Inheritance Tax

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During the 20th century there have been three taxes on wealth in this country: estate duty, capital transfer tax, and inheritance tax. The last of these was introduced in 1988, replacing capital transfer tax, and it remains the one UK tax on wealth. This paper provides a short history of how the taxation of wealth has changed, summarises the present provisions of inheritance tax, and discusses a number of the proposals that have been made for reform.

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Summary

• The taxation of a person's wealth at the time of their death dates from the late 1600s. In 1894 estate duty, the forerunner of inheritance tax, was introduced: a graduated tax charged on the value of a person's estate. In 1974 estate duty was replaced with capital transfer tax, which was charged on all gifts made by an individual throughout their lifetime, as well as their estate at death. In turn, capital transfer tax was replaced by inheritance tax in 1988.

• Inheritance tax is levied on the value of a person's estate at the time of their death. The tax is charged at 40 per cent above the tax-free threshold, which is £154,000 for 1995-96. Generally, personal gift giving is free from tax. However most gifts made out of someone's estate within seven years of their death are assessed as part of that person's estate, and are liable to tax as well.

• In certain circumstances, a gift giver retains the benefit of their gift. This type of gift is called a 'gift with reservation'. One example would be when a parent gives away their house to their children, but continues to live in it as before. A short description is given of the way in which inheritance tax is charged in these cases.

• There are a number of important reliefs from inheritance tax. This paper discusses the operation of taper relief, and the relief given to those passing family businesses and family farms to their descendants.

• There has been some speculation that inheritance tax might be abolished outright, in the light of comments made by John Major earlier this year. During Prime Minister's Questions on 13 July, Mr Major said, "When it is appropriate and we can afford to do so, I wish to abolish both capital gains tax and inheritance tax ... Unlike the Labour party, I believe in trying to pass wealth down between generations" [cc 1085-1086]. The arguments for and against the abolition of the tax are analyzed in some detail.

• Some commentators have argued that inheritance tax should be charged on the recipients of an estate, rather than the owner of the estate - a donee-based tax, rather than a donor-based one. The advantages of this type of reform are examined, along with the controversial relief from inheritance tax given to heritage property.

• A one page summary of the most important exemptions from inheritance tax is provided at the end of this paper.

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I Introduction

> All that type of stuff, dying and so on, was a long way off, not such a long way off as it had once been, admitted, and no doubt the time when it wouldn't be such a long way off as all that wasn't such a long way off as all that, but still. Still what?
>
> from *A Girl Like You*, Kingsley Amis (1960)

Death and taxes, certain things both. Taxes on death, however, are a more recent phenomenon. The taxation of someone's estate at the time of their death has its origin in the 5*s*. stamp duty, first charged under the *Stamp Act 1694*. The duty was charged on "every piece of parchment or paper upon which should be engraved or written any probate of a will or letters of administration, for any estate above the value of 20*l*," and it represented one of a number of new taxes to fund the war then being waged with France.[1]

Duties were charged on documents which had a legal operation, or composed a necessary step in a suit in the law courts. In the case of death, the probate of a will provided the executor of an individual's will with his authority to administer the deceased's property. Even so, it was not until the end of the last century that the consolidation of a number of death duties into a new estate duty produced a tax that bears some basic similarities with present day inheritance tax; ie, a tax charged on the value of a person's estate at the time of their death.

In fact, inheritance tax combines two charges: death duty and a tax on gift giving. The gift tax 'element' of inheritance tax derives from its predecessor, capital transfer tax. For most taxpayers this aspect is irrelevant through the operation of the tax's most important exemption. Any gift made to an individual more than seven years before death is free of tax (commonly known as the 'seven year rule'). Tax is levied at a flat rate of 40 per cent. The first £154,000 of an estate is charged a nil rate, and is free of tax. The combined effect of the seven year rule, and the nil rate threshold, is that relatively few people pay inheritance tax in practice: about 25,000; compared to the 85,000 paying capital gains tax, and the 25,700,000 people who pay income tax.[2]

That said, the burden of the tax on those who do pay tends to be rather unfair. One commentator writing in the *Financial Times* put it forcefully:[3]

> "This absurd tax is worth more to the avoidance business than to the Inland Revenue. The rules are riddled with so many loopholes that anyone with a lot of money and a half-decent accountant should be able to blow raspberries at officialdom from the battlements of their stately home. Meanwhile, those unfortunate enough to lack expert help get hit by one of the highest inheritance tax rates in the world."

1 Just over 100 years later war with France fostered another new impost: income tax.

2 Estimate for 1995-96 : source : *Inland Revenue Statistics 1995* p.14

3 "So you thought death was final", *Financial Times*, 19 August 1995

Tax planning is not the exclusive preserve of the wealthy, especially in this area. In the *Which? Guide to Giving and Inheriting*, the author makes some telling points about the implications of thinking ahead:[4]

> About three-quarters of the British population give away money to charities, and most people also make personal gifts to family and friends. Few of us would put the Inland Revenue high on our list of worthy recipients, yet year after year tax relief on some gifts is ignored and other gifts are needlessly wrapped in a tax bill ... Similarly, when we pass on wealth to our heirs, there may be a tax bill which could have been avoided with a little forethought. But tax is not the only problem: it is estimated that only three out of ten adults have made a will. Without a will, it is not just the Inland Revenue who might be your lucky heir - your children might inherit at the expense of your spouse, or your wealth could all end up with estranged relatives instead of the family close to you.

This paper is concerned simply with inheritance tax. It provides an outline of the tax's operation, and a summary of several proposals that have been made for its reform in recent years. A detailed discussion of tax planning issues is well beyond its scope. It is arguable that making provision for one's heirs represents one of the most important financial transactions in life. Individuals considering such decisions are, as always, recommended to obtain professional advice.

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4 Jonquil Lowe, *The Which? Guide to Giving and Inheriting*, 1992 p.7

II Taxing Wealth

A. Estate Duty

In 1894 there were six separate duties chargeable on death. In that year, the Chancellor of the Exchequer, Sir William Harcourt, consolidated four of the duties into a single estate duty charged on all property passing on death. The two remaining taxes - legacy and succession duties - were only abolished in 1949, by which time their fiscal importance had seriously declined.

Estate duty was charged on the value of a person's estate at their death. When assessing an estate's taxable value, provision was made to include gifts made out of someone's estate in the very last years of their life. Estate duty was imposed at graduated rates ranging from 1 per cent to a maximum of 8 per cent and represented the first consistent application of the principle of progression in the British direct tax system.

In 1927 the Colwyn Committee considered the incidence of estate duty.[5] The Committee concluded that relating the rate of duty to the value of the estate was an equitable basis for this tax, but recognised that this principle ignored the circumstances of the beneficiaries of any estate who suffered the burden of the tax in practice. The Committee suggested that the legacy and succession duties might be developed so that the death duty system as a whole might pay more attention to donees rather than donors. In fact nothing was done on these lines, and the basic structure of the death duties remained unchanged until 1974.

B. Capital Transfer Tax

In March 1974 Dennis Healey, the new Chancellor, announced as part of his Budget statement that a second Finance Bill would be drawn up later in the year to introduce a new tax on all gratuitous transfers of capital, both by way of lifetime gift and on death. Capital transfer tax, as it was called, was to close two loopholes in estate duty: the exemption of trusts; and, the seven year rule. One criticism made of how inheritance tax works now concerns the operation of a similar seven year rule, so a short digression on how it worked in practice seems appropriate.

Generally, gifts made during someone's lifetime - *inter vivos* gifts - would be free of estate duty. However, duty was charged on gifts made at the end of someone's life, to prevent individuals minimising the tax charge by making large transfers out of their estate just before their death. Latterly, this provision had treated any gifts made within seven years of death as if they had been made on death, and dutiable with the remainder of the estate. Those taxpayers who were well-advised - usually the wealthiest individuals - avoided this charge by

5 *Colwyn Committee on National Debt and Taxation*, Cmd 2800, 1928

giving away all, or part, of their wealth, well before they expected to die. It was the Chancellor's contention that this ran counter to the raison d'être of the tax itself:[6]

> "Nothing is more offensive to the vast majority of ordinary taxpayers, most of whom are subject to PAYE, than the knowledge that people far better off than themselves are avoiding taxation by exploiting loopholes in the existing law. If the existing estate duty operated effectively, the great concentrations of private wealth would already have been broken up and with them many of the unfair advantages enjoyed by generation after generation of the heirs and relatives of wealthy men. In practice, however, estate duty has always been a largely avoidable, indeed, a voluntary tax. In particular, it does not bite on transfers of wealth made long enough before death to fall outside the charge ... I am determined to ensure that the new taxes will be effective instruments for redistributing wealth as a means to greater justice and equality in our society."

In contrast to estate duty, capital transfer tax (CTT) was to be designed to charge **all** gifts made by a donor throughout his or her lifetime at progressive rates. The new tax combined two separate charges: first, taxing the value of a person's wealth at their death, and second, taxing gifts made by that person during their life. In August 1974 the Government published a White Paper[7] setting out its proposals for CTT in detail, and legislation effecting the introduction of CTT formed part of that year's second Finance Bill.[8] Initially it had been intended that transfers between husband and wife would be charged CTT, in the same way as transfers to one's spouse were charged estate duty. Following the significant degree of opposition shown to the new tax, the Government decided to introduce an important exemption: that *inter vivos* gifts between husband and wife would not be charged tax, and property left by one partner to the other on their death would be entirely exempt as well.

