Reform of Inheritance Tax

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Abstract

This article looks at the options for reform of inheritance tax in the UK including alternatives such as a donee based tax similar to that in Ireland, the replacement of inheritance tax by capital gains tax and some of the issues surrounding a wealth tax. While everyone agrees the current system of taxing wealth is unfair and unsatisfactory, policy makers, academics and politicians cannot agree on sensible alternatives. The article therefore looks at some of the design issues that need to be considered in the adoption of any new regime and concludes that a simple system may ultimately be the most effective and subject to the least avoidance.

A. Introduction

In the post-COVID world, the UK's Chancellor will need to raise more revenue: the taxation of wealth and capital is an obvious place to look. There is often talk (usually quashed) of a mansion tax before a budget but maybe now is the time to consider wholesale reform of inheritance tax (IHT).

Currently wealth in the UK is taxed by means of a tax on transfers of wealth, known as IHT. Resistance to reform of this tax has been strong for some decades, mainly because no one can agree what to replace it with. While IHT is described as "almost uniquely unpopular"[1] and "Britain's 'most hated tax'"[2] it has survived almost unchanged since 1986 and bears many similarities to estate duty that was introduced in 1894. The *Mirrlees Review* on taxation of wealth,[3] published in 2010, noted the unpopularity of IHT and discussed some alternatives including a donee based tax. Some difficulties with a donee based model are considered later in this article.

The burden of IHT is seen as falling disproportionately on the middle classes whose main asset is often tied up in a home that they cannot give away. One blog writer commented:

> "[I]f you are a well-advised aristocrat with a few 100,000 acres the system is positively generous. If you are a widow in Guildford with only one dormant asset, your home, you will be punished – punished at 40%."[4]

* A version of this article appears in G. Loutzenhiser and R. de la Feria (eds), *The Dynamics of Taxation* (Oxford: Hart Publishing, 2020), forthcoming. A shorter version of this chapter appeared in the *Tax Journal* at E. Chamberlain, "Comment: How to reform inheritance tax", *Tax Journal*, 24 February 2020.

[1] Office of Tax Simplification, *Inheritance Tax Review – first report: Overview of the tax and dealing with administration* (OTS First Report) (gov.uk, November 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/758367/Final_Inheritance_Tax_Report_-_web_copy.pdf* [Accessed 14 May 2020].

[2] E. Agyemang, *Inheritance tax: what does the future hold?, Financial Times*, 11 July 2019, available at: *www.ft.com/content/10370c58-a235-11e9-974c-ad1c6ab5efd1* [Accessed 14 May 2020].

[3] R. Boadway, E. Chamberlain and C. Emmerson, "Taxation of Wealth and Wealth Transfers" in J.A. Mirrlees, et al. (eds), *Dimensions of Tax Design: The Mirrlees Review* (Oxford: OUP for The Institute for Fiscal Studies, 2010).

[4] J. Blundell, *Inheritance Tax Only Makes the Rich Richer* (Institute of Economic Affairs, 1 May 2005).

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This view is partly borne out by the evidence produced by the Office of Tax Simplification in its first report[5]: the average rate of tax increases from under 5 per cent for estates with a net value of under £1 million to up to 20 per cent for estates valued at £6–7 million, after which the rate falls to 10 per cent for estates with a value of £10 million or more. The main reason for the falling tax rate may well be the presence of reliefs such as business property relief (BPR) and agricultural property relief (APR) that provide 100 per cent exemption from IHT on death and lifetime giving and will generally only be applicable to the better off. Moreover, the above figures take no account of lifetime giving, which probably increases the distortion still further, as people whose main asset is the family home cannot easily give it away during their lifetime.[6] Academics seem as divided as the public on whether and how to tax wealth.[7]

Despite its unpopularity, IHT raises relatively little revenue. In 1895–96 the £14 million from death duties represented about 35 per cent of taxes. By 1968, estate duty produced only about £382 million or about 5.8 per cent of total revenue receipts.[8] The yield in 2018–19 stands at a record £5.4 billion but now comprises less than 1 per cent of total tax revenues. Fewer than 5 per cent of deaths now result in the payment of inheritance tax. There are 588,000 deaths each year, of which 275,500 require the completion of an IHT form; of these only 24,500 result in payment of any tax.[9] Surely there is something wrong with a tax where there is so much form filling for so little result.

In January 2020 the All-Party Parliamentary Group published a report (the APPG Report)[10] on the reform of IHT, co-written by this author, in which some alternatives to the current IHT system were discussed. A more detailed chapter on options for wealth taxes is forthcoming in November 2020 in *The Dynamics of Taxation*.[11]

B. The past

It is worth learning lessons from the past before launching into wholesale reform of current IHT. Too often the same mistakes are repeated. The difficulty at present is that IHT is an uncomfortable mish mash of estate duty (with its seven year rule and anti-avoidance provisions to stop donors

[5] OTS First Report, above fn.1.

[6] See, for example, the recent case of *Shelford v HMRC* [2020] UKFTT 53 (TC) where an attempt to do so failed.

[7] See, for example, N. Lee, "Inheritance Tax - An Equitable Tax No Longer: Time for Abolition" (2007) 27(4) *Legal Studies* 678. A pro-IHT view is espoused by S. White, "Moral Objections to Inheritance Tax" in M. O'Neill and S. Orr (eds), *Taxation: Philosophical Perspectives* (Oxford: OUP, 2018). For a US perspective, see D.G. Duff, "Alternatives to the Gift and Estate Tax" (2016) 57 *Boston College Law Review* 893.

