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Inheritance tax: a future?

Summary of OECD Report

In May 2021 the OECD published a report (the Report)[1] looking at taxes on wealth transfers in 36 countries. This followed its earlier report in 2018 on Wealth Taxes (i.e. taxes on the ownership of wealth).[2] It is an invaluable guide for any interested student in this area.

Chapter 1: wealth distribution

The Report starts by examining wealth distribution and household wealth in some detail across 28 countries,[3] concluding that wealth is generally highly concentrated at the top of the distribution and the wealthiest 10 per cent of households own half of all household wealth on average across 27 OECD countries. The OECD sits its Report firmly in the context of wealth inequality noting that "wealth is highly concentrated at the top of the distribution, much more so than income"[4] and has increased over time as a consequence of increases in asset prices and savings rates. It notes the share of inherited wealth in total private wealth has increased in some countries and COVID-19 and public spending may require governments to start looking at other ways of raising taxes.[5]

Chapter 2: the case for inheritance taxes

In Chapter 2 the arguments for and against inheritance taxation are reviewed, providing an excellent summary of the main points on both sides of the debate. The Report concludes that there is a good case for making greater use of inheritance taxes in terms of both reducing wealth inequality and raising revenue.

Arguments cited in favour of an inheritance tax include enhancing equality of opportunity, strengthening horizontal and vertical equity, reducing wealth inequality, preventing the build-up of dynastic wealth and the accumulation of extreme wealth, improving efficiency in the use and allocation of assets and encouraging charitable giving (presumably to avoid inheritance tax (IHT)). The double taxation argument is often a popular objection to inheritance taxes but is firmly rejected here on the basis that this is far from unique to IHT and that the position should not be looked at simply from the perspective of the donor but from the standpoint of those who inherit. Inheritance taxes are preferred to wealth taxes as being administratively simpler and

[1] OECD, OECD Tax Policy Studies, *Inheritance Taxation in OECD Countries* (Paris: OECD Publishing, 2021), *https://doi.org/10.1787/e2879a7d-en* [Accessed 1 September 2021].
[2] OECD, OECD Tax Policy Studies, No.26, *The Role and Design of Net Wealth Taxes in the OECD* (Paris: OECD Publishing, 2018), *https://doi.org/10.1787/9789264290303-en* [Accessed 1 September 2021].
[3] The US, Luxembourg, the UK, Australia, Canada, New Zealand, Belgium, Spain, Norway, Japan, Korea, Austria, France, Ireland, Germany, Italy, Portugal, the Netherlands, Finland, Poland, Denmark, Slovenia, Estonia, Greece, the Slovak Republic, Chile, Hungary and Latvia.
[4] OECD, OECD Tax Policy Studies, *Inheritance Taxation in OECD Countries* (2021), p.3.
[5] This was a point made by the Resolution Foundation and the Standard Life Foundation in their July 2021 report on wealth inequality: Jack Leslie and Krishan Shah, *(Wealth) gap year: The impact of the coronavirus crisis on UK household wealth* (Resolution Foundation and Standard Life Foundation, July 2021).

raising fewer liquidity issues with an increased ability for countries to tax capital effectively now that there is greater international tax transparency.

Chapter 3: history and design

Chapter 3 looks at the current design of inheritance and gift taxes across the OECD countries. Of the 36 countries reviewed, 24 levy wealth transfer taxes and of these 21 levy inheritance taxes on the beneficiaries of wealth transfers. Only three countries (Denmark, the UK and the US) levy estate taxes on deceased donors. Most countries that levy inheritance or estate taxes also levy some form of gift tax on inter vivos transfers but one country, Ireland, imposes a combined inheritance tax and gift tax which broadly considers all wealth transfers received by beneficiaries over their lifetime. Latvia and Lithuania tax inter vivos gifts through the personal income tax system but Latvia does not tax death inheritances.