At the time of its inception, CTT used a cumulative total to establish the amount of tax due. The total commenced with the value transferred by the first chargeable lifetime disposition. The value of each subsequent lifetime disposition was added, with a final addition for the value of an estate immediately before death. Two separate tables had to be used to calculate the amount of tax becoming due, one for the estate immediately before death and lifetime transfers made within the last 3 years, and one setting out reduced rates for lifetime gifts outside the final 3 year period. In both cases, the rate of tax charged was set on a sliding scale, from zero up to 75 per cent.[9] In 1978-79, the first £25,000 of an estate was charged the zero rate of tax. Expressed in 1995-96 prices, this limit is around £73,000 (ie, the figure if the limit had increased in line with inflation).[10] This compares with the current tax-exempt limit of £154,000 for inheritance tax purposes.

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[6] HC Deb 26.3.74 cc 313-314

[7] *Capital Transfer Tax*, Cmnd 5705, August 1974

[8] Measures relating to the introduction of CTT composed Part III of the *Finance Act 1975*.

[9] Inland Revenue, *Capital Transfer Tax CTT1*, January 1983 pp 114-115

[10] Between 1978-79 and 1995-96, the retail price index rose by a factor of 2.9.

Exempt transfers were excluded from liability to CTT. The principal exemptions were:

- Gifts made to one's spouse.

- Gifts made as normal expenditure - on a regular basis, such as under a covenant - which come out of one's income.

- Gifts made during the one tax year up to an annual limit.

- Any number of individual gifts, worth up to a specified limit, made during the year to different persons.

- Gifts, up to a specified maximum, given to the bride or groom, in consideration of marriage, by parents, grandparents, prospective spouse, or a third party.

- Gifts to charities and political parties, up to a specified limit.

- Dispositions for the national interest.

All of these types of transfer have remained exempt under inheritance tax. No significant additions have been made to this list, though in all cases - except for marriage gifts - the specified limits have been increased. These exemptions are:

- Annual exempt amount: 1979 - £2,000; 1995 - £3,000.

- Small gifts limit: 1979 - £100; 1995 - £250.

- Wedding gifts (remain unchanged since 1979) :
  Gifts made by each parent : £5,000
  Gifts made by grandparent, bride or groom : £2,500
  Gifts made by third party : £1,000.

- Gifts to charities limit: 1979 - £100,000; 1995 - unlimited.

- Gifts to political parties limit: 1979 - £100,000; 1995 - unlimited.

Since 1979 a series of changes have been made to CTT, culminating in its replacement by inheritance tax, shifting it from being a tax on gifts, whenever made, to being a tax on bequests. In 1981 Geoffrey Howe, then Chancellor, proposed two reforms to encourage individuals to make gifts throughout their lifetime:[11]

> "One new concept introduced as a feature of [CTT] was the idea of cumulating gifts made at any time in a person's life. Some allowance was made for the earlier payment of tax on transfers during life than on death, but only at the bottom of the scales. As a result, people are deterred from

[11] HC Deb 10.3.81 c.778

> transferring their property during their lifetime. This is undesirable. Business property, in particular, should be permitted to pass more freely from one generation to another. I propose therefore to recast the lifetime scale. At the bottom the charge to gifts will remain half that on death; at the top it will become two-thirds. I also propose limiting cumulation to 10 years ... I hope that, by encouraging gifts, the Exchequer will benefit as well as the taxpayer."

In 1986 Nigel Lawson, who was then Chancellor, took two further steps in the same direction. He argued CTT was "a thorn in the side of those owning and running family businesses, and as such has had a damaging effect on risk taking and enterprise within a particularly important sector of the economy." Taxing lifetime gifts was especially damaging, distorting the reinvestment of business assets. He proposed to abolish it completely:[12]

> "In essence, the CTT is two taxes, as its two separate scales imply: an inheritance tax and a lifetime gifts tax. We have had an inheritance tax in some shape or form ever since Sir William Harcourt introduced his estate duty in 1894. But the lifetime gifts tax which the Labour Government introduced in 1974, in the teeth of united Conservative opposition, is an unwelcome and unwarranted impost. By deterring lifetime giving, it has had the effect of locking in assets, particularly the ownership of family businesses, often to the detriment of the businesses concerned.
>
> Accordingly, I propose to abolish entirely the tax on lifetime gifts to individuals. As with the old estate duty, there will be a tapered charge on gifts made within seven years of death and provision to charge gifts made with reservation ... In recognition of the radically changed nature of the tax, I have decided to rename it the inheritance tax."

Any gift made to an individual was not to be charged at all in the first instance, but only taxed if the donor died within seven years of making it. This may look rather like a return to estate duty but it was somewhat different. For estate duty, gifts given within the seven years were treated as part of the estate at death. Under the 1986 regime, gifts made within seven years were chargeable as if they were an *inter vivos* gift, though they increased the starting point on the rate scale for the estate at death. The point is slightly technical - many who pay the tax now gifts are taxed at the same rate as their estate - but it is perhaps worth underlining, in the context of the tapered tax charge on gifts, mentioned by Nigel Lawson in the extract above. The issue is examined below, for those who are interested (see pp 16-18).

Though CTT was renamed inheritance tax, it was not repealed and replaced by a new tax, and many of the provisions of the consolidated *Capital Transfer Tax Act 1984* continue undisturbed. Mr Lawson modified inheritance tax further in 1988, substituting a uniform 40 per cent tax for a structure of four bands with a top rate of 60 per cent. Inheritance tax continues to be levied at this flat 40 per cent rate, another aspect of its operation which has come in for some criticism.

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[12] HC Deb 18.3.86 c.175

III How Inheritance Tax Works

A. Rate & Structure

Generally, inheritance tax (IHT) is charged on someone's estate after their death. It is due at 40 per cent on the value of the estate above the tax-free threshold (£154,000 for 1995-96). IHT will also be charged on transfers made out of someone's estate within seven years of their death. The relevant legislation is embodied in the *Inheritance Taxes Act (IHTA) 1984*, as amended.

There are two types of gift which would give rise to an IHT charge at that time they are made: gifts to or from a company, and gifts to a discretionary trust. Here, IHT is charged at 20%, though, as such cases are relatively rare, this paper ignores them. For most people, IHT is only charged on their wealth after they have died, since the gifts they make to other individuals during their lives can be made exempt of tax.

Although most people's concern will be with avoiding tax on their gifts, strictly speaking IHT is charged on certain specified 'transfers of value'; this is the expression used in the relevant legislation. Some types of gift are not defined as transfers of value: for example, the maintenance of dependants,[13] or interest free loans. However, most gifts will be treated as chargeable transfers. Of these, some types of gift are completely exempt from IHT, irrespective of whether one makes them while one is alive or makes them in one's will. Gifts or bequests made to a spouse,[14] to charities and to political parties, as well as transfers made for the public benefit, are all tax-exempt.

There are some gifts which one can make in the last seven years of one's life which do not attract IHT; these include:

- Gifts made as normal expenditure - on a regular basis, such as under a covenant - which come out of one's income.

- Gifts made during the one tax year of a total not exceeding £3,000.

- Any number of individual gifts, worth up to £250, made during the year to different persons (this relief is in addition to the annual allowance of £3,000).[15]

- Gifts, up to a specified maximum, given to the bride or groom, in consideration of marriage. Parents can each give up to £5,000; grandparents may give £2,500, as may the bride or groom. Anyone else may give £1,000. Parents can make gifts to either party in the marriage; so that, say, a bride's parents could each give £5,000 to their son-in-law.

[13] This would cover gifts to provide housing, food or education for one's spouse, or ex-spouse, child or dependent relative.

[14] If one's spouse is not domiciled in the UK, this exemption is limited to £55,000.

[15] This exemption cannot cover the first £250 of a larger annual gift made to any one person.

Other gifts which do not fall under these criteria may be "potentially exempt transfers" (PETs) and, as such, be exempt from tax. Most important, all gifts made to individuals may be PETs.[16] In certain circumstances, one may make a gift, and yet retain an interest in it; one example is where a parent gives their house to their child, but continues to live in it as before. These 'gifts with reservation' as they are known cannot be PETs (those interested are referred to pp 15-16 of this paper).

PETs become exempt from IHT only if the donor lives for **at least** seven years after having made the gift concerned: the seven year rule mentioned above. If the individual dies during this seven year period, the PET becomes a chargeable transfer, and its recipient becomes liable to pay the tax charged on it. Of course whether IHT is charged on the gift in practice would depend on the value of the donor's estate at death, and whether both gift and estate came to less than the zero-rate threshold (ie, £154,000 for 1995-96).

It is important to remember that, when assessing the value of someone's estate, the Inland Revenue **includes** gifts made by this person in the last seven years of their life. As a consequence, even though someone's wealth may be less than £154,000 when they die, their estate may still be liable for IHT, since the inclusion of PETs made in the previous seven years may push it over the £154,000 threshold. The tax payable on the estate depends on the rates of IHT in force at the date of death. Notably, it is the recipient of the PET who is liable to pay the tax. The operation of this rule can penalise those who wish to pass on assets to family members or other beneficiaries, but have not done so before death intervenes.

B. Receipts

In 1995-96 IHT is expected to raise around £1,500m, compared with a figure of £68,900m for income tax. Total revenues from IHT have risen over the past fifteen years, from £401m in 1979-80; income tax revenues that same year were £20,599m. The numbers of people paying IHT has fluctuated somewhat, year on year, over the past sixteen years. On average, over the past four financial years, 23,750 people paid IHT during the year; this compares with an average of 52,250 for the four years ending 1979-80.