See, also, E. Chamberlain, "Capital Taxes - Time for a Fresh Look" [2015] BTR 679 and E. Chamberlain, "A Review of Agricultural Property Relief and Business Property Relief" [2016] BTR 509.

[8] E. Chamberlain, "Estate Planning for Businesses" in B. Häcker and C. Mitchell (eds), *Current Issues in Succession Law* (Hart Publishing, 2016), Ch.11.

[9] Office of Tax Simplification, *Inheritance Tax Review – second report: Simplifying the design of inheritance tax* (OTS Second Report) (July 2019), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816521/Final_Inheritance_Tax_2_report_-_print_copy.pdf* [Accessed 19 May 2020].

[10] The All-Party Parliamentary Group, *Reform of Inheritance Tax* (Society of Trust and Estate Practitioners (STEP), January 2020), available at: *www.step.org/sites/default/files/Policy/Reform%20of%20inheritance%20tax%20report%20Jan%202020%20final%20ALT.pdf* [Accessed 19 May 2020].

[11] E. Chamberlain in G. Loutzenhiser and R. de la Feria (eds), *The Dynamics of Taxation* (Oxford: Hart Publishing, 2020), forthcoming. A shorter version of this chapter appeared in the *Tax Journal* at E. Chamberlain, "Comment: How to reform inheritance tax", *Tax Journal*, 24 February 2020.

benefiting from the assets they have given away) and capital transfer tax (CTT) which was introduced in 1974 by Denis Healey when it was envisaged as a cradle to the grave tax with all transfers of wealth being cumulated over a lifetime.[12] This means IHT is both complex (for example in the allocation of the nil-rate band and the rules on reservation of benefit (ROB) which are discussed elsewhere in this Issue)[13] and easy to avoid (by the wealthy donor making lifetime gifts more than seven years before death). Both CTT and IHT are low yielding, mainly because, unlike estate duty, they have an unlimited spouse exemption.

IHT has not exactly generated political consensus but, as nobody knew what to do with it, the tax remained largely unchanged for 20 years until 2006 when Labour introduced major changes to the taxation of trusts[14] and in 2007 introduced the transferable nil-rate band[15]: the ability to transfer the nil-rate band between spouses and hence use two nil-rate bands on the last spouse to die. For the last 11 years, since April 2009, that nil-rate band has been frozen at £325,000. A new residential nil-rate band was phased in from April 2017.[16] From April 2020 this is £175,000[17] per individual but only if the house or sale proceeds are left to children. However, the skeleton body of IHT remains largely unchanged.

The lack of joined up policy thinking can be seen when considering the effect of the tax on families. A married couple with a joint estate of, say, £1 million leaving everything to the children on the last to die will pay no IHT even if they hold the estate unequally. An unmarried couple will pay no tax on that £1 million provided: 1. they own £500,000 each so can maximise the use of reliefs; and 2. they each leave it directly to the children on death. However, if they instead leave their share to each other first, and then to the children only on the last death, £70,000 is payable on the first cohabitee's death[18] and £200,000 on the second death.[19] There seems no clear policy reason for the difference. Is the Government even aware of this distinction?

Another area of needless complexity relates to capital gains tax (CGT). CGT was introduced in 1965[20] and until 1971 was also chargeable on death although it was deductible for estate duty purposes. After 30 March 1971 CGT was no longer charged on death,[21] and a CGT step-up was given on death for CGT purposes. By contrast, CGT remains payable on most lifetime gifts (and in general is not deductible against the IHT liability that may arise on the donor's death within seven years). Thus, a discrepancy opened up (and remains) between lifetime and death gifts. It is hard to think that policymakers wanted CGT to be payable on some lifetime gifts and not others but never on death. The interaction of wealth taxes with CGT is discussed further below.

[12] FA 1975 s.19 and Sch.4.
[13] E. Chamberlain, "Buzzoni v HMRC and Lady Hood v HMRC: a reservation too far?" [2020] BTR 164; FA 1986 s.102.
[14] FA 2006 s.156 and Sch.20.
[15] FA 2008 s.10 and Sch.4; IHTA ss.8A–8C.
[16] F(No.2)A 2015 s.9.
[17] F(No.2)A 2015 s.9(4) inserting IHTA s.8D(5)(a)(iv).
[18] £500,000 – £325,000 nil-rate band – £175,000 x 40% = £70,000.
[19] The second to die will have an estate of, let us assume, £1 million and a nil-rate band and a residential nil-rate band of £500,000 together leaving £500,000 taxable at 40%.
[20] FA 1965 s.20.
[21] FA 1971 s.59.

C. The way forward: a wealth tax alongside IHT?

Some countries, such as Austria, Sweden, India, New Zealand, Australia and Canada, have abandoned estate duty and have no tax on transfers of wealth other than (in some cases) CGT; but IHT has remained in the UK, a mix of CTT and estate duty. Should the UK now abolish any form of estate duty altogether? This article assumes, for the reasons outlined in the APPG Report,[22] that there are still good reasons to retain taxes on wealth transfers.

Should there also be a wealth tax to supplement IHT? There have been recent calls for a progressive European tax to fund the European COVID response.[23] A tax on the holding of wealth is often cited as producing greater horizontal equity because it suggests equal treatment of those with the same taxable capacity and superficially takes account of the advantages brought by wealth which income tax alone cannot do. A wealth tax taxes valuable assets that yield little income, but confer significant benefits, such as art and houses. It is sometimes said that the beggar and the lord have the same income but very different taxable capacity and advantage in terms of independence and security.

