund	Chartered Institute of Taxation
Association of Accounting Technicians	Country Landowners Association
Associations of Lloyd's Members	Department for Environment, Food & Rural Affairs
Association of Tax Technicians	Duncan & Toplis Ltd
BDO LLP	DWF LLP
Beacon Hill Far Holidays	Eaton Manor Country Estate
Belle Grove Barns	Estates Business Group
BDB Pitmans LLP	EY
Bishop Fleming	Family Education Trust
Blankney Estates Ltd	Field House Farm Cottages
Boodle Hatfield LLP	Field Seymour Parkes LLP
Bosinver Farm Cottages	Forsters LLP
Bourne Leisure Ltd	Gillespie Macandrew LLP
Broomhill Manor Country Estate Ltd	Grant Thornton LLP
Burness Paull LLP	Grosvenor Estate
Canada Life	Group Risk Development

Hargreaves Lansdown	Old Mutual Wealth
Higher Menadew Farm Cottages	Opes Tax
Higher Wiscombe Ltd	Penningtons Manches LLP
Historic Houses	Personal Finance Group of the Sheffield U3A
HM Revenue & Customs	Philanthropy Impact
HM Treasury	Pitt Farm Holiday Cottages
Hunters	Plover Ltd
Institute of Chartered Accountants in England and Wales	Professional Association of Self Caterers PwC
Institute for Family Business	Remember A Charity
Institute of Directors	Rosehill Lodges
Institute of Fundraising	Royal London
Institute of Legacy Management	Royds Withy King
Insuring Change	RSM UK Tax and Accounting Ltd
Investment & Life Assurance Group	Saffery Champness
Jane Clayton & Company Ltd	Salvation Army
Johnston Carmichael LLP	Scottish Land and Estates
Kerridge End Holiday Cottages	South West Tourism Alliance
Kilik & Co	St James's Place Wealth Management
Kings Court Trust Ltd	Society of Trusts and Estates Practitioners
Knowle Farm	Tenant Farmers Association
Llanfendigaid Estate	The Association of British Insurers
London Stock Exchange Group	The Institute of Chartered Accountants of Scotland
Low Incomes Tax Reform Group	The Law Society of England and Wales
Macfarlanes LLP	The Law Society of Scotland
Manx Insurance Association	The TaxPayers' Alliance
Michelmores LLP	Tourism Management Institute
Mills & Reeve LLP	UJIA
My Country Houses Ltd	University of Birmingham
National Council for Voluntary Organisations	Valuation Office Agency
National Farmers Union	Wedlake Bell LLP
Octopus Investments	Wheeldon Trees Farm
OHL Ltd	Wrigleys Solicitors LLP

Annex D

Technical terms and acronyms

- **14 year rule** – when working out if Inheritance Tax is payable on a relevant gift, the value of the gift must be added not only to other relevant gifts to individuals within the 7 years before death, but also to any chargeable lifetime transfers in the 7 years before the date of the gift concerned. This means that gifts may be taken into account up to 14 years before the date of death
- **Agricultural property relief (APR)** – provides relief from Inheritance Tax on agricultural property, by reducing the value of the relievable property transferred by either 50% or 100%. See Chapter 5 for more detail about the conditions of the relief
- **AIM** – Alternative Investment Market
- **Annual gift exemption** – gifts that total £3,000 per year are exempt from Inheritance Tax, any unused exemption can be carried forward for one year
- **Beneficiary** – this may refer to the beneficiary of an estate or trust. It is a person who receives a benefit from the trust or estate, for example cash or assets that are distributed to that person
- **Business property relief (BPR)** – provides relief from Inheritance Tax on business assets, by reducing the value of the relievable property transferred by either 50% or 100%. See Chapter 5 for more detail about the conditions of the relief
- **Capital Gains Tax** – a tax on the gain made when you dispose of an asset. Disposing of an asset includes selling it, giving it away, swapping it and getting compensation if it is lost or destroyed. Some assets are exempt, for example your main home, and your car. Capital Gains Tax is only chargeable on any gains above your tax free allowance, which is called the annual exempt amount. This is currently £12,000
- **Capital gains deferral** – this arises when the recipient acquires the asset at the donor's historic acquisition cost and any gains are held over until a subsequent disposal of the business or farm.
- **Capital gains uplift** – when someone inherits assets, the acquisition value of the assets for capital gains purposes is the market value of those assets on the date of death
- **CTT** – Capital Transfer Tax