The exemptions and reliefs described in the previous section mean that the vast majority of estates are not subject to tax. For those who died in 1991-92, just over 255,000 estates were notified for probate. Of these, just under 16,500 were subject to IHT, or 6.5% of the whole.[17] If one focuses on those estates with a net value over £200,000, then only 58% of these were taxed.[18] A report by the National Audit Office on IHT published in December 1992 estimated that under 4% of deaths resulted in IHT being charged on someone's estate.[19]

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16 Gifts made to accumulation or maintenance trusts, as well as trusts set up for disabled persons, may also be PETS.

17 Inheritance tax payments as a proportion of total deaths would be significantly lower, since the figure quoted excludes estates either so small or held in such a form to make a report to the Capital Taxes Office unnecessary.

18 *Inland Revenue Statistics 199*5 p.10 pp 114-115

19 National Audit Office, *Inheritance Tax*, 16 December 1992 pp 1-3

One should add that in evidence, the Revenue considered that serious fraud or negligence was present in very few cases, and that the NAO concluded the Capital Taxes Office dealt well with what remains a relatively complicated system.

The table shown on the next page breaks down the number of estates notified by probate, for the four years up to 1991-92, showing those on which IHT was charged in practice:[20]

[20] *Inland Revenue Statistics 199*5 p.115

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Estates notified for probate : by year of death

Numbers: actual; Amounts: £ million

Range of net estate (lower limit) £	1988–89 Number not taxed	Number taxed	Tax	1989–90 Number not taxed	Number taxed	Tax	1990–91 Number not taxed	Number taxed	Tax	1991–92 Number not taxed	Number taxed	Tax
0	49,083	–	–	52,437	–	–	47,814	–	–	41,661	–	–
10,000	42,432	–	–	40,841	–	–	37,660	–	–	36,887	–	–
25,000	34,423	–	–	37,886	–	–	33,503	–	–	35,356	–	–
40,000	16,179	–	–	18,618	–	–	17,139	–	–	17,022	–	–
50,000	15,272	–	–	20,252	–	–	16,048	–	–	17,364	–	–
60,000	29,038	–	–	33,976	–	–	29,532	–	–	30,786	–	–
80,000	22,523	–	–	23,383	–	–	21,827	–	–	24,351	–	–
100,000	19,378	13,028	168.2	23,900	11,253	140.3	25,386	8,386	94.0	28,395	6,799	63.5
200,000	3,325	4,209	199.9	3,134	4,416	196.8	3,735	4,639	186.5	3,807	4,502	168.5
300,000	1,592	2,634	244.5	2,027	2,904	248.5	1,794	2,929	244.1	1,967	3,098	256.6
500,000	504	1,218	222.4	718	1,600	272.9	778	1,533	272.7	799	1,527	265.9
1,000,000	113	310	110.6	188	426	152.2	156	380	134.1	228	406	148.0
2,000,000	48	105	106.8	64	170	160.5	65	145	120.3	59	157	141.2
Total	233,912	21,504	1,052.5	257,426	20,768	1,171.3	235,437	18,014	1,051.7	238,682	16,489	1,043.8

An idea of how much less important death duties now are to Government tax receipts, compared with the earlier years of this century, may be got by comparing the share of total Inland Revenue receipts that estate duty and/or capital transfer tax have accounted for. In 1908-9, this share was around 19% (just over 14% of central government tax revenue). By 1958-59 estate duties accounted for just over 6% of the Revenue's tax receipts, or about 3.5% of central government's total tax receipts. Using the figures given for estimated receipts from IHT for the current tax year, the share of tax receipts accounted for by IHT has dropped to 1.5% (or 0.8%, respectively).[21]

C. Gifts With Reservation

Up to now the discussion has centred on lifetime gifts. Serious problems arise if someone gives something away but continues to derive some benefit from it. This would cover the case of a person who gave their home to their children, but continued to live in it, since they would still enjoy the benefit of their own house. This type of gift is called a 'gift with reservation', and it is made in the following circumstances:

- The donor of the gift does not really lose possession of it; say, in the case where someone gives away a valuable painting, but insists that it continues to hang in their own house.

- The donor of the gift continues to derive some benefit from the gift; that is, unless they pay a full market rate - or the equivalent in kind - for their use of the asset; eg, when someone gives their house to their children, but they go on living in it rent-free.

In these cases it is important to determine the date at which the donor stopped benefiting from the gift. If they enjoyed it right up until the time of their death, then this gift is treated as being part of the donor's estate, and given away only at the time of death. If the donor stopped benefiting at some stage before death, then the gift is treated as a PET given at the time when the donor's benefit stopped: ie, if this happened within seven years of their death, there might well be a tax charge on the gift.

A gift ceases to be a gift with reservation as soon as the donor cedes any benefits he or she enjoys from it. In the case of one's home, there are ways in which one may continue to live in it, and yet give it away. One could buy a lease at a full market rate, which lets one live in it for a specified period - maybe long enough to cover the rest of one's expected life. Another solution would be to pay rent, or to offer rent-in-kind - such as one's services as housekeeper and gardener - equivalent in value to the market rent for the property one continues to occupy.

In addition, a gift of a house, or other real property, is not counted as a gift with reservation, if the donor's enjoyment of the property arises out of an unforeseen change in circumstances,

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[21] *Inland Revenue Statistics 199*5 pp 9-10

and the donee is either a relation of the donor of the gift, or their spouse. One example would be where someone gave up a house to their children, moving somewhere smaller oneself. If, some years later, they were forced by ill health to move back in to this house, to be looked after by their children, the 'reservation' element of their original gift would be ignored. It is important to note that such a gift would **only** be treated as a PET **if** the donor's change of circumstances - ill health, financial ruin - were unforeseen at the time the gift was made, and were not brought about by the donor to receive this benefit.

Leaseback schemes have provided a third means to avoid IHT in such cases. The owner of a house donates the freehold of their property to a trust, for which their children are beneficiaries, and receives a rent-free lease for a specified period, say 20 years. As the home owner is no longer able to sell the freehold, and spend those proceeds on himself or herself, the gift of the property is taken to be a lifetime gift. It should be noted that the costs of setting up such schemes might well result in their only proving profitable for those with considerable assets. In May 1995 the Inland Revenue lost a case, contending that property covered by leaseback schemes would be subject to a reservation.[22] The Revenue have already stated that they intend to appeal against the decision, though it is possible that the Government may be considering an amendment in the law itself.[23]

D. Taper Relief

As mentioned above, IHT is charged on the value of a person's estate at death, and on potentially exempt transfers (PETs) made within seven years of death. There is provision to reduce the tax charge that would be imposed on PETs, if these PETs are made between three and seven years before the donor's death. Taper relief, as it is called, is only given to mitigate the inheritance tax charge that would be made on gifts made in this period. For this purpose, gifts are considered **before** the rest of the estate. If these gifts fall below the £154,000 threshold, they would be tax-free in any case. If so, the estate is not eligible for taper relief at all, even if the total value of the donor's estate at death - gifts included - is above the £154,000 limit, and therefore liable to tax.

The following example shows how this relief operates:

> Mr X dies leaving an estate worth £200,000. However, he had given away a chargeable gift of property worth £50,000 between 3 and 7 years before his death. To calculate whether Mr X's estate is eligible for taper relief, one looks first at the gifts made out of the estate. As the gift of £50,000 falls beneath the nil band of £154,000, no tax would have been assessed on the gift itself. As a consequence, there is no IHT charge to which taper relief can apply. Turning now to the whole estate, and the tax to be charged to it, tax falls to be due at 40% on the total of the whole estate above the nil band; ie, £96,000 (ie, £250,000 - £154,000).

[22] "Law report : Property transfer avoids inheritance tax", *Times*, 23 May 1995

[23] "When the taxman knocks on your door", *Times*, 20 May 1995

Taper relief is beneficial only if someone can give away more than £154,000 before they die. Relief is available as a percentage reduction in the tax payable on the gift itself; the nearer the donor is to surviving seven years after the gift, the greater the relief:

Years between transfer and death	% reduction in tax payable
0 - 3	0 %
3 - 4	20 %
4 - 5	40 %
5 - 6	60 %
6 - 7	80 %

Clearly, taper relief is of value only to the better-off. One commentator has noted that "it would be fairer if the relief were reformed. One course would be to reduce the size of the lifetime gift itself for tax purposes by 20 per cent a year once three years has elapsed rather than cut the tax."[24] In answer, one might say that the character of taper relief relates to the character of IHT itself: a tax on the value of someone's estate at death. In determining the way in which this is done - provided one thinks that such sums should be taxed - there are a number of different choices to make, in designing a fair charge on death: how do you determine the value of the estate (ie, do you include transfers made out of the estate close to the date of death); what is the minimum size of an estate you should charge tax on; and, how do you equate the wish to charge a rate of tax in a fair manner with the unpredictable timing of anyone's death?

It is just this final issue to which taper relief relates. Without taper relief, transfers out of an estate of such a size to be charged IHT in their own right (ie, that already exceeded the £154,000 limit) could either be charged a zero rate of tax, if made outside the seven year period, or the full tax rate at death, if the donor happened to die a day or so earlier. One might argue that this effect was unfortunate, but should not be the subject of a specific relief.

Alternatively, one might say that the way in which the value of an estate is calculated is unfair; ie, that it should be in part determined by the pattern of transfers made in the last seven years of life. In effect, the value of the estate at death for tax purposes would be less if the estate's owner made most of his or her PETs, say, six years before death, rather than one year before death. In a sense, this is a quite separate issue. Tying this criticism to the provision of taper relief ignores the way in which the relief operates in combination with the seven year rule and the £154,000 ceiling.