A wealth tax is also said to promote vertical equity by constraining inequality and redistributing wealth. One argument is that it encourages greater efficiency in asset use (particularly on holdings of land) by encouraging non-yielding assets into greater productivity. People do not want to pay wealth tax on land that produces zero profit. Therefore (so the argument goes) it incentivises people to develop land. Countries such as Cyprus, Iceland and Spain introduced temporary wealth taxes following the financial crisis in 2008. This is superficially popular, as the wealthy are seen to be "paying their way" in times of adversity. A wealth tax can also provide valuable data about the wealth of a population, which can inform future policy making and counter avoidance.

However, an annual wealth tax faces significant practical problems. The Organisation for Economic Co-operation and Development (OECD) 2018 report stressed it cannot be assessed in isolation as it will depend on the country's overall tax system and economic circumstances.[24] The idea was proposed in the manifesto of the Labour Party in the two 1974 general elections[25] and then taken forward in a Green Paper in 1974,[26] but Healey abandoned it for many of the practical reasons discussed below. It is worth noting that of the 12 OECD countries that operated a wealth tax in 1990, only four still had it on any permanent basis in 2017.[27] Sweden abandoned

[22] APPG Report, above fn.10, s.D Appendix 1.
[23] C. Landais, E. Saez and G. Zucman, *A progressive European wealth tax to fund the European COVID response* (Vox CEPR Policy Portal, 3 April 2020), available at: *https://voxeu.org/article/progressive-european-wealth-tax-fund-european-covid-response* [Accessed 19 May 2020].
[24] OECD, *The Role and Design of Net Wealth Taxes in the OECD*, OECD Tax Policy Studies, No.26 (Paris: OECD Publishing, 2018).
[25] February 1974 Labour Party Manifesto, *Let us work together - Labour's way out of the crisis*, available at: *http://www.labour-party.org.uk/manifestos/1974/Feb/1974-feb-labour-manifesto.shtml* [Accessed 19 May 2020]; October 1974 Labour Party Manifesto, *Britain Will Win With Labour*, available at: *http://www.labour-party.org.uk/manifestos/1974/Oct/1974-oct-labour-manifesto.shtml* [Accessed 19 May 2020].
[26] Green Paper, *The Introduction of a Wealth Tax* (HMSO, 1974), Cmnd.5704.
[27] OECD, above fn.24.

it.[28] The German federal courts declared it unconstitutional.[29] France has now restricted it to real estate.[30]

Common objections to a wealth tax include the following:

1. Administrative complexity and valuation issues. A five year revaluation model could be adopted with the taxpayer effectively self-assessing the position (as they do under the annual tax on enveloped dwellings (ATED)) but this can be unfair if the assets later fall in value and it does not deal with the problem of how to value private companies, particularly minority shareholdings.
2. Liquidity issues lead to inefficient use of resources. How is wealth tax to be paid in respect of non-yielding assets such as the main home? Owners of private companies have to fund the tax by declaring dividends to shareholders rather than reinvesting in the business. Wealth taxes can discourage private businesses and start-ups that may in the longer term be profitable, even if initially low yield. Saving is ostensibly discouraged as it leads to taxation.
3. Unfairness. Unless there is comprehensive coverage wealth tax is unfair. A small family company may be taxed more heavily than a civil servant with an index linked pension even though the family company may be the pension. How do you tax the family unit? What about families who hold wealth through trusts? Is each trust to be taxed as a separate unit? The person who inherits a £5 million house will pay the same amount of wealth tax as someone who buys the same house with their earnings that have been subject to income tax. Moreover, a house with a mortgage could be subject to the same amount of wealth tax as a house free of mortgage unless a deduction is made for debt but this can open the door to avoidance by reducing the value of assets through borrowing.
4. Interaction with other taxes. Should wealth tax be deductible against IHT or CGT? Should the same reliefs apply across taxes? Could wealth tax function as an alternative minimum tax?
5. Enforcement. Wealth tax is seen as a capital drain as it deters rich people from remaining in a country or from going there in the first place. This was one reason for its abolition in Sweden (which also has no IHT on death). What if people leave the UK—is there to be an exit tax? This concern is less apparent in the debate on wealth taxes in the US where the relevant tie is citizenship rather than residence and is harder to sever.

[28] See G. Du Rietz and M. Henrekson, "Swedish Wealth Taxation (1911–2007)" in M. Henrekson and M. Stenkula (eds), *Swedish Taxation: Developments Since 1862* (New York: Palgrave Macmillan, 2015), Ch.6, 267–302, available at: *https://www.palgrave.com/gp/book/9781137478146* [Accessed 4 June 2020].

[29] BVerfG, Judgment of the First Senate of 17 December 2014 - 1 BvL 21/12, paras (1-7), available at: *http://www.bverfg.de/e/ls20141217_1bvl002112en.html* [Accessed 28 May 2020].

[30] Impôt sur la fortune immobilière (IFI): personnes concernées Vérifié le 09 janvier 2018 - Direction de l'information légale et administrative (Premier ministre).

D. General considerations on reform of wealth transfer taxes

For the moment we leave discussion of wealth tax for another day and instead consider reform of the current IHT system, looking at the practical design issues that must be addressed. The type of wealth transfer tax (WTT) chosen logically affects its design. A system where tax is levied on the *donor* who makes gifts in their lifetime or on death is called here an "estate tax". A system which taxes the *donee* on gifts and legacies cumulatively over that donee's lifetime is called an "accessions tax" (AT). The current UK IHT is an estate tax.