- **Chargeable lifetime transfer** – gift that would be immediately chargeable to Inheritance Tax, if the amount transferred exceeds the available nil rate band (and no relief is available such as normal expenditure out of income, BPR or APR). Transfers to trusts or gifts to a company may be chargeable lifetime transfers
- **Discounted gift trust** – a type of trust usually set up in connection with an investment bond. The person gifting the money into the trust retains a right to a pre-determined lifelong income from the trust
- **Downsizing** – if the deceased sold, gave away or downsized to a less valuable home before they died, their estate may qualify for the residence nil rate band if they meet the following conditions: the person sold, gave away or downsized to a less valuable home on or after 8 July 2015, the former home would have qualified for the additional threshold if they had kept it until they died, and their direct descendants inherit at least some of the estate
- **Entrepreneurs' relief** – reduces the Capital Gains Tax payable on disposals of certain assets
- **Estate** – an estate is comprised of all assets that were held by an individual before their death. This includes cash, property, investments, business assets, vehicles and any payments received from life insurance policies
- **Executor** – the person or people who have responsibility for administering the estate, including dealing with any Inheritance Tax consequences and applying for probate. If a person does not leave a will, then someone can apply to be an 'administrator' of the estate. In this report we use 'executor' to embrace both roles
- **Gift holdover relief** – the option not to pay Capital Gains Tax at the time business assets are given away. The person receiving them is treated as acquiring them at the donor's acquisition cost and pays Capital Gains Tax (if any is due) when the assets are later sold
- **Gift with reservation** – a gift made by an individual where that individual continues to use or benefit from the gifted property. If this is the case, then the gift is treated as part of their estate for Inheritance Tax purposes on death if the reservation of benefit occurred in the previous 7 years
- **Grossing up** – the calculation required to work out the amount of Inheritance Tax due in estates where there is an exempt beneficiary, gifts left free of tax or where reliefs are due
- **HMRC** – Her Majesty's Revenue & Customs
- **HMT** – Her Majesty's Treasury
- **Limited liability partnership (LLP)** – a type of partnership where some or all of the partners have limited liability. They are regarded as 'transparent' for tax purposes with each member or partner being assessed to tax on their share of the LLP's income or gains as if they were members of a 'normal' partnership

- **Nil rate band** – the value under which an estate is not chargeable to Inheritance Tax. The nil rate band is currently £325,000
- **Nil rate bands** – the nil rate band and the residence nil rate band, along with any that are available to be transferred
- **Nil rate band trust** – a type of trust used in estate planning to reduce liability to Inheritance tax on the death. Under this arrangement, an amount equal to the Nil Rate Band is given to the trustees who are then given a discretion as to ultimately who will benefit
- **No gain no loss transfer** – an asset is transferred at the historic base cost of the transferor for Capital Gains Tax purposes
- **Normal expenditure out of income exemption** – exempts regular gifts made out of a person's surplus income. There is no definition of surplus income, but the person must be able to maintain their standard of living from the remaining income
- **OTS** – Office of Tax Simplification
- **Pre-owned assets charge to Income Tax (POAT)** – this is an annual Income Tax charge on benefits received by a former owner of property. The charge is applied to individuals who owned assets and then disposed of them but continue to receive a benefit from them. It applies to land, household and personal goods and intangible property or cash, stocks, shares and insurance products. It will not apply if the property that the individual retains a benefit from is still counted as part of their estate and so subject to Inheritance Tax
- **Residence nil rate band** – this is an amount additional to the NRB, available where an estate includes a home, either in whole or in part, that is passed on to the deceased's direct descendants (for example children or grandchildren). The amount available is currently a maximum of £150,000, but will increase each tax year to reach £175,000 by tax year 2020-21. The amount available will be the lower of the value of the home (or part of a home) or the maximum residence NRB available. For estates valued over £2 million, the maximum residence NRB available will be reduced by £1 for every £2 above that amount
- **Relevant gifts or relevant lifetime gifts** – lifetime gifts that use up any available nil rate band or are subject to Inheritance Tax
- **Small gifts exemption** – exempts gifts of up to £250 to each recipient from Inheritance Tax each year
- **Taper relief** – for lifetime gifts on which Inheritance Tax is payable, taper relief reduces the rate of tax on a sliding scale depending on the time that has elapsed between when the relevant gift was made and the date of death
- **Transferable nil rate band** – the NRB is transferable between spouses and civil partners, when not fully used on the first spouse or civil partner's death