The purpose of taper relief was discussed in 1986 by the then Minister of State at the Treasury (Peter Brooke) when the provisions for IHT were first introduced; specifically, within the Standing Committee examining the Finance Bill of that year. Mr Brooke pointed

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24 "When cash gifts leave you short", *Guardian*, 20 November 1993

out that without this relief, the actual tax rate charged on gifts would turn on the capricious matter of the time of someone's death:[25]

> "The rates of taper have been carefully chosen to graduate the charge on a gift made during the pre-death period, and thus reduce the possibility that large differences in liability on such transfers turn on the precise date of death. So the percentage of full death rates charged increases in equal steps from 20 per cent in the seventh year before death to 100 per cent in the third and later years. The amendments [then being debated] propose a different scheme under which the percentage moves in smaller steps from 20 per cent to 50 per cent and then jumps to 100 per cent. That reintroduces the same steep jump that existed under capital transfer tax and which the Government proposals avoid."

E. Family Businesses & Farms

The suggestion that IHT should be abolished is not a new one. At the Conservative Party Conference in October 1991, John Major discussed the reform of inheritance tax as one of the party's pledges in the forthcoming election:[26]

> "In the 1980s we began a great revolution. Our aim was a life enriched by ownership, in which homes, shares and pensions were not something for others, but something for everyone ... But this revolution is still not complete. In the 1990s we must carry it further. We must extend savings and ownership in every form. And we now have the chance to make enduring change. For people in their middle years are inheriting houses, businesses, farms on a scale never before seen. The pioneers of the property-owning democracy are the parents of the capital-owning democracy.
>
> We Conservatives have always passed our values on, from generation to generation. I believe that personal property should follow the same course. I want to see wealth cascading down the generations. We do not see each generation starting out anew, with the past cut off and the future ignored. So, in the next Parliament I believe we must go much further in encouraging every family to save and to own. To extend every family's ability to pass on something to their children, to build up something of their own - for their own."

This theme was picked up in the 1992 Conservative Party election manifesto, in which an increase in the tax threshold was promised:[27]

> "Inheritance tax is particularly inequitable. It falls only on those who do not dispose of their assets seven years or more before death. It is inevitably the case that these tend to be people who are not rich enough to engage in high powered tax planning, or who, for lack of knowledge or advice, fail to take the necessary precautionary action."

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[25] Standing Committee G 10.6.86 c.404

[26] Extract from speech by the Prime Minister, John Major, to 108th Conservative Party Conference 11 October 1991

[27] Conservative Central Office, *The Best Future for Britain*, March 1992 p.8

In the event, the then Chancellor, Norman Lamont, announced a slightly less wide-reaching reform than some had hoped. First, the threshold for paying IHT was raised to £150,000, a slightly larger figure than simply applying indexation in line with inflation would have produced (ie, £147,000). In addition, most family businesses and family farms were to be taken out of IHT altogether.

The existing 50% relief from IHT - given for holdings in unincorporated partnerships, owner-occupier farmland, and interests greater than 25 per cent in unquoted companies - would be increased to 100%. (This covers bequests, or gifts given out of an estate within seven years of death, as gifts falling outside the seven year period would not be charged IHT.) In addition, IHT relief for shareholdings falling below the 25 per cent threshold, and farmland owned by agricultural landlords, would be raised from 30% to 50%.

Mr Lamont concluded his announcement with a promise:[28]

> "Inheritance and capital are no longer a privilege of the wealthy few. Ordinary families want to be able to pass on the wealth that they have built up over their lives to their children without an excessive proportion being taken by tax. Over the years to come I shall continue to look for ways of lightening the burden on inheritance tax."

The measure was seen as being particularly important for farmers, since giving away shares or assets from this type of business is much harder. Indeed, both the National Farmers' Union and the Country Landowners' Association had lobbied for reforming IHT in this fashion.[29] Subsequently the Country Landowners' Association has suggested that this tax relief was vital to revive the ailing landlord tenant system.[30]

When debated in Standing Committee, Anthony Nelson, then Economic Secretary to the Treasury, claimed the relief would "be widely welcomed throughout the country" as decisions to bequest these family assets would no longer be distorted by aspects of the tax system:[31]

> "At present, there is a fiscal inducement to give away business assets or farming land before death because if the donor survives the inter vivos period no tax liability will arise. The decision to give the land away during the lifetime is tax-driven in many instances. If, in a large number of cases, the transfer on death is relieved of any inheritance tax - potentially exempt transfers will be included - the decision to give way assets during a lifetime is more neutral. That is as if should be."

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28 HC Deb 10.3.92 c.754

29 "Farmers welcome 'substantial boost'", *Daily Telegraph*, 11 March 1992

30 "Farmers lobby against capital gains tax", *Western Mail*, 28 December 1992

31 Standing Committee B 30.6.92 cc 413-414

At the time, the exemption from tax of holdings of over 25 per cent in unquoted companies was criticised. In Committee William Powell suggested that the distinction was "arbitrary" and inefficient:[32]

> "The logic of the reform is that there should be no distinction at all. The valid distinction must be between quoted and unquoted companies ... The tax will be proportionately heavier on small holdings of employees and ex-employees ... [An unquoted company] will be vulnerable to the drip, drip, drip effect of payments of inheritance tax on such diffuse and dispersed shares. I have advocated the only solution to the problem literally hundreds of times before - there should be a 100 per cent business property relief on shares in all unquoted companies."

The CBI has strongly argued for widening IHT relief for family businesses. In its 1994 Budget Submission, it proposed two changes.[33] First, the 100% relief should be given to shareholdings in unquoted companies smaller than the 25% threshold. Second, relief should be given to family businesses, even if they were quoted on the Stock Exchange:[34]

> "Currently holdings of over 25% in unquoted companies are exempt from inheritance tax. The CBI welcomed the introduction of this scheme, and sees no reason why it should not be extended to holdings of less than 25%. The forthcoming abolition of the Unlisted Securities Market (USM) ... could make it appropriate for some family businesses to seek a listing on the Stock Exchange, in which case family members would lose exemption from inheritance tax on those shares. The CBI urges the Government to ensure that inheritance tax exemption still applies to a family member's stake in their genuine family business, even if it becomes listed after the abolition of the USM. This would be achieved by extending exemption to all 'small' companies, whether quoted or unquoted (with 'small' defined, for example, as any company meeting the criteria for being a 'close' company, but without the exclusion of certain quoted companies)."

In January 1995 the Chancellor announced that tax relief for the bequest of landlord interests in let farmland would be extended from 50% to 100%.[35] In fact, the Government had opposed this extension when it was proposed in Standing Committee in June 1992. On that occasion, Mr Nelson said the following:[36]

> "In the Government's view, that would be going too far. We consider it right to exempt owner-occupied farmland because of worries that large inheritance tax bills could impair the development of business or lead to its break-up. Similar concerns do not extend to agricultural landlords. We

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32 Standing Committee B 30.6.92 cc 411-412

33 Both proposals were reiterated in the 1995 Budget submission : Confederation of British Industry, *Keeping a Steady Course*, September 1995 p.11

34 Confederation of British Industry, *The Way to Balanced Growth*, September 1994 p.12

35 Inland Revenue press notice, *IHT relief for agricultural property*, 27 January 1995

36 Standing Committee B 30.6.92 cc 420-422

> believe that for them a considerable measure of tax relief is justified - hence, we are increasing the rate of relief from 30 to 50 per cent. That is a valuable extra benefit which, in our view, gets the balance right."

The measure was designed to act as a supplement to the changes being made in agricultural tenancy law, set out in the *Agricultural Tenancies Act 1995*, and, as such, would come into effect on the same day as the Act itself: ie, 1 September 1995.

In Committee, Mr Nelson summarised the purpose of this measure:[37]

> "The relief, together with the other inheritance tax improvements that we have made over the years, ensures that most family farms can be passed on intact without a forced sale or break-up arising from the need to pay an inheritance tax bill. It also recognises the special role of landlords in the agriculture industry. The new clause ... equalises the inheritance tax treatment of working farmers and agricultural landlords by extending full exemption to let farmland. It underlines the objectives of our tenancy reforms and provides further valuable encouragement to landowners to make more land available to tenant farmers ... The relief has strict qualifying conditions which target it on farm land used for the purpose of agriculture. The land has to be both owned by the landlord for a period of seven years and used in farming throughout that period. Thus speculative short-term investments would not benefit from the extended relief."

[37] Standing Committee D 9.3.95 cc 690-692

IV Reforming the Tax

A. The Possibility of Abolition

During an exchange with Tony Blair at Prime Minister's Questions in July 1995, John Major reiterated his commitment to abolish inheritance tax, as well as capital gains tax:[38]

> "When it is appropriate and we can afford to do so, I wish to abolish both capital gains tax and inheritance tax. I repeat the point for the right hon. Gentleman; I have made that clear and it must wait for when resources allow. I make no apology for that. The distortion of capital gains tax will need to be tackled. Unlike the Labour party, I believe in trying to pass wealth down between generations, whereas it squirms and wriggles whenever we talk of any tax reduction."