Whatever system is chosen it is suggested that five factors must be satisfied:

1. The relevant system must tax all transfers of wealth comprehensively. This means taxing both lifetime and death transfers of wealth. Taxing only inheritances on death or taxing lifetime gifts differently from gifts on death simply opens the door to avoidance and unfairness (as rich people can afford to make lifetime tax-free gifts).
2. There must be some political and public consensus. Wealth transfer taxes have a long timeframe. In the case of CTT, many waited until the Conservatives took office before making gifts as they knew there would be tax rate reductions. If the public are to accept any tax then they must understand it so it must have straightforward principles with few exceptions.
3. There is no point in having a system where the rates are so high that the rich leave the relevant jurisdiction. And as Denis Healey noted in his autobiography, high rates inevitably mean lots of exceptions and reliefs.[31] So in one sense this favours simplicity and comprehensibility but in another sense may point to flat rather than progressive rates. This could be perceived as unfair.
4. The interaction with other taxes and their reliefs has to be considered. Too often revenue departments work in silos, concentrating on IHT without considering CGT or stamp duty land tax (SDLT) or other relevant taxes. This opens gaps (for example, the current differences between lifetime and death gifts) and encourages avoidance. This is particularly the case if a wealth tax is introduced—it is pointless to have a wealth tax that is designed totally differently from a wealth transfer tax.
5. Any WTT must deal with trusts, foundations and other vehicles commonly used to hold and pass on wealth. This is one major objection to AT—it is not clear to the author that an AT can adequately deal with trusts and other such vehicles. A detailed blueprint for the taxation of trusts under a reformed IHT is discussed at the end of this article.

E. A fairer WTT compared with the current IHT: some points for IHT reform

1. What connecting factors should be used?

Here one has to consider the following factors:

1. residence of the donor;

[31] D. Healey, *The Time of My Life*, revised edn (London: Methuen Publishing Ltd, 2015).

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2. residence of the donee; and
3. situs of the asset being given.

Currently, IHT offers a rather arbitrary form of relief: foreign domiciled donors who have been in the UK for fewer than 16 years only pay IHT on UK assets and even after 15 years will not pay IHT on foreign assets settled into a trust before the 16 year deadline. Hence IHT is linked not only to long-term residence but also to the concept of domicile of the donor; the residence or domicile status of the donee is irrelevant, which is logical for an estate tax.

The Canadian model deals with the problem of persons who become resident in Canada (who will not want to pay tax on their worldwide estate if they happen to die shortly after arriving in Canada) by imposing CGT not IHT on death and rebasing the assets to the market value at the time when the donor first arrived in Canada so only gains accruing in the course of Canadian residence are taxed. An exit charge is then levied if the person becomes non-resident so that gains accruing during the period of Canadian residence are captured. France has a five year run-off period before full IHT becomes payable.

Factor 3 above—situs—is relatively easily dealt with. Whatever WTT system is adopted, all gifts of UK situated property should potentially be within the scope of estate tax/AT irrespective of the residence or domicile of the donor or donee. That is the current position under IHT with a few exceptions.[32] In addition, the current position of taxing UK residential property held in enveloped vehicles should remain. So it is suggested that the present IHT system on situs should be followed.

Factors 1 and 2 are more difficult to address. It is suggested that domicile should be abolished altogether as a relevant concept in taxing transfers of wealth. Liability could depend not on someone's domicile ("where their heart lies")[33] but be linked solely to an objective test of residence. Logically, an estate tax should be charged by reference to the residence status of the donor and AT should be charged by reference to the status of the donee. However, this could lead to significant avoidance. Whatever model is adopted, it is suggested that the tax base should be extended to cover all transfers where *either* the donor or donee is a long-term UK resident (say resident in the UK for more than 10 out of the last 15 tax years). This is very different from the current model where both donor and donee can be UK resident without paying IHT if the donor is not domiciled there.

One problem with this option is that if the donee living in the UK is taxed on gifts received from a foreign resident donor, including a trust, there may well be double taxation as some countries will tax transfers of wealth made *by* persons living in their country.

Another question is what happens if the long-term resident leaves the UK. Currently IHT carries a long tail for those with a domicile of origin as this domicile is always the default in the event they do not positively decide to settle permanently in another state. A desire to settle "in the US", for example, or a wish "never to return to the UK" is not sufficient to lose a UK domicile of origin. It is necessary to settle in a particular US state. Even then it takes another three years

[32] For example, in relation to government gilts owned by a non-UK resident and authorised unit trusts and open-ended investment companies (OEICs) held by foreign domiciliaries.
[33] The common law rules on domicile are complex and do not equate to residence or even habitual residence. For a full discussion see Lord Collins of Mapesbury and J. Harris (eds), *Dicey, Morris & Collins on the Conflict of Laws*, 15th edn, mainwork and fifth supplement (Sweet & Maxwell, 2018).

before the UK domiciliary can lose their domicile for IHT purposes.[34] For those who have a foreign domicile under common law but have been UK resident for more than 15 years out of the last 20 they are deemed domiciled for UK IHT purposes and only lose this domicile at the start of the fourth tax year of non-residence and assuming they remain non-UK resident for six tax years.

Another problem is that the concept of domicile as understood in common law jurisdictions is itself very uncertain, fact sensitive and patriarchal. In an age of global mobility, it may not be sensible to search for the place which someone regards as "their permanent home" or "where their heart lies" as they may have homes in many different jurisdictions for varying purposes. A person may not be settled in any particular place in which case the domicile of origin (based generally on their father's domicile at birth) is the default one. This is not likely to lead to a fair result where the person has never had any meaningful connection to that jurisdiction.