- **Transferable residence nil rate band** – the residence NRB is transferable between spouses and civil partners, when not fully used on the first spouse or civil partner's death
- **Trust Inheritance Tax regime** – when trusts are referred to within this document, we generally mean discretionary trusts unless otherwise stated
- **10 year charges** – certain trusts may be charged Inheritance Tax on every 10 year anniversary since the trust started. There is a complex calculation to work out the amount of tax due on each 10 year anniversary, using an effective rate, broadly calculated as if a chargeable lifetime transfer of the value of the relevant property in the trust were made by the settlor, taking into account their total chargeable lifetime transfers in the seven years leading up to the creation of the trust. This value is set against the NRB available, which is currently £325,000. No relief for BPR/APR is available in establishing this effective rate. The effective rate is then applied on the net value of the property in the trust, meaning a deduction of any reliefs or exemptions can be claimed, at this point in the calculation. Trusts are eligible to claim many of the same reliefs as estates on death
- **Exit charges** – there may be an Inheritance Tax charge when assets are taken out of a trust, for example when they are distributed to beneficiaries or when the trust comes to an end. This is known as an exit charge. Not all payments out of a trust give rise to an exit charge, but when they do, the calculation to work out any Inheritance Tax due is complex. As with the 10 yearly charge, there is no set single rate applied to the value of the property exiting, but again an effective rate is calculated

Annex E

Data sources used in this report

Introduction

This Annex contains the HMRC data and projections that are published for the first time in this report. In producing the data used in this report, HMRC have provided further breakdowns of the published National Statistics for the 2015-16 tax year.¹

Unless stated otherwise, the data presented in this report does not take into account transfers into trust. In particular, the data on the cost of the normal expenditure out of income exemption, and the business and agricultural property reliefs, does not take into account their use when transferring assets into trust. This means that the Exchequer impact projections of these reliefs and exemptions is understated as are any projections about their future cost.

The Exchequer impact projections set out in this report are estimates produced using the Office for Budget Responsibility's (OBR) October 2018 economic forecast. They have not been certified by the OBR and are therefore indicative and subject to change. In addition, the projections are on a static basis only. This means they do not take into account the potential impact of any changes to people's behaviour as a result of the considered policy change.

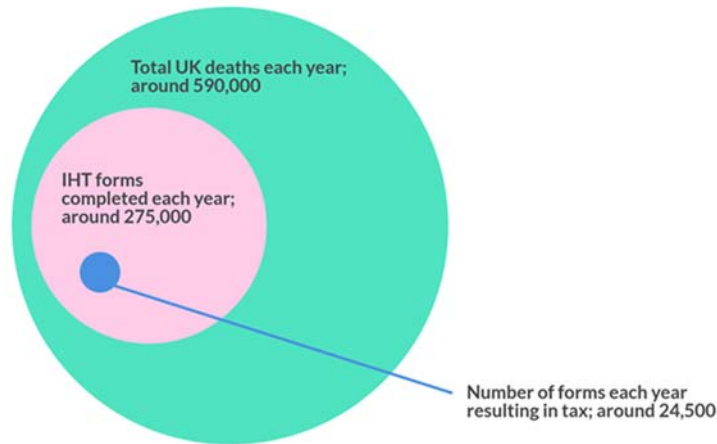
All Exchequer impact projections presented in this report have been presented based on when the liability to pay the tax arises (known as 'liabilities basis') rather than when the tax would eventually be paid to HMRC (known as 'receipts basis').

¹ This is the most recent full tax year for which HMRC have complete data. This is because the Inheritance Tax bill does not have to be settled until six months after the end of the month in which the person died. There are then further considerations if, for instance, the valuation of the estate cannot be settled easily. HMRC have provided these further breakdowns in line with the Statistical Code of Practice rules on trustworthiness: <https://www.statisticsauthority.gov.uk/code-of-practice/>.