It is noted that within some countries, regions have considerable autonomy. For example, the cantons in Switzerland have full autonomy over the imposition and design of their inheritance, estate and gift taxes. Similarly the regions in Spain levy inheritance taxes and wealth taxes in concert with the central government which sets the main design features but rates vary hugely from zero in Madrid to high rates in Andalusia. The US levies an estate tax at the federal level but some states impose an additional levy on death.

Ten OECD countries have abolished estate or inheritance taxes (including Israel, Australia, Canada, Austria, New Zealand, Norway and Sweden) and two countries (Estonia and Latvia) have never imposed inheritance or estate taxes. Lack of political support for such taxes was cited in the Report as the key driver for repealing or not imposing such taxes. Inheritance taxes are unpopular with the public and are generally seen as administratively inefficient by governments which consider them to be complex and produce meagre revenues, in part due to the highly preferential tax treatment granted to assets such as farms and pensions. The most common rationale cited by countries for keeping inheritance taxes was not so much to raise revenue but to redistribute wealth and increase equality of opportunity as well as tax unearned windfalls.

The Report acknowledges that the majority of estates currently go untaxed, usually due to high exemption thresholds and significant reliefs. In seven countries, less than 13 per cent of death estates were taxed. The share of total tax revenues collected from inheritance and estate taxes decreased sharply in the 1970s on average across OECD countries examined and has remained stable since. Revenues from inheritance, estate and gift taxes exceed 1 per cent of total taxation in only four OECD countries (Belgium, France, Japan and Korea). Most countries other than France have increased exempt thresholds since the 1980s, narrowed the tax base and lowered the top tax rates (the UK reduced the rate from 75 per cent to 40 per cent between 1980 and 1988 with a complete exemption for most lifetime gifts made more than seven years prior to death).

The Report considers the different ways in which countries impose inheritance taxes, examining connecting factors, exemptions, the interaction with lifetime gift taxes and general design. Almost all treat each inheritance as a separate event which allows tax exemption thresholds to be manipulated. For example, in a country applying a €300,000 tax exemption threshold, a beneficiary receiving two inheritances of €200,000 each would not be liable for inheritance taxes whereas a beneficiary receiving one inheritance of €400,000 would be liable. An alternative approach recommended in the Report is to consider all wealth received by beneficiaries over their lifetime

through a tax on lifetime wealth transfers similar to that in Ireland. Two beneficiaries would then face the same tax liability where they have received the same amount of wealth.

Another approach not mentioned in the Report is to adopt the "cradle to the grave" approach taken by the capital transfer tax that was in place in the UK from 1974 to 1986. Under this design, all lifetime and death transfers of wealth by the donor are cumulated so that over time the more wealth the donor gives away, the higher the rates of tax imposed on that donor. The capital transfer tax approach took no account of the situation of the recipient except that for the first time a comprehensive spouse exemption was introduced.

The connecting factors governing liability and estate taxes are considered in Chapter 3, i.e. whether it should be the nationality, domicile or residence of the donor, the physical location of the assets or the tax status of the donee. The most common approach is to levy inheritance or estate taxes on the total worldwide estates of tax resident donors and on total immovable assets located within the jurisdiction for non-residents. Nine countries levy tax if the donee is tax resident at the time they received the inheritance. Some countries apply tail provisions for a taxpayer who then continues to be liable for IHT for some minimum period after leaving the country. The UK has a particularly long tail in that those who are UK resident for more than 15 out of the last 20 years but foreign domiciled under common law have to be non-UK resident for at least three complete tax years to escape IHT and must not actually return within six years of leaving. Those who are UK domiciled by origin remain within the IHT net indefinitely even if they are not UK resident unless they settle in a state permanently. In addition those who acquire a foreign domicile of choice, having previously been UK domiciled under general law, must be non-resident for at least three years (not necessarily tax years) after the point at which they have acquired a foreign domicile of choice.

It is noted that treaty networks to prevent inheritance or double taxation are very limited and this can result in double taxation with the donee taxed as well as the donor. The Report recommends more work is done on harmonising rules and establishing an order of priority of taxing rights.