Example 1

Giles (domiciled in England) left the UK in the 1950s for the US, living first in New York and then, due to work, moving to California. He retired and died in Massachusetts. While in New York he had two children. Both children are likely to have a UK domicile of origin even though they may never live in the UK as Giles may not have intended to return to the UK but he never intended to settle in a particular US state until retirement.

The current IHT rule that someone born in the UK with a domicile of origin is deemed domiciled in the UK if they spend more than one tax year in the UK is particularly egregious. Consider the following:

Example 2

Julian is domiciled by law in Massachusetts having lived there more than 30 years. He emigrated when a student but was born in the UK and his father was UK domiciled. When he is 50 Julian returns to the UK to nurse his elderly father and ends up spending longer than anticipated in the UK. He is UK resident for two tax years and leaves to return to Massachusetts promptly on the death of his father at the end of his second tax year. During the second year the discretionary trusts he was advised to set up in the US where he is a beneficiary face a 10 year anniversary charge. Although they were excluded property trusts when he set them up they are now within the IHT net and a 6 per cent tax charge arises. Julian would have to claim treaty relief on the basis that he was domiciled in the US when he set up the trusts. Depending on whether he retains UK nationality and the impact of Article 5(4) of the US/UK Estate Duty Treaty[35] he may not be successful in such a claim. Moreover, if Julian dies while UK resident there is potentially a ROB on his death and no spouse exemption.

[34] See IHTA s.267(1)(a).
[35] Double Taxation Relief (Taxes on Estates of Deceased Persons and on Gifts) (United States of America) Order 1979 (SI 1979/1454).

Example 3

Now contrast the position of Aaron who is Israeli domiciled by origin and set up trusts while still foreign domiciled. He has now (in his 12th year of UK residence) decided to settle permanently in the UK and dies resident and domiciled there. The settled property remains excluded property for IHT purposes and is not taxed on Aaron's death provided the trusts hold no UK situated property directly or UK residential property directly or indirectly.

If domicile is the relevant connecting factor, it is odd that the person actually domiciled in the UK by law escapes IHT and the person in the UK only temporarily pays it.

A suggested reform is to say that the donor (or donee if an AT is introduced) will remain within the scope of IHT if they have been UK resident for 10 out of the last 15 tax years to prevent deathbed emigrations. On that basis the IHT position in the first two examples would be reversed. Moreover a bright line statutory residence test would be more certain than relying on concepts such as intention and "where the heart lies".

2. What is the taxable unit?

Most countries provide for some relief on, if not outright exemption from, transfers of property between spouses and civil partners although the UK was almost the last to do so in 1972 under estate duty when a limited £15,000 exemption was given. Currently IHT provides an outright exemption for all lifetime and death transfers between spouses extended to gifts to foreign spouses in some cases where that recipient spouse has elected to be deemed domiciled in the UK.[36] In many civil law countries, a lower rate of tax is also levied on transfers to close relatives; the reasoning is that inheritance from a friend rather than a parent should be considered to be more in the nature of a windfall and therefore taxed more heavily. Ireland's AT (called capital acquisitions tax or CAT) levies tax at a lower rate on gifts to children than on gifts to friends.

Should spouse exemption only apply on death or should it apply to all lifetime transfers? Should the relief be extended to cohabitees? It is suggested that the argument for spouse or civil partner exemption is stronger where rates are higher as the hardship suffered on the first death is greater. However, the same hardship argument could be raised by cohabitees, although there may be more practical difficulties in monitoring whether someone is a cohabitee as opposed to whether they are married. The same point would apply if a wealth tax were to be introduced. Extending IHT exemption to cohabitees is likely to cost too much and would probably reduce the yield so much as to make the tax wholly uneconomic.

IHT is flat rate: 0 per cent and then 40 per cent. However, a more progressive estate tax raises further issues as illustrated by the example of when one estate of £1 million passes on the last spouse to die more tax will be paid than on two estates of £500,000. Hence the deferral of tax on the first death comes at some cost. IHT seeks to solve these problems by allowing transfers of nil-rate bands between spouses and civil partners. In effect the same rate of tax is paid on the first as on the last death. In the case of AT, there are other complications: if, say, a husband inherits from his wife, and the inheritance is spouse exempt, should this inheritance be ignored altogether in calculating the rate of tax on the husband's other inheritances? Does it make a

[36] See IHTA s.267ZA.

difference if the husband inherits from his wife in trust rather than outright? The taxable unit may be particularly troublesome in relation to AT but Ireland ignores outright transfers between spouses in calculation of the tax. These transfers simply get taxed on onward transmission to others.

Another issue is whether it is right to tax gifts to distant relatives or friends more heavily than gifts to (say) children. This question is more relevant to a progressive tax. The windfall argument, referred to above, is not necessarily well-founded. A friend or distant relative may well have legitimate expectations if they have been close to the deceased. Moreover, in the case of AT, any differentiation in favour of close family members would arguably increase concentrations of wealth when one of the main objectives of this system is to disburse wealth more widely. The Resolution Foundation report favours AT and does not suggest differential rates.[37] The current IHT regime does not set lower rates for issue than for more distant relatives except in one respect: if the main house is left to the issue of the deceased then an additional nil-rate band up to £175,000 can in certain cases be claimed. This relief is exceptionally complicated and, it is suggested, should be abolished.[38]

3. Tax base: rates, reliefs and exemptions. Abolition of the potentially exempt transfer (PET) regime

Currently, the UK gives very generous tax breaks to trading businesses[39] and in relation to agricultural land.[40] Should these continue? Again much depends on the rate of tax. A high rate will generally require greater reliefs for businesses who will object that, otherwise, family companies will need to be sold to pay tax due on death, which is not a planned or voluntary event. However, BPR and APR currently do not require the person who inherits on death to retain the asset for any minimum length of time; hence, the business can be sold immediately after death without any CGT or IHT payable at all by the heirs. The rules are different for lifetime gifts increasing distortions in behaviour. However, introducing a minimum period of ownership for the heir who inherits on death (as seen in Germany and Ireland) is not desirable if it encourages economic inefficiency. In any event, the rule is in practice easily avoided by selling to a buyer who allows the seller to retain preference shares in the business for the required minimum length of time.