Executive summary

Number of Inheritance Tax forms resulting in tax being paid

Chart A: Number of Inheritance Tax forms resulting in tax being paid



Source: HMRC data

Data to support Chart A

Number of UK deaths each year	588,000
Number of IHT forms completed	275,500
Number of forms resulting in tax	24,500

Source: HMRC data

Table notes:

Note 1: The values are available from the IHT National Statistics:

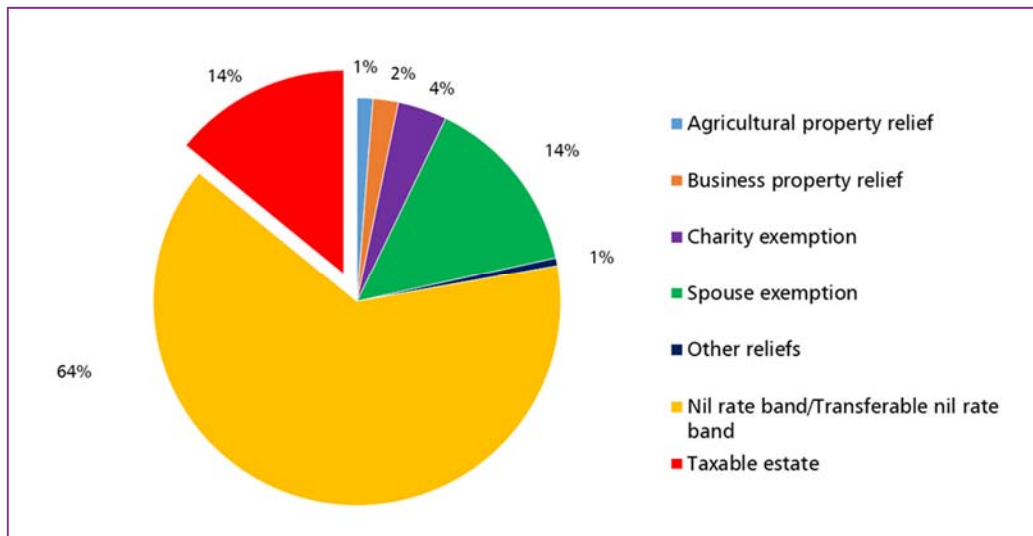
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/731610/Inheritance_Tax_National_Statistics_Commentary.pdf. See Table 12.3

Note 2: The values used above differ from those used in the first OTS report on Inheritance Tax due to a fuller picture now being available. The values used here are the actual values for the tax year 2015-16. In the previous report averages were used.

Breakdown of net capital value of estates for 2015-16

Chart C below provides a breakdown of the total net value of estates for 2015-16 showing the extent to which this value is covered by the various major exemptions and reliefs.

Chart C: Breakdown of net capital value of estates for 2015-16



Source: HMRC data

Notes to Chart C

Note 1: The percentages in the Chart are derived from the numbers below

Category	Value in 2015-16 (£m)
Taxable estate	£11,200
Agricultural property relief	£1,000
Business property relief	£1,600
Charity exemption	£3,100
Spouse exemption	£11,400
Other reliefs	£500
Nil rate band/transferable nil rate band	£50,600
Total net capital value of estate*	£79,300

*'Net capital value of estate' means the value of all estates after any debts or liabilities have been deducted.

Note 2: The values are available from the IHT National Statistics:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/731610/Inheritance_Tax_National_Statistics_Commentary.pdf. See Tables 12.2 and 12.4.

Note 3: This chart uses data for estates where details of the estates are notified to HMRC using Inheritance Tax returns. Such returns often do not need to be completed for estates where a person's assets are all left to their surviving spouse or civil partner. The total value of assets benefitting from the exemption for transfers to surviving spouses or civil partners is therefore substantially higher than shown in this chart.

Chapter 1. Lifetime gifts: exemptions

Nil rate band and gift exemptions adjusted for inflation

Table 1.A compares the current level of the nil rate band and two of the monetary gift exemptions with the level they would be at had they been adjusted for inflation since the last time they were adjusted.

Table 1.A: Level of nil rate band and gift exemptions if increased to reflect inflation

	Current Limit	Limit in 2019-20 if increased to reflect inflation
Nil rate band	£325,000	£423,000
Annual gift exemption	£3,000	£11,900
Small gifts exemption	£250	£1,010

Table 1.A notes:

Note 1: The nil rate band rise to £423,000 in 2019-20 is based on using the Retail Prices Index (RPI) between 2008-09 and 2010-11, and then the Consumer Prices Index (CPI) from 2011-12 onwards.