Of the countries surveyed in Chapter 3, only three (Latvia, the UK and the US)[6] allow full testamentary freedom as opposed to imposing forced heirship rules. The latter require property to be divided between close relatives in fixed proportions at death. The surviving spouse is generally either fully exempt from inheritance taxes or a high tax-free threshold is applied (the latter approach is taken in Germany, Italy, Korea and the Netherlands although Finland, Belgium, Greece and Spain have relatively low exempt thresholds for the spouse). Tax exemption thresholds on transfers to children show greater variation with several countries giving only low exemptions on transfers to the children (Belgium and Spain have low tax-free thresholds compared with the UK which effectively has an exempt threshold of up to £1 million for children).[7] Italy has a threshold of US $1.1 million and the US an exempt threshold of around US $11.6 million. Many Swiss cantons as well as Poland, Portugal and Hungary exempt transfers to children altogether.

[6] Even in the case of the UK there may be restrictions if certain dependants' claims remain unsatisfied: see the Inheritance (Provision for Family and Dependants) Act 1975.

[7] In the UK, each parent can leave £325,000 tax free to the children on death if no earlier lifetime gifts in the previous seven years have been made. That nil rate band is transferable between spouses/civil partners. In addition each parent can leave up to £175,000 tax free to issue if they do own or have owned a residential property.

A few countries such as Italy, Korea, Spain, the Netherlands and Switzerland provide an additional tax-free threshold for heirs who have a disability. In Ireland, gifts and inheritances received by heirs who have a disability are exempt if used for qualifying expenses such as medical treatment and associated maintenance.

The Report points out that there is a correlation between lower tax rates and higher exemption thresholds. Two-thirds of the countries surveyed apply progressive rates and one-third apply flat tax rates. Fifteen countries apply progressive rates (up to 80 per cent in Belgium) although often (as in Belgium and Germany) the level is related to the proximity of relationship between the donor and the beneficiary rather than the overall level of wealth given or received. Progressive rates for spouses and children are typically lower and vary less widely than transfers to other relatives such as siblings or to friends. Flat inheritance taxes range from 4 per cent (Italy) to 40 per cent (the UK and the US). Generally countries with a higher top marginal rate have higher exempt thresholds. Thus Korea applies a top marginal tax rate of 50 per cent once the inheritance exceeds US $3 million while the Netherlands applies a top marginal rate of 20 per cent once the inheritance exceeds around US $170,000. However, among countries that levy flat rates there is no clear connection between the level of the rate and the level of the threshold; relatively similar tax rates apply in Denmark (36.25 per cent) and the US (40 per cent) but operate at very different thresholds (US $46,000 and US $11.6 million respectively).

Chapter 3 examines different countries' approaches to reliefs. Land used in agriculture or forestry is exempt or taxed preferentially in 10 countries. Full exemptions for pensions apply in eight countries and family-owned businesses receive preferential treatment in 16 countries. All countries apply some form of preferential treatment to residential property apart from Switzerland and eight give some favourable tax treatment to items of historical or cultural value conditional on these items being accessible to the public.

There are similar variations in both valuation approaches and administrative procedures with the UK perhaps adopting the harshest approach: generally fair market value will always apply and the death estate cannot be sold or distributed until a grant of probate is filed and IHT paid.

The design of inter vivos gift taxes and their integration with inheritance or estate taxes varies widely across the countries. Of the 24 countries that levy an estate or inheritance tax 23 also levy a gift tax on inter vivos transfers but the degree of alignment differs. Gift taxes and inheritance taxes may be very similar in some countries with identical rate structures and asset treatment but countries such as the US operate a different tax base. The UK exempts most gifts made more than seven years prior to death, but gifts made within seven years prior to death are reinstated and IHT is imposed. Lifetime gifts can also affect the amount of tax due on the death estate (as the nil rate band threshold of £325,000 is allocated to lifetime gifts made in the seven years prior to death in priority to the death estate).