IHT legislation contains many other lifetime reliefs: small gifts exemption[41]; gifts in consideration of marriage[42]; annual exemption with carry forward[43]; gifts for family maintenance[44];

[37] A. Corlett, Intergenerational Commission Report, *Passing On: Options for reforming inheritance taxation* (Resolution Foundation, May 2018), available at: *https://www.resolutionfoundation.org/app/uploads/2018/05/IC-inheritance-tax .pdf* [Accessed 28 May 2020].
[38] For a detailed critique see R. Wallington, "Sections 93–97 and Schedule 15: inheritance tax, etc." [2016] BTR 598.
[39] See IHTA Pt V, Ch.I, s.104.
[40] IHTA Pt V, Ch.II.
[41] IHTA s.20.
[42] IHTA s.22.
[43] IHTA s.19.
[44] IHTA s.11.

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normal expenditure out of income exemption[45]; charity exemption[46]; maintenance funds[47]; employee trusts[48]; conditionally exempt transfers for objects or land of pre-eminent or outstanding interest[49]; a nil-rate band of £325,000 renewable every seven years[50]; the PET regime under which the gift is exempt if the donor survived seven years and does not reserve a benefit. Many of these reliefs date back to estate duty and need a wholesale review.

It is suggested that whether AT or reformed estate tax is adopted, an exemption for small gifts should be kept so any gift not exceeding £250 in value does not have to be taken into account by either donor or donee. This avoids over-reporting on small cash or other gifts. Furthermore, an annual lifetime allowance would still be needed for either the donee (if AT is introduced) or for the donor on an estate tax like IHT irrespective of other lifetime reliefs. A level of £20,000–£30,000 exemption each year with no ability to carry forward that annual exemption could be considered in exchange for the abolition of all other lifetime reliefs other than (possibly) spouse and charity exemptions.

The OTS suggested in its second report (discussed elsewhere in this Issue[51]) that the nil-rate band should be prorated and the estate should be made liable for all tax even on failed PETs.[52] The author wholly rejects this idea. It fails to appreciate the unfairness on the death estate as the donees would walk away with a tax-free lifetime gift but the heir of the estate (often the surviving spouse of a second marriage) would bear tax not only on the death estate but also on lifetime gifts if the donor died within seven years. The donor would have no certainty as to how much their heirs on death would take as it would all depend on how long the donor survives. Moreover, trustees would have no certainty as to how much, if any, of the lifetime gift was tax-free and this would affect the rate of tax to which they would be liable on 10 year anniversaries and on capital distributions. Trustees would have to wait seven years before making significant capital distributions.

It is suggested instead that much more fundamental reform of IHT rather than tinkering at the edges is required and this is discussed in the next section.

4. Trusts

How do you deal with trusts, foundations, usufructs and other similar structures which do not die and can provide benefits to people without actually transferring wealth to them? In many trusts, income accrues to one group of beneficiaries and capital to another. How should these different interests be taxed? The benefits accruing to beneficiaries are not always capable of being valued as they are contingent or discretionary.

Possible approaches include the following:

[45] IHTA s.21.
[46] IHTA s.23.
[47] IHTA s.27.
[48] IHTA ss.13 and 28.
[49] IHTA s.30.
[50] IHTA s.3A.
[51] C. Whitehouse, "The Office of Tax Simplification's second inheritance tax report" [2020] BTR 137.
[52] OTS Second Report, above fn.9, Ch.10.

1. Treat the trust as transparent. That is, include the trust fund within the taxable estate of the settlor or the trust's beneficiaries on the basis HMRC simply "look through" the trust. In the US, for example, a grantor trust is a trust whose settlor is treated as the owner of the trust assets for all US tax purposes. As a result, distributions of income or capital to other beneficiaries are treated as gifts from the settlor.
2. Attribute ownership of capital to the income beneficiary. Until 22 March 2006 this was the approach taken by the UK so that the capital interest in a trust fund was attributed to the individual entitled to the income. This approach is now limited to trusts for disabled beneficiaries and certain trusts arising on death.
3. Create a fictional taxpayer. In this case, the trust is taxed as a separate entity and is subject to a separate system of rates. This approach has been adopted for most UK lifetime trusts for IHT purposes since 2006 with a 6 per cent periodic charge every 10 years and exit charges of lesser amounts plus an entry charge of 20 per cent. A trust set up every seven years has its own nil-rate band.

HMRC suggest that taxation should be neutral between outright gifts and gifts in trust so that a donor uses a trust for purely non-fiscal reasons.[53] How to achieve this in the context of wealth transfer taxes and particularly AT is not straightforward. The general effect of trusts is to maintain concentrations of wealth and discourage distributions, which is the opposite of AT's objectives. If a life tenant is taxed at the same rate as an outright gift to that individual, how does this affect that individual's lifetime cumulative accessions total, particularly if they never actually receive any capital but just an income interest? Is it fair to tax the donee at a higher rate on other inheritances simply because they are treated as receiving the underlying capital of the trust fund even if they take a revocable income interest? If the donee is taxed on the value of their income interest rather than the underlying capital, how is that income interest to be valued given it may be revocable?