Note 2: The annual gift exemption rise to £11,900 in 2019-20 is based on using RPI between 1980-81 and 2010-11, and then CPI from 2011-12 onwards.

Note 3: The small gifts exemption rise to £1,010 in 2019-20 is based on using RPI between 1980-81 and 2010-11, and then the CPI from 2011-12 onwards.

Note 4: This approach reflects the indices and rounding conventions generally used by the government for inflation uprating during these periods.

Table 1.B: Normal expenditure out of income exemption claims

Table 1.B shows the number of normal expenditure out of income claims in the 2015-16 tax year, based on a review of 2015-16 Inheritance Tax returns conducted by HMRC. These figures do not take account of lifetime gifts made into trust.

Value of gifts (£)	Number of claims	Proportion
<25,000	321	55%
25,000 – 49,999	90	16%
50,000 – 74,999	52	9%
75,000 – 99,999	36	6%
>99,999	80	14%
Total	579	100%

Table 1.B note: Value of gifts is the value of the gifts after any exemptions or reliefs such as the annual exemption.

Cost of increasing the small gifts exemption

This data provides an estimate of the cost of increasing the small gifts exemption to £1,000. It is based on based on the review of 2015-16 Inheritance Tax returns conducted by HMRC.

Increasing the small gifts exemption to £1,000 would reduce Inheritance Tax receipts by less than £100,000 per annum

Introducing a personal gift allowance

On the basis of their review of 2015-16 Inheritance Tax returns, HMRC has provided data on the interaction between a personal gift allowance and the normal expenditure out of income claims.

A personal gift allowance of £25,000 would cover the value of 55% of all normal expenditure out of income claims

Chapter 2. Lifetime gifts: time limits and taper

These tables provide some information about lifetime gifts made to individuals in 2015-16.

Table 2.B: Lifetime gifts to individuals by year between gift and death

This table and Table D below show that in 2015-16, 4,860 estates (about 20% of the total number of taxpaying estates) recorded lifetime gifts made less than 7 years before death with a total value of £870m. 54% of gifts made were within 3 years of death. Around 24% of gifts were made 5 or more years before death.

Years	Number of gifts	Net Value of gifts (£m)	Net tax chargeable (£m)	Average gift value (£)	Median gift value (£)
0-1	1,590	160	15	98,000	31,000
1-2	1,120	140	18	124,000	41,000
2-3	980	110	11	115,000	50,000
3-4	830	120	12	144,000	64,000
4-5	740	110	8	152,000	72,000
5-6	700	120	6	172,000	100,000
6-7	770	110	1	144,000	94,000
7-14	160	20	0	133,000	77,000
Total	6,890	890	71	129,000	53,000

Table 2.B notes:

Note 1: Number of gifts is different from number of estates. One estate may make multiple gifts.

Note 2: Net value of gifts represents the value of gifts less any exemptions or reliefs on gifts, such as the annual exemption.

Note 3: Only gifts on which Inheritance Tax is payable are included in the data. Gifts covered by the nil rate band are not included.

Note 4: Gifts in years 7-14 relate to those where prior transfers into trusts are involved.

A small proportion of Inheritance Tax relates to gifts made more than 5 years before death

In 2015-16, only £7 million out of total Inheritance Tax of £4.38 billion related to gifts to individuals made more than 5 years before death.

This is less than 10% of the £71 million of Inheritance Tax in 2015-16 relating to all taxable lifetime gifts to individuals.

However, it is important to recognise, for example, that such gifts reduce the nil rate band available to the estate, which in turn, increases the Inheritance Tax paid by the estate.

Table D: Estates reporting lifetime gifts in 2015-16

This table, which does not appear elsewhere in the report but is included here for completeness, shows the number of estates in 2015-16 where a lifetime gift has been made.

Number of years elapsed between gifting and death	Number of estates where lifetime gift has been made
0-1	1,090
1-2	720
2-3	650
3-4	590
4-5	530
5-6	560
6-7	720
7-14	160
Total	5,010

Table D notes

Note 1: Figures have been rounded, so the total does not match the sum.

Note 2: Only gifts on which Inheritance Tax is payable are included in the data.

Note 3: Gifts in years 7-14 relate to those where prior transfers into trusts are involved.