During a debate on the economy held the previous day, the Chancellor, Kenneth Clarke, supported the idea that inheritance tax should be reformed, even abolished, though he emphasised abolition was not an immediate prospect:[39]

> "In the longer term, I know that the Prime Minister believes that it should be reasonable to get rid of capital gains tax and inheritance tax as well. Inheritance tax is extremely uneven in the way that it falls ... But the Prime Minister has given no sort of commitment about when we might achieve such an ambitious objective."

Several commentators, the *Economist* among them, have noted the abolition of either tax would benefit a relatively small number of people:[40]

> "If you use 1994-95 as a guide, over half the benefit of scrapping capital gains tax would go to around 2,500 people who make annual capital gains of more than £250,000 each, and to firms. Half the benefit of ending inheritance tax would go to the heirs of the 2,000 biggest estates, which would be relieved of paying an average of £350,000 each."

Before examining the case for doing away with IHT, it is worth making the point that it is a very different tax to capital gains tax, though some recent comment in the press has not distinguished them clearly. The function of capital gains tax (CGT) is, in essence, a means to discourage tax avoidance. Its greatest strength is in deterring taxpayers from trying to reclassify their income as capital gains, and avoid any tax charge thereby. Abolishing CGT would significantly distort income tax, though abolishing IHT would not.

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[38] HC Deb 13.7.95 cc 1085-1086

[39] HC Deb 12.7.95 c.975

[40] "Death to taxes", *Economist*, 22 July 1995

One of the strongest proponents for abolition of IHT has been the Institute of Directors (IOD). Following the Prime Minister's speech in October 1991, the IOD was enthusiastic about the prospects for abolition; the following is taken from their 1992 Budget submission:[41]

> "We have for many years argued that inheritance tax should be abolished. At the personal level, inheritance tax is a capricious tax on misfortune; at the level of the economy, it is a fiscal assault on saving, enterprise and the institution of personal capitalism. Death duties in their various forms have been a principal reason for the relative and absolute decline of the family business in Britain; and they have much increased the already formidable task of maintaining heritage assets.
>
> We, therefore, warmly welcome the increased sympathy for the institution of inheritance expressed in a number of speeches this year by the Prime Minister ... We urge that the 1992 Budget should at least increase business property relief significantly for all classes of holding and preferably should increase the relief immediately to 100 per cent.
>
> However, we would not favour a regime which entirely exonerated business property while remaining as harsh as now for other assets, since ... a prosperous capitalist economy requires personal ownership of passively-held capital as well as of business assets. The threshold of the tax, therefore, should be raised, and the rate of tax reduced."

In the event, the Chancellor did announce the substantial extension of IHT relief to family businesses and farms, though he did not cut the rate of IHT, or double the nil rate threshold to £300,000 as the IOD had proposed. By contrast the CBI has not argued for abolition, though it strongly supported the relief given to family businesses (see above, pp 18-21).

In their most recent Budget submission, the IOD states its case in trenchant fashion:[42]

> "Inheritance tax is [a] complex tax with correspondingly high compliance costs but the answer could not be simpler. It should simply and immediately be abolished ... It fulfils no revenue protection purpose and raises little direct revenue. But there are substantial compliance costs and it leads to distortions in insurance and other financial products markets. It also takes capital out of the economy which the Government spends mainly as income, and, by reducing personal share ownership, it contributes to the concentration of shares in the hands of financial institutions. And, in spite of the recent extensions in reliefs, it is hostile to enterprise, saving and the spread of employee share ownership."

Writing in the *Times* in October 1995, Kenneth Baker suggested inheritance tax was in need of a "fundamental overhaul", though he did not recommend abolition:[43]

> "It is now imposed at a flat rate of 40 per cent with a low threshold of £154,000 ... these rates are far too high, and affect a particularly productive section of society. There is a good case

[41] Institute of Directors, *Rebuilding the Capital Base*, January 1992 pp 22-23

[42] Institute of Directors, *A Budget for Business*, September 1995 pp 17-18

[43] "The taxes we should cut", *Times*, 17 October 1995

> for abolishing inheritance tax, but it does bring in significant revenue and it is no bad thing if the children of the successful have to work to recreate something of what their parents had ... I suggest raising the threshold [to] £300,000 and a rate of 30 per cent above that. In addition, assets given to children, or other direct dependants, should be taxed at half that rate, namely 15 per cent. Under this regime, larger estates would continue to pay a substantial amount in tax; moderate estates would be exempt; and the passage of family savings from one generation to the next would be encouraged."

Perhaps one of the weaker arguments for scrapping IHT relates to the 'voluntary' nature of the tax. One accoutant supporting abolition gave his reasons for doing so to the *Guardian*:[44]

> "The super-rich are able to avoid IHT by giving away most of their assets in the last years of their life, and still keep enough to live comfortably. That option is not open to those with more modest assets."

However, the fact that particularly rich persons are likely to pay a smaller proportion of their wealth in tax than, say, someone whose estate consists solely of a £400,000 house, is not, in itself, a case for doing away with the tax:[45]

> "Inheritance tax ... is widely avoided ... that could be an argument for making the tax work better, not for scrapping it. Certainly, if some redistribution of wealth from rich to poor is desirable, death is the most economically efficient time to do it. After all, it is less likely than other taxes to reduce the taxpayer's incentive to work."

If it is socially desirable to redistribute some of society's rewards, from the richest to the poorest, taxing estates at the time of death may provide the best solution. Of course, as the Institute for Fiscal Studies has pointed out, many of the richest in our society have not become so through their own efforts:[46]

> "Today's very rich have mainly become wealthy by inheritance. This is at odds with the notion of wealth as a reward for effort."

Refusing to tax inheritance could be thought to have serious implications for the incentives facing those who do work for their living:[47]

> "Everyone in a democratic society expects to have an equal chance of maximising their potential, regardless of their background. Thus the existence of unequal opportunities deriving from accidents of birth makes for social friction and disharmony ... Inheritance saps the

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44 "Major eases burden for those who can afford to pay most", *Guardian*, 14 October 1995

45 "Death to taxes", *Economist*, 22 July 1995

46 Institute for Fiscal Studies, *Death : the Unfinished Business*, November 1988 p.2

47 "Inherited wealth makes a mockery of meritocracy", *Observer*, 17 November 1991

> incentive to work hard for self, family, friends, by putting unearned income before earned income. Thus it militates against the [creation of an] innovative, entrepreneurial and motivated society ... Governments should be soft on savings, but hard on inherited wealth."

Without taking the argument this far, there remain strong arguments against exempting a person's receipts from tax, simply because they did not work for them:[48]

> "Since a wealth transfer is a clear signal of ability to pay, there is also a persuasive equity case for taxing such a transfer. The second equity argument is that a very uneven distribution of wealth is seen to be inherently unfair, and a wealth transfer tax is perhaps the best tool for eliminating such inequalities. Third, and most importantly of all, it also seems unfair that the person who earns £100 should pay £25 or £40 in tax while the person who receives £100 as a gift or inheritance pays no tax."

While these arguments focus on the recipient of inheritance, those who argue for the abolition of IHT concentrate on the rights of those who have wealth to use it how they wish. In addition, for some, the dramatic inflation in house prices over the past decade is a reason for abolition, as it has shown up the unfairness of the tax:[49]

> "It is quite typical for families in London and the Home Counties to own homes worth £120,000 or even as much as £200,000 but live on modest incomes and pay income tax at only the basic rate. And yet they are liable to pay the full rate of inheritance tax on the top slice - exactly the same as a millionaire."

The desire to pass on one's home to one's children can be a very powerful one. Even so, if one abolished IHT, or simply exempted housing from the tax charge, one effect would be to encourage many older people, whose families had moved away, to remain in large houses ill-suited to their needs. Of course, a parent may still give their home to their children, and avoid IHT being charged on the gift, provided they do so seven years before their death.

The Institute for Fiscal Studies for one has criticised the proposal to exempt housing:[50]

> "One of the objections to IHT often cited is that the family home has to be sold to meet the tax demand, which would be avoided if housing were exempted. UK residential building compromises 41% of an estate's value on average, so the cost of this measure would be in the region of £600m. This reform would create huge distortions because it would give strong incentives to people to maximise their wealth held in property, just at the time when trading down might be the most appropriate action to their needs. The corollary of this is, of course, that this would ensure an inefficient use of the UK housing stock."

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48 Institute for Fiscal Studies, *Death : the Unfinished Business*, November 1988 p.2

49 "Let the wealth cascade", *Times*, 20 July 1995

50 Institute for Fiscal Studies, *Options for 1996 : the Green Budget*, October 1995 p.102

B. A Donee Based Tax

Although abolition of IHT is a controversial proposal, the belief that IHT should be reformed is far more widespread. One major criticism of the tax is that it charges a flat rate 40 per cent rate on all taxable transfers, irrespective of whether the person receiving these funds is a pauper or a millionaire. The notion that death duties should be charged on the recipient of inheritance, rather than its donor, is not a new one. In fact in 1927 the Colwyn Committee had suggested that the existing legacy and succession duties might be developed, so that the system of death duties might pay more attention to donees rather than donors.[51] Nothing was done on these lines, and, as was mentioned above, estate duty remained largely unchanged until its replacement by capital transfer tax in 1974.

One argument for a donee-based tax (or accessions tax as some call it) relates to the ease with which the wealthiest members of society now avoid IHT. A tax specialist writing in the *Guardian* made this observation recently:[52]

> "UK taxpayers currently enjoy the most benign inheritance tax regime in decades ... A married couple with a £300,000 home and small savings should not have to pay inheritance tax if they arrange things properly in advance."