Trusts are significantly easier to deal with under an estate tax system than under AT. The discretionary trust periodic charge (say every 10 years) can be fixed by reference to the overall rate levied on the death of a donor. So a 20 per cent death rate might justify something like a 3 per cent 10 year periodic rate.

However, in the case of AT, it is less easy to work out a compensating "neutral" position for trusts. Ireland operates capital acquisitions tax (CAT) (a form of AT) with no tax on entry into a discretionary trust, CAT on the distribution of capital to a beneficiary and an initial charge of 6 per cent on the later of the death of the settlor or (broadly) the last child of the settlor reaching 21. From then on a 1 per cent annual charge is also imposed while the assets remain in trust. The status of the beneficiary and their history of inheritances is ignored while the property remains in trust. This position is not, as such, a neutral position.

A detailed plan for the taxation of trusts under reformed IHT is set out in section F below.

[53] See, for example, HMRC, *The Taxation of Trusts: A Review: Consultation document* (7 November 2018), available at: *www.gov.uk/government/consultations/the-of-taxation-of-trusts-a-review* [Accessed 20 May 2020].

5. Other taxes

IHT (and wealth transfer taxes generally) cannot be treated in isolation and some of the arguments for and against a wealth tax have been discussed earlier in this article.

What about CGT? As noted in section B above, when CGT was introduced in 1965, death was also an occasion of charge although the charge would be set off against estate duty. The CGT charged on death was abolished in 1971 and a step-up introduced. The abolition was for the practical reason that (in the Government's view) the levy of two taxes on the same event, CGT as well as estate duty, imposed an excessive burden on estates, and particularly family businesses. By contrast, the CGT charge on lifetime gifts remains unless the gifted asset is a qualifying business or is given to a lifetime trust in which case the gain can be held over.[54] In the case of the estate tax, the liability for both CGT and estate tax on gifts will fall on the donor. In the case of AT, the donor bears the CGT, and the donee pays AT. Nevertheless, it is still likely to be perceived as double taxation. Although double taxation is not necessarily irrational, as the two taxes are doing different things, whether in practice it would be tolerated is doubtful.

A compromise may be to roll over the accrued gain on any gifted asset (whether transferred during lifetime or on death) to the donee. In this way, the gain will be subject to tax in the long run, but the double charge to CGT and WTT on the same occasion is avoided. The pros and cons of CGT on lifetime and death transfers are considered further in a forthcoming chapter in *The Dynamics of Taxation*.[55]

F. A blueprint for reform of IHT: the flat-rate gift tax

A reformed IHT was the APPG's preferred option[56]: an estate tax levied on the donor although with some modifications to take account of trusts. This blueprint is based on the assumption that if rates are low enough and the tax is kept simple, extensive reliefs are not needed; tax avoidance stops and the tax base widens.

The practical effect of some of the suggestions are illustrated in the APPG's detailed examples to which reference should also be made, although some variations on the APPG Report[57] are outlined below and a more detailed consideration of trusts is provided. Transitional provisions would need to be considered carefully to forestall avoidance before the legislation came into effect by donors accelerating lifetime gifts.

1. All lifetime gifts (other than to a charity, spouse or civil partner) should be taxed on the donor *when made* at 10 per cent (possibly rising to 20 per cent on lifetime gifts totalling more than £1 million for the donor[58]) subject to a £20,000 annual exemption.[59] The death allowance could be something similar to the current nil-rate band of £325,000, available only on the death of individuals and not available for

[54] See TCGA s.260.
[55] Chamberlain, above fn.11.
[56] APPG Report, above fn.10.
[57] APPG Report, above fn.10.
[58] Although this goes back to the issue of cumulation. Having 10% tax on lifetime gifts and 20% on large death estates would open up an avenue of avoidance. However, having 10%/20% on lifetime gifts then means there is a need to keep records of the donor's history of lifetime gifts.
[59] The level of lifetime annual exemption is for debate and would need to be indexed.

trusts at all. This would mean that less well-off families that cannot afford to use the annual exemption are not penalised.

All the complications of allocating lifetime gifts to the unused nil-rate band if the donor dies within seven years disappear, and there is no taper relief as it is irrelevant how long the donor lives. The arbitrary deadline of seven years is abolished. The death allowance can be transferred between spouses. But it is not a renewable nil-rate band every seven years. The donee knows how much tax is payable when the gift is made. Nothing more is due and tax does not depend on the donor surviving an arbitrary deadline of seven years.

2. On gifts of cash, 10 per cent is withheld by the donor. On gifts of an illiquid asset, the donor has the option to pay over 10 years in interest-bearing instalments (although in the case of trading businesses and farms this could be interest-free instalments).[60] The donor could transfer this liability to the donee by agreement. There is no grossing up so it does not make any difference to the rate of tax as to who pays.
3. The ROB rules and the pre-owned assets tax (POAT) code are abolished; all lifetime gifts are taxed when made in the same way as death transfers (subject only to the annual exemption) so there is no need for anti-avoidance legislation.
4. The loss to estate, cumulation (except, possibly, in relation to lifetime gifts over £1 million) and grossing-up principles inherent in IHT are abolished. No nil-rate band is given to trusts, so there is no gift of £325,000 tax-free to trusts every seven years. The tax treatment of trusts is discussed further at point 8, below.
5. All pension funds left at death are taxed at the flat rate of 10 per cent (or added to the estate and the excess taxed at 20 per cent to the extent the value of the estate is over £1 million) unless passing to the spouse.
6. Tax is payable on death at 10 per cent on the worldwide estate unless either it is over £1 million (in which case the rate increases to 20 per cent) or exempt due to the spouse/civil partnership and charity exemption. The harsh distinction between no exemption for cohabitees who pay up to 40 per cent inheritance tax versus complete exemption for spouses/civil partners is tempered as rates are lower (see examples 1 and 2 of the APPG report[61]). No other death reliefs such as BPR/APR are available.
7. Foreign domiciliaries. Domicile is abolished as a connecting factor. Donors who have been UK resident for more than 10 out of the last 15 years will pay tax on all subsequent lifetime gifts including gifts into trust and transfers on death on a worldwide basis at 10 per cent/20 per cent. Gifts by donors who are not long-term UK resident are still taxed if the donee is a long-term UK resident, but the donee would then be accountable for the tax.

