Simplifying the Design of Inheritance Tax
Second Report of the Office of Tax Simplification
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Simplifying the Design of Inheritance Tax

On 5 July, the Office of Tax Simplification (OTS) published its second report on Inheritance Tax (IHT) and its complexities. Often considered an unpopular, unfair and unevenly applied tax, the UK IHT regime is one of the most difficult to navigate in its current format.

Following its first report in November 2018, the OTS has now provided a number of suggestions to the Government. Although many of these would be widely welcomed by taxpayers, other proposed measures may extend the reach of IHT to estates currently benefiting from favourable tax reliefs.

Overview of the IHT Regime

Of the 590,000 deaths in the UK each year, around 275,000 estates need to submit IHT returns to HM Revenue & Customs (HMRC). However, of these only 24,500 actually have an IHT liability as a result – or just 4.2% of all estates.

There are broadly three areas of the UK IHT regime where charges may arise:

1. On certain gifts made during a lifetime where the person who made the gift continues to benefit from it
2. Trusts, including certain trusts that are not resident in the UK
3. On the death of individuals, depending on their domicile status. UK domiciled individuals are subject to IHT on their worldwide assets, whereas non-UK domiciled individuals are subject to IHT only on the UK assets

All individuals within the scope of IHT are entitled to a tax-free ‘nil-rate band’ of up to £325,000 (this can be reduced in some situations). Any unused nil-rate band can also be transferred to the surviving spouse, in most cases. Special rules apply for non-doms and trusts.

There are a number of other exemptions and reliefs currently available, including:

- Gift between spouses and civil partners
- £3,000 annual exemption and £250 small gifts exemption
- Regular gifts out of excess income
- An additional nil-rate band for homes left to direct descendants
- Qualifying business and farming assets
- Gifts to qualifying charities and political parties
- National Heritage Assets

These reliefs, exemptions and thresholds often operate in very different ways, with complex interactions between them. The OTS has been tasked with suggesting ways of simplifying the IHT regime, and their second report focuses on three areas:

1. Lifetime gifts
2. The interaction between IHT and Capital Gains Tax (CGT)
3. Businesses and farms

Lifetime Gifts

Exemptions

The myriad of exemptions are complicated, poorly understood and often require extensive record keeping. The OTS has recommended that the Government reviews a number of exemptions for lifetime gifts, including the introduction of an overall personal gifts allowance. The level of this allowance has not been proposed by the OTS, but would be a welcome simplification. The OTS has also recommended reforming or replacing the exemption for regular gifts out of excess income, which particularly requires extensive records.

Potentially Exempt Transfer, the ‘7-Year’ Clock

Lifetime gifts that are not exempt are potentially exempt transfers (PETs). If the donor survives for 7 years following the gift, it then becomes exempt from IHT (subject to certain provisions relating to the donor retaining an interest in the gifted assets). In a small number of specific cases relating to gifts into trusts, this period can be up to 14 years. Three years after the gift has been made, ‘taper relief’ applies to reduce the rate of IHT applicable to a PET if the donor dies as 7 years have elapsed.

The OTS has recommended that taper relief be abolished, and the ‘clock’ reduced from seven years to five. This would simplify not only the calculation of tax payable on the death of a donor, but would also reduce the volume of records required to be maintained, collected and reviewed by executors of estates. The OTS has also recommended that the Government simplifies and clarifies the rules relating to payment of IHT on lifetime gifts.

Interaction with Capital Gains Tax

Under current rules, assets that are inherited on death are treated as being received at their ‘probate value’ (the market value at the time of death). This tax-free uplift in the Capital Gains Tax (CGT) base cost means the asset can then be sold immediately without any CGT charge. If the asset is also exempt from IHT or covered by the nil-rate band, there will also be no IHT charge on the inheritance.

The OTS has recommended the Government removes this CGT uplift if relief or exemption from IHT also applies. Instead, the person receiving the...
asset would be deemed to do so at the original base cost of the person who has died.

The OTS believe that the current regime “puts people off passing on assets to the next generation during their lifetime”. Although the proposed change may change people’s decisions regarding succession planning, particularly relating to businesses, it is unlikely to be welcomed by taxpayers who have already factored the CGT uplift into their affairs. We will await any further information from Government, should they decide to pursue this proposal.

BUSINESSES AND FARMS

The proposals by the OTS in respect of Business Property Relief (BPR) and Agricultural Property Relief (APR) are generally to be welcomed. Although many business-owners and farmers are aware of these reliefs and their importance, offering up to 100% relief from IHT on qualifying assets, they are complex to apply in practice with a number of inconsistencies.

The OTS has therefore recommended that the Government reviews a number of these inconsistencies and complexities, including why there are different tests for classifying a company as “trading” between BPR and other tax provisions (such as Entrepreneurs’ Relief). This is likely to result in a higher degree of trading activity required to qualify for BPR (currently only 51% under the “wholly or mainly” test), but would be a welcomed simplification.

Furnished holiday lets are currently generally denied IHT relief on the basis that they do not constitute a trade, which is in contradiction with the provisions for income tax and CGT. The OTS therefore recommends this is reviewed, which again would be welcome. Other areas where the OTS has recommended reviews include the treatment of Limited Liability Partnerships (LLPs), farmhouses and valuations of businesses and farms.

OTHER RECOMMENDATIONS

The OTS has also highlighted other areas that they recommend are reviewed by the Government, namely the IHT treatment of payments from term life insurance policies and the ongoing necessity of the pre-owned asset tax (POAT). POAT is an income tax charge designed to combat certain IHT avoidance, but is amongst the most poorly understood rules in personal tax legislation.

WHAT NEXT?

Although these are only proposals, there has long been a desire for the IHT regime to be simplified. It may not be immediately appropriate for action or restructuring to take place until further details materialise, but clients and their advisors should bear in mind the direction of travel outlined in the OTS report. Taxpayers should, in any case, review their affairs regularly. The release of this second report by the OTS may be a welcome reminder to do so in anticipation of potential reform.

HOW LANCASTER KNOX CAN HELP

As individuals and families become ever more global, it is vital that their tax affairs are managed proactively and holistically. The team at Lancaster Knox has a wealth of experience working with private clients in the UK and abroad, and takes a long-term approach to building strong relationships with clients and their advisers. We consider individuals’ specific circumstances and objectives to provide commercial, pragmatic and robust advice appropriate for their needs.

CONTACT US

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