Chapter 4. Interaction with Capital Gains Tax

Capital Gains Tax on death compared with Inheritance Tax

In Table 4.A, HMRC has provided an indicative projection of the impact on the estimated number of taxpaying estates and tax raised per annum if Capital Gains Tax were to be introduced on death. Two scenarios are considered, Capital Gains Tax on death with no change to the principal private residence relief, and Capital Gains Tax on death without principal private residence relief. These figures are compared with the equivalent numbers for Inheritance Tax as per HMRC's published 2015-16 National Statistics.

Table 4.A: Capital Gains Tax on death compared with Inheritance Tax

	Capital Gains Tax on death	Capital Gains Tax on death (if no PPR)	Inheritance Tax
Estimated annual number of taxpaying estates	55,000	182,000	24,500
Estimated tax raised per annum	£1.3 billion	£2.8 billion	£4.38 billion

Table 4.A notes

Note 1: PPR is the Capital Gains Tax exemption on the main home, known as principal private residence relief.

Note 2: The Inheritance Tax data in this table derives from the Inheritance Tax National Statistics, which can be found here: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/731610/Inheritance_Tax_National_Statistics_Commentary.pdf

Chapter 5. Businesses and Farms

Chart 5.A: Value of business and agricultural property reliefs

The figures below are based on HMRC projections.

16,380 – number of estates expected to benefit from APR or BPR over the next five years

£5.85 billion – total cost to the Exchequer of APR and BPR over the next five years

£357,000 – average benefit for each eligible estate of both reliefs over the next five years

£30.4 billion – total Inheritance Tax yield expected over the next five years

Removing the reliefs and lowering the rate of Inheritance Tax

Abolishing APR and BPR entirely would fund a reduction of the main rate of Inheritance Tax from 40% to around **33.7%**.

It should be noted that this does not account for transfers of such assets into trusts so the 33.7% represents a costing on death cases only. Neither does it take account of behavioural change.

Table E below presents the underlying data for Chart 5.A, as well as the statement that abolishing BPR and APR would fund a reduction of the main rate of Inheritance Tax to 33.7%.

Not all of the figures in this table have been included in the main body of the report, but they have been included below to show what these figures are based on.

Table E: Impact of APR and BPR

Tax Year		2019-20	2020-21	2021-22	2022-23	2023-24	Total
Original	Liabilities (£m)	5,500	5,770	6,050	6,370	6,740	30,430
	Projected estates	22,680	23,340	24,050	24,870	25,710	120,650
Remove APR and BPR	Liabilities (£m)	6,590	6,900	7,220	7,580	7,990	36,280
	Difference (£m)	1,090	1,130	1,170	1,210	1,250	5,850
	Projected estates	23,320	23,970	24,670	25,500	26,360	123,820
	Difference	640	630	620	630	650	3,170
Remove APR and BPR; Reduce IHT rate to 33.7%	Liabilities (£m)	5,530	5,790	6,060	6,360	6,710	30,450
	Difference (£m)	30	20	10	-10	-30	20
	Projected estates	23,310	23,960	24,660	25,490	26,350	123,770
	Difference	630	620	610	620	640	3,120

Impact of APR and BPR over the next 5 years

Number of estates claiming APR/BPR	3,240	3,260	3,270	3,300	3,320	16,390
Average cost per estate (£)	336,420	346,630	357,800	366,670	376,510	356,806

Table E notes

Note 1: Please see the introduction of this Annex for an overview of what these projections do/do not include.

Note 2: The policy changes considered here are assumed to apply from the start of the 2019-20 tax year.

Chapter 10. Residence nil rate band

The expected effect of the residence nil rate band on the number of estates that pay Inheritance Tax

Chart 10.A below shows the projected effect of the residence nil rate band on the number of estates that pay Inheritance Tax.