[60] The disadvantage of offering interest free instalments to trading businesses is that it sets up an artificial boundary requiring the determination of what is a qualifying trading business. It may be better to say that tax on all businesses that is due on death transfers is either interest free or interest bearing without discrimination in favour of trading businesses.

[61] APPG Report, above fn.10, 15 and 16.

8. Trusts. The position could operate as follows:
   (a) Discretionary trusts set up by a long-stay UK resident settlor are subject to a 10 per cent/20 per cent entry charge (in the same way as a gift to an individual).
   (b) Discretionary trusts set up prior to the settlor becoming a long-term UK resident would not be subject to any entry charge.
   (c) Discretionary trusts are subject to a periodic tax of 3 per cent every 10 years from the date the settlor first becomes a long-term UK resident (and for as long as the settlor remains long-term UK resident or if they die a long-term UK resident). There is no nil-rate band, so there would need to be some allowance of, say, £50,000 for each trust so no periodic tax would be paid on assets with a value of less than £50,000. This would take most trusts holding term life policies out of the tax net. The residence status of the beneficiaries is ignored while the assets are held in a discretionary trust. That £50,000 allowance would be split between trusts set up by the same settlor to avoid fragmentation.
   (d) However, a distribution from any discretionary trust to a long-stay UK resident beneficiary would be subject to estate tax at 10 per cent/20 per cent (with a possible credit for the past periodic tax paid) even if the settlor has never had any connection to the UK.
   (e) A life interest trust set up by a long-stay UK resident settlor would be subject to a 10 per cent/20 per cent tax on the gift into trust irrespective of the status of the life tenant. A trust set up by a settlor with no UK connection would also be subject to a 10 per cent/20 per cent tax on the lifetime gift to a life interest trust if the life tenant was a long-term UK resident beneficiary which is in line with the principle discussed earlier that if either donor or donee is a long-term UK resident, tax should be paid. (If the trust set up by a non-resident settlor was initially discretionary and then became interest in possession for a long-stay UK resident, the 10 per cent/20 per cent would be charged at that point to reduce avoidance.)
   (f) On death or earlier termination of the life interest, a 10 per cent/20 per cent tax would be payable if either the life tenant or the settlor was a long-stay UK resident or the recipient on termination of the life interest was an individual long-stay UK beneficiary. Hence the current long-term IHT tax-free status of trusts set up by foreign domiciliaries for UK resident beneficiaries would be curtailed. It would not be possible for a trust to pay out to a non-resident which then pays to a UK resident as the donee is then taxed on receipt. (See section E.1, above, on connecting factors.)
   (g) Any discretionary trust of a settlor who dies long-term UK resident remains within the periodic charge even if the trust was set up prior to the settlor taking up long-term UK residence. The periodic charge is not geared around the nil-rate band of the settlor. It is simply a fixed rate on a value

less than £50,000. To stop the splitting of trusts, the £50,000 would be split between the number of trusts set up by the settlor in the same way as an annual CGT exemption would be split.

9. Finally, the CGT death uplift would be abolished on all assets, and they would pass on a no-gain no-loss basis; gains on all lifetime gifts of assets would also be held over. The playing field between lifetime and death gifts would thus be equalised. The heir would therefore eventually pay CGT on the gain realised but only on an actual sale. At the same time reform of principal private residence relief (discussed in *The Dynamics of Taxation*[62]) could be considered.

The above represents a complete package for reform of IHT. Unfortunately political realities may intervene. For example, a Chancellor could announce a tax on lifetime gifts without lowering rates. The result is likely to be increased avoidance and emigration. The Government lowers rates without abolishing reliefs targeted at the wealthy. Certainly the wealthy will resist the removal of advantageous reliefs. As at July 2019, 16,380 estates are expected to benefit from BPR and APR on death over five years at a total cost to the Exchequer of £5.85 billion, but this does not take into account the cost of the reliefs on lifetime transfers.[63] Nor does the current IHT regime measure the cost of the CGT uplift on death (which effectively means a business or farm can be free of both CGT and IHT even if sold shortly after death). There is little meaningful data on the transfer of wealth over a person's lifetime, much of which can pass tax-free if that person survives seven years and so does not need to be reported. Nor is the tax saved by foreign domiciliaries using trusts reported. Abolition of the PET regime is likely to be resisted. The taxation of trusts may not be consistently operated or CGT may not be properly reformed to integrate lifetime and death transfers. However, perhaps a post-COVID world is one occasion when the reform of IHT that combines a lowering of rates with a widening of the tax base may be politically feasible.

[62] Chamberlain, above fn.11.
[63] OTS Second Report, above fn.9, 98.

Gifts; Inheritance tax; Potentially exempt transfers; Tax reform; Trusts; Wealth