Different approaches are adopted for capital gains tax (CGT): most countries that levy inheritance taxes on death do not tax unrealised capital gains at death even if the death estate is exempt due to spouse exemption or another relief. There are three possible approaches outlined in Chapter 3 to the transfer of assets showing unrealised capital gains but the three options which the writer sets out below are outlined only briefly in the Report with no deeper analysis there of some important design issues:

1) Option 1: imposing CGT on the unrealised gains on a transfer of the asset as a gift or bequest. The Report does not consider whether this should only apply if the gift is exempt from IHT (which was recommended by the OTS in its second IHT report in July 2019[8]) or to all assets passing on death. If the latter, some consideration would need to be given to whether the CGT payable on death reduces the net taxable value for IHT purposes. Otherwise someone who sells an asset just before death and is liable to CGT would be better off as the CGT would be a deduction against the death estate.
The tax treatment of IHT and CGT on lifetime gifts should be aligned to that on death but there is little discussion in the Report of the current discrepancies. In the UK gains can be held over on lifetime gifts that are chargeable to IHT or comprise business or farming assets.
2) Option 2: operating a carry-over basis under which the transferee inherits the donor's base cost. This raises issues if the estate or the donee need to sell the asset in order to pay the IHT on death. Should the CGT be deductible against the IHT or reduce the taxable value of the asset for IHT purposes? How soon after death does the asset need to be sold to get the CGT relief? Should the CGT potentially payable be deducted against the death estate?
3) Option 3: operating a step-up basis. The capital gain that accrues to the donor is not subject to CGT and the heir acquires the asset at market value. This is simple but can lead to unfairness and avoidance particularly if lifetime gifts are differently taxed. Moreover it means that someone who leaves assets pregnant with gain to a spouse (say) can avoid IHT and the spouse can then give them away free of CGT and free of IHT (in the UK if they survive seven years).

Chapter 4: summary and recommendations

Common themes emerge from the above: the inheritance tax base has narrowed over time reducing revenues, efficiency and fairness. Less than 0.5 per cent of total tax revenue is now from inheritance taxes across the OECD countries that still levy inheritance and estate taxes. Some estates go entirely untaxed due to exemptions on transfers to close relatives (the spouse exemption is almost universal) and because of the reliefs provided on transfers of specific assets such as the main residence, business and farm assets, pension assets and life insurance policies. Much avoidance takes place by making lifetime gifts or using trusts and usufructs. As Chapter 3 illustrates there is wide variety in design of rates, thresholds and overall approach but no one approach seems notably more successful than another. In the light of this, should we give up?

The Report does not recommend surrender and remains more positive about inheritance taxes than wealth taxes while recognising that they can only ever be a limited source of revenue. The Report recommends the following:

1) Imposing tax on recipients of wealth transfers rather than on donors or the death estate. This ensures that a donee who receives more inherited wealth over a lifetime

[8] OTS, *Inheritance Tax Review — second report: Simplifying the design of Inheritance Tax* (July 2019).

is taxed at higher rates than one who receives less. While most of the countries reviewed already impose IHT on the donee rather than the donor, only Ireland has a cumulative donee based tax that takes into account all the past inheritances of the donee. "It is the amount of wealth received by each recipient that should matter for equality of opportunity rather than the overall amount bequeathed by the donor."[9] A lifetime recipient tax improves horizontal equity by ensuring that individuals who receive the same amount of wealth pay the same amount of tax and progressive rates can help vertical equity by ensuring those who receive more wealth over their lifetime pay more tax. Whether it raises more revenue is (in this writer's view) perhaps more doubtful.

2) Imposing progressive tax rates taking into account the total wealth received over an individual's lifetime and allowing only a small amount of wealth to pass tax free. Renewable lifetime exemptions should be carefully monitored.

3) Existing exemptions such as reliefs on private pensions, savings, life assurance policies, business property and farms should be scaled back and better designed. If business relief is granted there should be strict eligibility requirements with claw-back of relief if the business is sold within a certain number of years of the inheritance. This writer agrees with the first statement but not the second for reasons set out below.

4) Political obstacles that impede effective inheritance taxes should be removed including providing more information to the public on the level of inherited wealth and inequality as well as better monitoring and recording lifetime transfers of wealth. This point is certainly true of IHT in the UK where it is a most unpopular tax and yet less than 5 per cent of estates actually pay IHT.