Chart 10.A: The projected effect of the residence nil rate band on the number of estates that pay Inheritance Tax

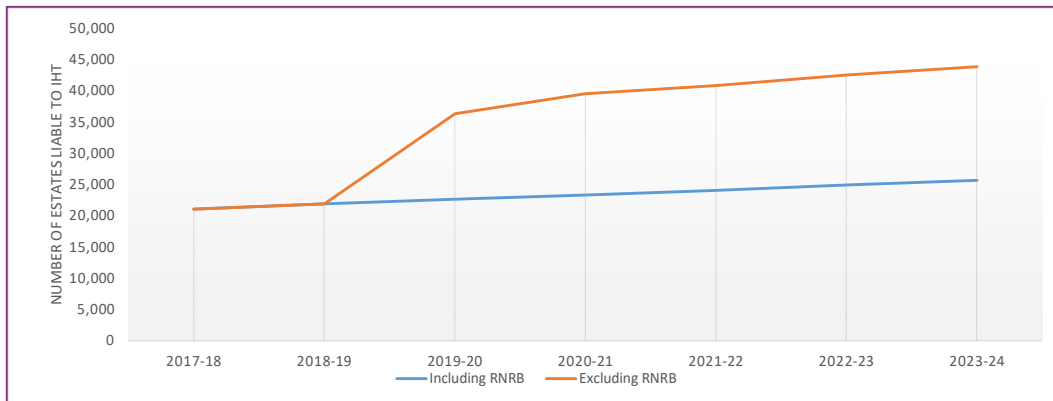


Chart 10.A note: This chart shows the estimated number of estates that would become liable to Inheritance Tax in a given tax year were the RNRB to be removed from 2019-20 onwards (in relation to deaths after 5 April 2019).

Projected number of tax paying estates	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Including RNRB	21,030	21,850	22,680	23,340	24,050	24,870	25,710
Excluding RNRB	21,030	21,850	36,280	39,500	40,810	42,490	43,820

The RNRB will mean that many estates do not have to pay Inheritance Tax

The residence nil rate band will, on average, take an estimated 16,450 estates per year out of Inheritance Tax over the next five years.

HMRC data projections for removal of the residence nil rate band and increasing the nil rate band

Box 10.1 sets out different scenarios regarding the removal of the residence nil rate band.

Box 10.1: Illustrations of the effects of changes to the residence nil rate band from 2019-20



Scrapping the residence nil rate band and using the cost savings to increase the nil rate band for all estates would increase the nil rate band by around £51,000 to £376,000.

Simply abolishing the residence nil rate band would lead to a 68% increase of the number of estates paying Inheritance Tax by 2023-24 and would raise approximately **£5.6bn in additional Inheritance Tax** over the same period.

If the residence nil rate band was abolished and the Exchequer savings were used to increase the nil rate band, it would be possible to increase the nil rate band to **£376,000**. By tax year 2023-24 however, this would still mean that an estimated **5,370 more estates** would have paid Inheritance Tax than would otherwise be the case.

If the residence nil rate band was abolished, and the nil rate band increased to £500,000, then by 2023-24 an estimated **34,400 fewer estates** would have paid Inheritance Tax than would otherwise be the case. However, this would cost the Exchequer around **£7.5 billion** during the same period.

Table F below presents the underlying data relating to the above statements.

Not all of these figures have been included in the report, but they have been included below to show how the calculations were made.

Table F: Impact of residence nil rate band removal

Tax Year		2019-20	2020-21	2021-22	2022-23	2023-24	Total
Baseline	Liabilities (£m)	5,500	5,770	6,050	6,370	6,740	30,430
	Projected estates	22,680	23,340	24,050	24,870	25,710	120,650
Remove RNRB	Liabilities (£m)	6,350	6,820	7,180	7,590	8,070	36,010
	Difference (£m)	850	1,050	1,130	1,220	1,330	5,580
	Projected estates	36,280	39,500	40,810	42,490	43,820	202,900
	Difference	13,600	16,160	16,760	17,620	18,110	82,250
Remove RNRB NRB £376,000	Liabilities (£m)	5,410	5,780	6,070	6,400	6,790	30,450
	Difference (£m)	-90	10	20	30	50	0
	Projected estates	22,020	24,150	24,940	26,290	28,620	126,020
	Difference	-660	810	890	1,420	2,910	5,370
Remove RNRB NRB £500,000	Liabilities (£m)	4,090	4,360	4,580	4,830	5,110	22,970
	Difference (£m)	-1,410	-1,410	-1,470	-1,550	-1,640	-7,480
	Projected estates	15,880	16,850	17,320	17,810	18,420	86,280
	Difference	-6,800	-6,490	-6,730	-7,060	-7,290	-34,370

Table F notes:

Note 1: Please see the introduction of this Annex for an overview of what these projections include.