Even before the extensions of tax relief to family businesses and farms in 1992, the operation of IHT had been severely criticised for being too easy to avoid; the case was presented by a *Financial Times* editorial in 1991:[53]

> "Since only bequests and gifts made in the seven years before death are taxable, gifts made more than seven years before death are normally outside the scope of the tax. Paying it is almost voluntary for those who can afford professional advice, with the burden falling on those who cannot (yet who may be asset-rich), people who die before their allotted three score years and ten, and parents who don't trust their children sufficiently to give away their wealth in advance. Every other OECD country with an inheritance tax deals with this by including all lifetime gifts within the tax net. The administrative burden can be minimised by the sort of sizeable exemptions which already exist for inheritance tax, requiring only exceptional gifts to be reported."

A recent book on tax policy in OECD countries suggests that the majority of OECD states tax gifts on death in the context of a donee-based tax (marked as H), rather than a donor-based one (marked as E). A table summarising its findings in this respect is reproduced on the following page:[54]

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51 *Colwyn Committee on National Debt and Taxation*, Cmd 2800, 1928

52 "Revenue throws lifeline to hard-up homebuyers", *Guardian*, 7 May 1995

53 "Death and the taxman", *Financial Times*, 3 October 1991

54 "Forms of capital and capital gains taxation" taken from K.Messere, *Tax Policy in OECD Countries*, 1993 p.293

Table 11.2: Forms of capital and capital gains taxation in OECD countries						
	Net wealth tax		**Transfer tax on gifts at death**		**Capital gains taxation**	
	First introduced	**1 Jan. 1990**	**First introduced**	**1 Jan. 1990**	**First introduced**	**1 Jan. 1990**
Australia	–	–	1914	–	1986	I
Austria	1923	W	1850	H	–	B
Belgium	–	–	1936	H	–	B
Canada	–	–	n.a.	–	1972	I
Denmark	1903	W	1903	H	1958	C
Finland	1920	W*	1920	H	1920	I
France	1982[1]	W*	1978	H	1976	I
Germany	1923	W	1923	H	–	B
Greece	–	–	1919	H	–	B
Iceland	n.a.	W*	n.a.	H	n.a.	I
Ireland	1975	–	1894	HA[2]	1975	C
Italy	–	–	n.a.	EH	–	B
Japan	1951	–	1950	H	1946	1
Luxembourg	1944	W	1817	H	1979	I
Netherlands	1892	W	1917	H	–	B
New Zealand	–	–	1885	E	–	–
Norway	1918	W*	1918	H	1911	I
Portugal	–	–	1958	H	1965	C
Spain	1978	W*	n.a.	H	1978	I
Sweden	1910	W*	1914	H	1928	I
Switzerland [3]	various	W*	various	HE	various	various
Turkey	–	–	1959	H	–	B
United Kingdom	–	–	1894	E	1965	C
United States	–	–	1916	E	1913	I

1. Abolished in 1987. Reintroduced 1989.

2. Accessions tax: aggregate gifts and legacies from any donor to determine the rate of tax.

3. All taxes are cantonal with considerable variation between the cantons.

A = Accession tax.

B = Taxation of capital gains for businesses (whether or not incorporated) but no comprehensive or capital gains on individuals.

C = Capital gains tax (separate).

E = Estate-type transfer tax.

H = Inheritance-type transfer tax.

I = Comprehensive taxation of capital gains under income tax.

W = Single-rate net wealth tax. W* = Multi-rate net wealth tax.

– = No tax.

n.a. = Not available.

Various sources.

In the terminology used in this text, "inheritance tax" (H) refers to a tax on death where the tax base and the rate of tax are governed by the amount received by the donee; "estate tax" (E) is a tax on death where both tax base and tax rate are governed by the amount transferred by the donor.

Other aspects of the current IHT regime have been taken as arguments for a donee-based tax, such as the capricious nature of the seven year rule:[55]

> "The seven year gifts provision is a state-created lottery with life, with perverse consequences. Suppose two men of the same age and wealth make similar gifts at the same time. One falls under a bus the next day while the other survives. The family more likely to need relief is that of the man who died soonest, not that of the survivor. Yet it is on the former's gift that duty is paid ....
>
> An accession tax, besides getting rid of the nonsense of the seven-year rule, has two advantages over the IHT. First, it is more equitable because it taxes directly in relation to benefit received. Secondly, it should be more effective in reducing concentrations of wealth. An accessions tax offers an incentive to the wealthy to spread their wealth ... More significantly, a tax on receipts strikes at the heart of the problem, because large receipts, not large estates as such, perpetuate inequality."

In 1988 the Institute for Fiscal Studies published a substantive report on taxes at death, firmly supportive of a donee tax:[56]

> "A donee-based tax makes more sense than a donor-based tax, because it fits in with the general principle of taxing those who enjoy an increased command over resources whether via income, capital gain or capital transfer. It might also encourage the dispersion of wealth since an estate divided among many will in general attract less tax than if left to one person."

The study went on to suggest that gifts and inheritances could be brought within an extended income tax net, especially as the current rates of income tax - 25%, 40% - are not nearly as high as they once were. That said, there are serious administrative problems with such a change:[57]

> "There are considerable administrative advantages in taxing the estate: it is not just that the tax can be extracted in a single transaction, but also that a large number of estates can be removed altogether from the tax net by the operation of a small estates exemption. These objections can be partially overcome by having a relatively high exemption limit for the recipients of inheritances or gifts. But there is always going to be a clear trade-off between the equity and efficiency gains from an extended income tax and the administrative costs of implementing it ...
>
> If it is seen as a political imperative that there should be no increase in administrative costs, most of the horizontal inequities associated with the present inheritance tax could be dealt with very simply by reintroducing a tax on gifts. There is certainly no case for abolishing inheritance tax altogether."

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55 "Tax the heir, not the estate", *Financial Times*, 4 April 1992

56 Institute for Fiscal Studies, *Death : the Unfinished Business*, November 1988 p.3

57 *op.cit.* p.4

In their most recent *Green Budget*, the IFS reaffirmed its support for the donee principle, citing the Prime Minister's aim for inheritance, though it was pessimistic about the chances of this type of reform being adopted:[58]

> "If inheritance were taxed on the donee (with suitable allowances) rather than the donor's estate, the inheritance tax system would give an incentive for donors to spread their lifetime assets more widely, which could have desirable redistributional consequences. The policy would not contradict a 'cascade of wealth flowing down the generations' but must be viewed as highly unlikely."

Though neither the Labour nor the Liberal Democrats have supported the notion of abolishing IHT, both parties have shown some support for an accessions-based tax. The possibility of this type of reform was raised by the Labour Party in its 1989 paper, *Meet the Challenge, Make The Change*:[59]

> "We are considering two important changes of principle. It may well be more attractive to opt for a recipient-based tax so that liability would attach to the person who received the benefit rather than to the donor or his or her estate. One advantage would be to discourage the continual accumulation of wealth, by creating an incentive for its wider dispersal. We will also consider assessing transfers of wealth and any exemptions from liability on a lifetime basis so that tax is charged according to the accumulated amount a beneficiary has received in gifts and bequests over a lifetime. By these means we believe that we will be able to tax wealth more effectively and make the avoidance of capital taxation, on which much ingenuity has been expended in the past, as difficult as possible."

The Liberal Democrats have been far more open in their support for this reform. In a paper published in 1990 on tax and benefit systems, the party summarised its case:[60]

> "We believe that the transfer of wealth is an appropriate point for taxation. It is also likely to become increasingly significant in the near future [in the context of] the recent escalation in land values ... We therefore propose to restore an effective tax on the passing of property by death or gift. We wish to do so for four reasons. First, a gift or inheritance represents an increase in the recipient's spending capacity, and in our view the increase in spending capacity is a more logical base for taxation than is income in the conventional sense.
>
> Second, while we recognise that a wish to pass property to children is natural and, in so far as it increases the incentive to save, beneficial, we also believe that allowing hereditary wealth to accumulate untaxed and undistributed is socially undesirable. Third, an ineffective tax, such as exists at present, benefits no one but the tax avoidance industry. Fourth, as tax rates would be based on the income of the successor and not on the size of the estate, there would be an incentive for testators to spread their wealth as widely as possible. We believe that the tax system should be designed so as to discourage the concentration of wealth in a few hands and encourage its wide distribution."

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58 Institute for Fiscal Studies, *Options for 1996 : the Green Budget*, October 1995 p.102

59 Labour Party, *Meet the Challenge, Make the Change : A New Agenda for Britain*, May 1989 p.34

60 Liberal Democrats, *Common Benefit*, December 1989 p.14

The Liberal Democrats have continued to argue for this reform; the following is taken from a paper on taxation published in 1994:[61]

> We would .. reform the way in which tax on gifts and inheritance is levied, with the aim of reducing taxes on small gifts or inheritances, but ending the avoidance of inheritance tax by those who can afford to make large lifetime gifts. We would:
>
> > • Replace the present, ineffective inheritance tax with an accessions tax, which is a tax charged not to the person who has died, but to the recipient.
> >
> > • Tax gifts as income, if they exceed an annual exempt amount.
> >
> > • Tax inheritances, in such a way that beneficiaries from inheritances could offset accessions tax against used past (and possibly future) tax exemptions.
>
> We would give relief, up to an appropriate limit, from tax on inheritance of business assets, including agricultural land and shares in a family company, to prevent a forced sale of these assets. We do not propose that the relief be an absolute exemption (as at present), but a deferment of tax liabilities until the asset is sold, subject to a similar 'rollover' relief to that available with capital gains tax.