5) Some consideration is given as to whether inheritances should be taxed at personal income tax rates in the hands of the donee but generally a separate tax on bequests is recommended.

Comments

Perhaps before considering reform, governments need to be clear about their objectives—are taxes on transfers of wealth imposed to raise more revenue from wealthy people or are they there to reduce wealth inequality? Inheritance taxes can in theory be used as a tool to enhance equality of opportunity and reduce wealth concentration but they do not seem to be succeeding. The recent report by the Resolution Foundation and the Standard Life Foundation on the wealth gap published in July 2021[10] noted that the pandemic has increased wealth inequality. While total wealth has risen, the gap between families' wealth across the wealth distribution has widened. The typical gap in wealth per UK adult between the top and the middle of the distribution now stands at 55 times the typical household income measured after housing costs. The pandemic seems to have accelerated wealth inequality and this may need to inform the UK Government's wider tax policies.

[9] OECD, OECD Tax Policy Studies, *Inheritance Taxation in OECD Countries* (2021), p.81.
[10] Leslie and Shah, *(Wealth) gap year: The impact of the coronavirus crisis on UK household wealth* (July 2021).

The idea of a donee based lifetime tax was one that appealed to Margaret Thatcher in the 1980s but was rejected on the basis that keeping records of someone's lifetime inheritance was too burdensome administratively. Making Tax Digital may make this objection less cogent now although the Irish approach of taxing donees at different rates and thresholds depending on whether they have inherited the wealth from a parent or a more distant relative or friend seems unnecessarily complicated and without much rationale. Why should someone who inherits property from an uncle be taxed at a higher rate than if they inherit from a parent? Surely it is the absolute level of inheritance that is relevant not who they inherit from? Cedric Sandford in the 1970s was a great proponent of the donee based tax[11] but there remain some key design problems including how to deal with gifts to trusts and foundations that do not die.[12]

This writer agrees with the OECD recommendation to align lifetime and death transfers: even if it is not feasible to tax all lifetime wealth transfers over a donee's lifetime it is still worthwhile reforming and better aligning the tax treatment and design of inter vivos gifts and end of life inheritances both in terms of IHT and CGT. The current discrepancy in the UK tax system between lifetime gifts and death transfers has no logic or equity and only favours the well-advised.

Some practical difficulties are not addressed by the OECD. Higher exemptions and renewable thresholds make avoidance easier as people can split their assets more easily and plan to make lifetime gifts over a period of time. Progressive high rates provide greater incentives to avoid the tax and increase pressure on politicians to introduce generous reliefs for businesses and farms. Lowering the rate to a flat 10 per cent may allow governments the political freedom to abolish such reliefs. That is not an approach considered by the OECD at all but it may be the only politically feasible one.

It is certainly true that IHT reliefs generally need to be better monitored to work out whether they fulfil the stated policy which is not always clear or consistent. For example, if the policy behind business property relief is to keep family businesses intact it is not clear why it has been extended to investments in alternative investment market listed companies. Is the policy in reality to encourage business activity more generally by the use of such reliefs? The OECD suggests clawing back the relief if businesses are sold within a short time after transfer but this may not be very economically efficient or practical. It encourages poorly performing businesses to be retained for a minimum period after death and in practice may be avoided by selling the business to a third party but taking a stake in the new business for the minimum length of time needed to avoid a claw-back.

In short, there is often a trade-off between simplicity and equity with the estate tax versus the donee based recipient tax perhaps the most obvious example of this. Given the capacity of wealthy people to avoid high taxes it may be better to keep the base broad and the rate low with no reliefs.

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[11] See C.T. Sandford, J.R.M. Willis and D.J. Ironside, *An Accessions Tax* (IFS, September 1973).

[12] For some further discussion of options for IHT see Glen Loutzenhiser and Rita de la Feria (eds), *The Dynamics of Taxation: Essays in Honour of Judith Freedman* (Hart Publishing, 2020), Ch.2.

[*] Barrister, Pump Court Tax Chambers.