Note 2: The policy changes considered here are assumed to apply from the start of the 2019-20 tax year.

Projected rise of the nil rate band through regular indexation

Paragraph 10.28 of the report refers to a gradual process of increasing the nil rate band and reducing the residence nil rate band.

One long term option would be to allow the nil rate band to rise gradually, through regular indexation (and to reduce the residence nil rate band by the same amount, keeping the total the same, until the nil rate band absorbed all of the residence nil rate band). However, if such indexation started now, from the existing level of the nil rate band, this would take around 20 years.

This projection is based on using CPI figures for the 5 tax years 2019-20 to 2023-24 inclusive (based on the Economic and fiscal outlook published by the Office for Budget Responsibility on 29 October 2018) and the Office for Budget Responsibility's long term economic determinants published on 12 March 2019 for the years 2024-25 onwards (for which, as per the Bank of England's inflation target, CPI is kept constant).

Chapter 11. Trusts

A small proportion of Inheritance Tax relates to settling assets into trust

In the past 5 years of available data, average Inheritance Tax receipts from transfers into discretionary trust were around **£17.2 million per year**.

Chapter 12. Charities

Legacy giving is a significant source of income for charities

The value of legacy giving in 2015-16 was over **£3 billion**.

Note: Available from Inheritance Tax National Statistics, Table 12.2:
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/730122/Table_12_2.pdf. This refers to exemptions for transfers to qualifying charities or registered clubs.

Chart 12.A: Level of charitable giving on death

Data shows 2.1% of all estates applying for probate gift more than 10% of their net assets to charity on average and this relatively small number of estates are responsible for most legacy gifts.

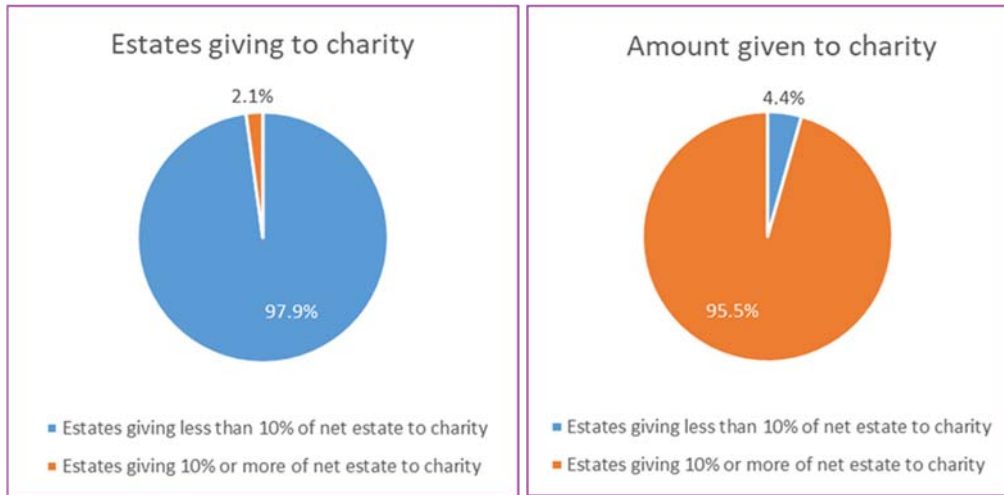


Chart 12.A note: these charts use average figures over the 2012-13 to 2015-16 tax year period. The underlying data is provided in the tables that follow.

Table G: Number of estates giving to charity

'000 estates	Number of estates giving to charity			
	2012-13	2013-14	2014-15	2015-16
Estates giving less than 10% of net estate to charity	273,600	261,900	278,600	269,100
Estates giving 10% or more of net estate to charity	5,700	5,700	6,200	6,100
Total charitable giving	279,300	267,500	284,800	275,200

Table G note: Rounded to nearest 100. Covers all estates applying for probate in each year.

Table H: Amounts given to charity by estates

£million	Total amount given to charity			
	2012-13	2013-14	2014-15	2015-16
Estates giving less than 10% of net estate to charity	£110	£100	£130	£130
Estates giving 10% or more of net estate to charity	£2,210	£2,280	£2,730	£3,110
Total charitable giving	£2,320	£2,380	£2,870	£3,240

Table H note: Rounded to the nearest £10m. Covers all estates applying for probate in each year.