The Labour party has shifted the emphasis of its position. At the time of the 1994 Budget, the party issued a policy paper on taxation, which, on inheritance tax, argued the tax "must be made effective and less easy to avoid, particularly for those who have come to regard it as a voluntary tax."[62] In June 1995, the party's Economic Policy Commission issued a consultation document - *A New Economic Future for Britain* - the appendix to which was slightly more specific in relation to IHT:[63]

> Inheritance tax must operate fairly without penalising those without access to sophisticated planning advice. The abuse of conditional exemption schemes originally intended to safeguard art collections and family farmland should be ended. Labour would introduce arrangements to protect bona fide family businesses and farms from being broken up.

Nicholas Brown made the case for an accessions tax, when the issue was debated during the proceedings of the Finance Bill in June 1992:[64]

> > "The current donor-based tax system levies a charge on the estate rather than the individuals receiving the bequest. It would be far better to tax the bequest for what it is - an addition to the ability to pay of the recipient. A tax levied on lifetime gifts as well as bequests and a tax levied on donees rather than donors would mean that incentives could be introduced to spread

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61 Liberal Democrats, *Opportunity and Independence for All*, June 1994 p.11

62 Labour Party, *Tackling Tax Abuses - Tackling Unemployment*, November 1994

63 "Appendix : Tackling Tax Abuse", taken from, Labour Party, *A New Economic Future for Britain*, June 1995

64 Standing Committee B 30.6.92 c.396

> the gifts more widely ... and promote the wider distribution of wealth ... Wealth in this country, is not, in the main, a reward for individual effort nor, more surprisingly, is the wealth that is passed on. Just 3 per cent. of the assets of estates in 1987-88 was in the form of shares in unlisted companies, trade assets or partnerships. For reasons of equity, a return to a more effective tax on wealth transfers is important if we are to reward enterprise and create incentives to work."

In answer, the then Economic Secretary to the Treasury, Anthony Nelson, suggested that an accessions tax would be contrary to the Conservative party's philosophy:[65]

> "Some intellectual arguments [could] be made for a donee basis of taxation. I would argue that the cost and complexities of change do not justify it ... The hon. Gentleman's approach seems to be, 'If it's taxable, tax it' and that people should get what is left. We have a fundamentally different approach. We believe that people's assets belong to themselves and their families, and that there should be compelling reasons to tax those assets ...
>
> [The hon. Gentleman] said earlier that a donee basis of taxation would encourage people to parcel out, divest and widen the distribution of their assets ... We have adopted a more neutral position in taxing the donor, who is then able to dispose of net assets or to make provision for such disposal at the end of his life in a way that is not influenced and pressurised by the basis of taxation ... It is laudable that people should want to accumulate substantial amounts for themselves, their families and heirs. We should not use the tax system - and especially not the capital tax system - to devise ways of encouraging people to do otherwise."

One writer in *Taxation* made a number of other points against a donee based tax (though his reference to family businesses predates the IHT exemption now afforded these assets):[66]

> "If one may consider the matter in relation to the normal or standard family unit of husband, wife and children ... then it is immediately obvious that an accessions tax related to the capital receipts within a family ... rather than the estate alone of, usually, the survivor of the husband and wife will result in a substantial reduction in the yield of tax payable by reason of death unless there is a very significant increase in the rates of tax payable ...
>
> "Is dispersal of wealth economically desirable? There are two very obvious examples where this may not be so. The first is agricultural land and estates. One does not have to be a farmer to know that large farms are more economic and profitable than small farms ... The other area where dispersal of wealth may be undesirable is in private companies. Owners of successful private companies will not generally wish to leave their shares equally between all their descendants. They would prefer to give shares to those members of the family who are working in the business and provide in other ways for those who are not working in it."

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65 *op.cit.* c.397 c.403

66 "An accessions tax?", *Taxation*, 5 March 1992

C. Instruments of Variation

A deed of variation allows the beneficiaries of an estate, regardless of whether there is a will, to rearrange their inheritances within two years of death. In the past this has allowed some flexibility in tax planning after someone has died. In very broad terms, the rules have operated in the following fashion. *A* dies, leaving their property to *B*. *B* gives it to *C* within two years of *A*'s death, and elects that *C* should be treated for inheritance tax purposes as though they had inherited the property directly from *A*.

When a spouse dies, leaving a substantial estate to their partner, this may leave their husband or wife with the problem of trying to pass it on to their children without incurring tax. One way to do this would be to make a deed of variation, changing the terms of the will to allow money to go direct to the children. Provided this sum does not exceed the nil rate threshold, no inheritance tax would be payable. In effect, the widower, or widow, makes a gift without any of the tax consequences. The relevant legislation is contained within section 142 of *IHTA 1984*. Clearly this is an advantage if the surviving partner fears that any gift they make will be charged tax, if they themselves die within seven years of making it. As mentioned above, deeds of variation must be executed within two years of a death, and a written notice given to the Revenue within six months of the deed being executed.

In 1989 the Government proposed to amend these rules, to limit the use of these instruments of variation for tax planning purposes. Only certain arrangements would continue to be backdated to the date of death:

- a disclaimer of benefits under a will or intestacy (or Scottish equivalent).[67]

- Court Orders making adequate provision for the deceased dependants.

- written variations by the beneficiaries themselves making adequate provision for the deceased dependants that could be ordered by the Court.

When the measure was debated in Standing Committee, the then Financial Secretary to the Treasury, Norman Lamont, described the reasons behind this proposal:[68]

> "In recent years, the number of instruments of variation has increased, particularly since capital transfer tax was replaced by inheritance tax. The purpose of inheritance tax was that if people retained property and did not take advantage of the opportunity that had been given them to pass on property free of tax, provided that they lived seven years, there should be a tax on death. That was the principle of inheritance tax, and it was because there has been an increasing use of instruments of variation since its introduction, precisely to avoid the charge on death, that we originally decided to bring forward this clause."

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67 A disclaimer is rather inflexible, as the person making it cannot direct to whom the inheritance passes.

68 Standing Committee G 20.6.89 c.507

However, the proposal was controversial, and the Government withdrew the clause completely.

At the time, Mr Lamont noted that "in many ways the clause could effectively be avoided by those with access to the appropriate advice, while it would cause major inconvenience to those who had arranged their affairs on the basis of the present law, especially the elderly." He went on to say that he saw "justification in principle" for the clause, and that the Treasury would keep the matter under review: "Next year we may come forward with more targeted specific measures to counter abuse."[69] Since then, no specific measures have been introduced, though this is quite possibly one area where a reform in the law might be made.

D. Heritage Property

IHT is not charged on bequests of land, buildings, chattels and works of art considered of sufficient standard to be regarded as part of the national heritage. Exemption is conditional on the owner complying with certain conditions concerning public access. Generally, as long as the public is able to enjoy the property - say, by visiting the owner's house, or a museum to which it has been lent - IHT will not be charged. The exemption stays in force indefinitely, provided the agreed conditions continue to be satisfied.

The relief dates back to when estate duty was first introduced, when certain types of object were exempted from the tax, including "any such pictures, prints, books, manuscripts, works of art or scientific collections, as appear to the Treasury to be of national, scientific, or historic interest, and to be given or bequeathed for national purposes, or to any university, or to any county council or municipal corporation."[70]

When capital transfer tax replaced estate duty in 1975, this exemption was maintained, though a number of conditions were attached: that the object had to be kept permanently in the UK, that "reasonable steps" had to be taken to ensure its preservation, and that "reasonable facilities" had to provided, either to ensure these requirements were being adhered to, or "for the purposes of research ... to any person authorised by the Treasury."[71] Conditional exemption was extended to "land which in the opinion of the Treasury is of outstanding scenic or historic or scientific interest" and buildings "for the preservation of which special steps should in the opinion of the Treasury be taken by reason of its outstanding historic or architectural interest."[72]

These rules were consolidated in section 77 of the *Finance Act 1976*. In the case of chattels, exemption was dependent on the property being "kept permanently in the UK" bar temporary absences "for a purpose and a period approved by the Treasury", and that "reasonable steps

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69 *op.cit.* cc 508-509

70 Section 15(2) of the *Finance Act 1894*

71 Section 31(2) of the *Finance Act 1975*

72 Section 34(1) of the *Finance Act 1975*

[are] taken for the preservation of the property and for securing reasonable access to the public." In the case of land, it was required that "reasonable steps" be taken "for securing reasonable access to the public."[73] In turn, the conditional exemption of both chattels and land was carried over into the provisions for charging inheritance tax. The rules are now contained in sections 31(2) and 31(4) of *IHTA 1984*; the wording, in both cases, was unaltered. No significant changes have been made in these rules since then, bar the transfer of the functions of the Treasury to the Revenue in this area in 1985.

It was not until 1992 that this exemption was given much public attention. Indeed, critics of this tax relief pointed out that virtually none of the public were aware of their rights to see the works of art that had been exempted from tax. All exempt chattels are listed in the Register of Conditionally Exempt Works of Art, maintained by the Revenue. Four copies of the register are available; in London (at the Victoria & Albert Museum), Edinburgh (National Library of Scotland), Cardiff (Museum of Wales), and Belfast (Ulster Museum). One press report claimed that the London copy, held in the V&A, was examined by an average of two people per year.[74] In addition, serious criticisms were made of the accuracy of the register, and the amount of information it actually provided to those wishing to see individual works.

During the proceedings of the Finance Bill in 1992, Chris Smith introduced a clause to make the commitment to public access much more explicit:[75]

> "I have no objection to the principle of relieving inheritance tax in return for gaining public access to important parts of our countryside and important works of art, but the additional access that is given in return for inheritance tax relief must be clearly available and information about it must be readily to hand ... The new clause provides that information about the rights of access that exist must be made readily available to the public, and it requires that access be free of charge. In relation to land, it requires that access must be available throughout the year, and in relation to works of art it requires that reasonable access must be available at least 52 days in every year, on a regular basis such as a day a week."

Anthony Nelson, then Economic Secretary to the Treasury, argued that the clause was unnecessary; the existing system provided an effective balance between access for the public and security for the owner, though a review was to be carried out into the arrangements:[76]

> "Entries in [the V&A list] describe the object, and provide information about the county in which it is located; they also give the name and address of a contact who can arrange viewing. In many cases, the contact will be an agent. That is an important way of providing the owners of the property with some security ... The existence of the V&A list is known to art scholars

[73] Section 77(2) (4) of the *Finance Act 1976*

[74] "Revealed: secret tax deals on works of art", *Observer*, 21 June 1992

[75] HC Deb 7.7.92 cc 200-201

[76] *op.cit.* c.226

> and researchers, but other members of the public may well be unaware of it ... I reject [the suggestion] that the system of allowing public access to conditionally exempt items is deeply flawed ... [However] the Government felt that there is scope for improving publicity for the V&A list and some of the more important items on it. The Inland Revenue, with the Department of National Heritage, is considering what can be done in that regard."

In the event, the measure was negatived.

In December 1992 the Revenue completed its review, and announced a number of changes to the standard of the entries in the register, its accessibility, and to the publicity afforded the register's existence.[77] Even so, when the Comptroller and Auditor General reported on the assessment and collection of IHT that same month, it made a number of criticisms of this relief, particularly in respect of public access to chattels. Between 1 April 1986 and 31 March 1992, the Revenue estimated that the relief for heritage property had cost a total of £591m in tax foregone (£555m for chattels; £36m for land and buildings). The NAO made the following recommendation:[78]

> "The Department should give further attention to the nature and frequency of the procedures to monitor owners' compliance with undertakings given in return for conditional exemption from inheritance tax on land, buildings and - particularly - chattels. They should also review the extent to which assurances on retention, maintenance and rights of access remain heavily dependent on owners themselves."

In May 1993 the Revenue announced that the register had been fully computerised, making it much easier to use in any of its four locations. In addition, a computer-readable format of the register was to be made available to the public from the Capital Taxes Office, for the price of £10.[79] Despite these changes, when the Committee for Public Accounts reported on IHT in October 1993, it concluded that the improved list should be better publicised, and that a better account should be made of the value of this tax relief to the taxpayer:[80]

> "We are concerned, however, that the list, and the fact that the 9,000 items are available for loan to public collections, may not be widely known to all museums and galleries ... We note that no account is taken of the substantial amounts of tax foregone when deciding eligibility for exempt status, or the public access to be provided. We recognise that there is no statutory requirements that the tax foregone should be taken into account, but we remain concerned in view of the requirements of confidentiality how the Department can determine value for money in these circumstances."

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77 Inland Revenue press notice, *Improvements to procedures for V&A list*, 7 December 1992

78 National Audit Office, *Inheritance Tax*, 16 December 1992 p.3

79 Inland Revenue press notice, *Improvements to the register of conditionally exempt works of art*, 10 May 1993

80 Committee of Public Accounts, *Inland Revenue : Inheritance Tax*, 27 October 1993 HC 688 1992-93 p.vi

In evidence to the PAC, the Revenue estimated that for 1992-93, relief for heritage property was worth just £43m (of which just £2m was for land and £41m was for chattels). However, an official at the Revenue went on to state "[the relief] fluctuates quite a lot from year to year. It just needs one or two very big cases for the figure to go up" (Q 53, p.7). One difficulty in estimating the cost of the relief is the lack of information on chattels owned in estates that may, at some time in the future, come into the ambit of the tax. In addition, since the exemption of items is not related to their potential value for IHT purposes, the Revenue does not make precise estimates for the value of exempt items. This is because if exemption comes to an end, tax would be charged on these items valued at that time. Publicising even rough estimates of the value of someone's exempt possessions would compromise taxpayer privacy (Qs 52-55, p.7). In the case of chattels alone, a recent written answer stated that 704 owners of chattels have been given conditional exemption from IHT or CTT under the rules for this relief.[81]

Although there is no single definition of 'public access', certain guidelines have been published. In the case of the V&A register - which now contains almost 14,500 works of art and other objects - the Revenue have stated the following:[82]

> • Where the object is on short term loan to a public collection, the owner or agent has to provide prospective viewers with the address or telephone number of the curator of the collection and also an indication of when the loan will end.
>
> • In all other cases if the owner or agent is unable to allow viewing on any of the days requested by the prospective viewer, the owner or agent must offer the choice of viewing between 10am and 4pm on any one of at least 3 weekdays and 2 Saturdays or Sundays in the following 4 week period.
>
> • If the owner or agent is unable to meet this minium requirement ... the prospective viewer should write to the Heritage Section of the Capital Taxes Office (CTO)[83] ... The CTO will pursue the matter with the owner whose failure to comply with the requirement of providing reasonable public access may result in a tax charge based on the current market value of the object.

A written answer in February 1995 described access arrangements to exempt land:[84]

> **Mr. Mandelson:** To ask the Chancellor of the Exchequer if he will list the countryside sites in Wiltshire and Hampshire for which publicity regarding public access has been given following conditional exemption from inheritance tax in the years since 1984-85.

81 HC Deb 9.6.95 c.340W

82 Inland Revenue press notice, *Register of conditionally exempt works of art*, 25 August 1995

83 Capital Taxes Office, Ferrers House, PO Box 38, Castle Meadow Road, Nottingham, NG2 1BB

84 HC Deb 3.2.95 c.907W

> **Sir George Young:** As with any matter concerning the tax affairs of the individual the normal rules of taxpayer confidentiality prevent me from giving details of individual cases where conditional exemption from inheritance tax, or its predecessor, capital transfer tax, has been granted.
>
> However, the owner of land which is conditionally exempt from inheritance tax is required to publicise the agreed public access arrangements. The heritage advisory agencies will discuss with each owner the appropriate level of publicity. Each case is considered individually and all relevant factors, including the existing level of publicity, are taken into account. Although the extent of public access may already be widely known, for example where substantial public access is already given, the owner will generally be required to take specific steps to publicise the public access arrangements, for example by advertising the access arrangements in a local tourist office or town hall. For new designations of scenic land in England, owners are required to display at all points of entry on to their land map boards showing the agreed public access.
>
> In addition, in England and Wales, a member of the public who wants information about public access in a specific area can contact the footpaths officer of the appropriate county council or national park authority. Details of footpaths and public access also often appear on maps and in commercial publications, particularly for major tourist areas.

Relief for heritage property continues to be controversial. An art expert at Sotheby's auction house quoted recently in the *Financial Times* said, "People would be surprised at what qualifies for exemption ... The test is not tough and 95 per cent of applications are granted ... In practice, once an object is put on the V&A list, you rarely hear anything more about it."[85] There are still just four places one can view the register free of charge: London, Edinburgh, Cardiff and Belfast. The register has never contained illustrations - a disincentive for some - and its continuing accuracy has been questioned. The authors of one article published in the *Independent on Sunday* found that of a sample of 18 works of art on the list, a third gave contact addresses/phone numbers that were apparently out of date or incorrect.[86]

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85 "So easy to be exempt", *Financial Times*, 19 August 1995

86 "Private view only: why you can't always get to see public property", *Independent on Sunday*, 23 July 1995

V Summary of Inheritance Tax Exemptions

This page summaries the most imporant exemptions from inheritance tax for 1995-96.

Certain gifts are exempt from IHT irrespective of their size, and irrespective of whether they are made during one's life, or made under the terms of one's will. These are:

- Gifts made to one's spouse.[87]

- Gifts made to charities.

- Gifts made to political parties.

- Dispositions for the national interest.

Inheritance tax is charged at 40 per cent on the value of the estate above the tax-free threshold, which is currently £154,000. Inheritance tax will also be charged on transfers made out of someone's estate within seven years of their death. There are some gifts which one can make in the last seven years of one's life which do not attract tax. The most important of these are:

- Gifts made as normal expenditure - on a regular basis, such as under a covenant - which come out of one's income.

- Gifts made during the one tax year of a total not exceeding £3,000.

- Any number of individual gifts, worth up to £250, made during the year to different persons (this relief is in addition to the annual allowance of £3,000).[88]

- Gifts, up to a specified maximum, given to the bride or groom, in consideration of marriage. Parents can each give up to £5,000; grandparents may give £2,500, as may the bride or groom. Anyone else may give £1,000. Parents can make gifts to either party in the marriage; so that, say, a bride's parents could each give £5,000 to their son-in-law.

[87] If one's spouse is not domiciled in the UK, this exemption is limited to £55,000.

[88] This exemption cannot cover the first £250 of a larger annual gift made to any one person.

VI Further Reading

A chronological list of the principal sources used in writing this Research Paper is given below:

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Economic policy & taxation

Research Paper

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95/87	Tax and Marriage	13.07.95
95/82	Economic indicators: July 1995	03.07.95
95/53	Building Societies (Joint Account Holders) Bill (Bill 104 1994/95)	26.04.95
95/46	The Pensions Bill (HL): pension fund regulation (Bill 87 1994/95)	24.04.95