



Inheritance tax changes

What to look out for in the
Chancellor's Budget on 11
March

With pledges both to increase public spending and not to increase income tax, national insurance or VAT, the Government is likely to have to look elsewhere for new tax revenue. Inheritance tax (IHT) is potentially one such place. Although not obviously a big earner (IHT brought in just £5.2 billion in tax in 2017/18, or 0.7% of the total tax take), there are several indications that it is an area where the Chancellor may choose to make changes, both raising revenue and being seen to simplify how the tax applies

A review of IHT by the Office of Tax Simplification (OTS) in the last parliament prompted unprecedented levels of responses and participation leading to a need to produce two reports: the first, published in November 2018 considered the administration of the tax and the more recent report, published in July last year focussed on the details of the tax itself, including the available reliefs. It is this latter report which might offer tax raising opportunities to the Chancellor.

In parallel HMRC published a consultation document looking at various aspects of the taxation of trusts, including inheritance tax. The consultation closed in February 2019 but as yet the responses to the consultation and any conclusions from HMRC have not been published. We might expect to see the outcomes of this consultation published alongside the Budget, with perhaps some suggestions for change.

Inheritance tax in its current form is widely acknowledged to be an unpopular tax and the Chancellor will need to consider whether he wishes to make limited reforms or whether to consider a bolder redrawing of inheritance tax such as that proposed in January by an All-Party Parliamentary Group which set out more ambitious suggestions for a root-and-branch reform of IHT.

The OTS recommendations

The OTS report did not look at wider policy but rather had a narrower focus on the simplification of existing reliefs and exemptions. One suggestion is a reduction in the length of time it is necessary to look back and consider lifetime giving to 5 years from 7, together with an abolition of the taper relief that currently applies to these gifts. The OTS report notes that this would help simplify compliance for taxpayers (since keeping track of gifts going back 7 years can be difficult) while resulting in very little loss of revenue to the Exchequer. Taper relief currently applies to the tax rate for gifts which are more than 3 years old. The OTS suggests that this relief is not well understood and should be abolished at the same time as the look-back period is reduced.

The report also suggests a replacement of the annual allowance and the myriad of exemptions for small gifts with an overall personal gifts allowance since it highlights the confusion caused by the complexity of the current reliefs and their interaction. It also recommends that the level of both the annual allowance and the small gifts allowance should be reviewed. Many of the existing allowances pre-date the introduction of IHT in 1984, for example the annual exemption has been frozen at £3,000 since 1981, the small gifts exemption has been set at £250 since 1980 and the exemptions for gifts on marriage or civil partnership have not changed since the introduction of Capital Transfer Tax in 1975. The OTS suggest that had these exemptions kept pace with inflation the nil rate band would currently sit at £423,000 and the annual exemption would be £11,900.

The gifts out of income exemption can be difficult to claim, unless the donor has considered it during his or her lifetime and kept documentary evidence - otherwise it requires considerable administrative work by the executors to provide evidence. The report suggests that the existing relief should be reformed either by removing the need for the gifts to be regular or by replacing the relief altogether with a higher personal gift allowance.

All of these suggestions may have little impact on the overall tax take for the exchequer, though could be presented as a populist move to modernise the tax. However, the current small gifts exemptions are not well understood by the unadvised and

research on lifetime gifting commissioned by HMRC and published in May 2019 (Lifetime Gifting: Reliefs, exemptions and behaviours research) suggests that these exemptions, and IHT more generally is not a consideration for the majority of those making gifts.

A potentially more significant proposal, at least for small business owners, is the OTS suggestion that the Government consider reform to business property relief (BPR). At present, up to 100% relief from inheritance tax is available where assets qualifying for BPR are transferred, either on death or during the donor's lifetime. The OTS does not suggest disturbing this. It does, however, recommend some changes. One such change is a suggestion that the criteria to qualify for the relief could be made more stringent to align it with the rules for entrepreneurs' relief.

The OTS also points out that the exclusion of Furnished holiday lets from BPR is anomalous, since furnished holiday letting is treated as a trade for income and capital gains tax purposes. There is also a recommendation to consider whether it is appropriate for the exemption to apply to AIM shares pointing out that in the case of third-party investments in AIM traded shares, BPR is not necessary to prevent the business being broken up.

A change to the rules for BPR qualifying assets to align the rules to the capital gains tax reliefs is likely to be tax raising. The total cost to the exchequer of both BPR and APR is estimated at £5.85 billion over the next five years. However, it is not clear how great an impact changing the qualifying criteria would have on the overall tax take. It is also worth noting that while in the context of IHT, £5.85 billion is a significant sum, in the context of the overall income of the exchequer, we are talking about tiny amounts.

CGT not IHT?

Another area the OTS report touches on is the possibility of removing IHT, which it describes as a “uniquely unpopular” tax and instead taxing all capital gains on death (such gains are currently exempt). The report notes a full exploration of the issues is beyond its scope, but that a capital gains tax on death would be simpler and likely to be better understood by executors. However, it notes that it would have the disadvantage of applying to far more people than IHT currently while raising less tax. Based on 2015/16 figures, the report suggests CGT would have raised just £1.3 billion (or £2.8 billion without private residence relief) compared to the £4.38 billion raised by IHT.

The report does however highlight the distortive effect which the tax-free uplift on death can have on decision making and recommends that in situations where a relief from IHT is available, the tax-free uplift should be replaced by a no-gain/no-loss transfer, such that the donee effectively inherits the base cost of the donor.

Changes to the rules for CGT on death are also suggested by the All-Party Parliamentary report in January.

All-Party Parliamentary Group recommendations

The proposals of the All-Party Parliamentary Group (APPG) in their report “Reform of Inheritance Tax” could almost be seen as a compromise between the existing system (perhaps with the more minor changes proposed by the OTS) and the abolition of IHT and its replacement with a gift tax (which has been proposed by various thinktanks in the last year).

The idea of a gift tax has been suggested by both the IPPR and the Resolution Foundation and formed part of Labour Party policy proposals in the report “Land for the Many”. Under this approach, tax on wealth transfers would no longer be payable by the donor during lifetime or by the estate in the case of gifts at death but would instead be borne by those receiving the gift. Every individual would have a lifetime allowance of gifts (£125,000 has been proposed) which could be received tax-free but above this level, tax would be payable on all gifts received. There could be a de minimis annual limit for untaxed gifts and it is likely that an exemption

for gifts between spouses/civil partners would continue. The tax might be progressive either by reference to the total level of gifts received over the individual’s lifetime or by reference to their marginal income tax rate

The cross-party APPG report suggests a radical rethink of inheritance tax with a much-reduced rate of charge - of only 10% (potentially rising to 20% for estates above £2 million). As a balance to this reduced rate of tax, most reliefs, including reliefs for business and agricultural property, would be abolished. However, there is a suggestion that those with certain qualifying assets should be given the chance to spread the IHT payment. Relief for gifts between spouses/civil partners and gifts into charities would remain. Any pension not transferred to the spouse would also be subject to inheritance tax under these proposals.

The APPG report also suggests an overhaul of the lifetime giving regime, such that the existing nil rate band would only apply to death estates. All lifetime giving would be taxable, with a much larger tax free annual allowance of £30,000 but no nil rate band would apply (as now).

Under these proposals, the CGT uplift on death would also be abolished and replaced with a form of holdover relief - such that the donee effectively inherits the base cost of the asset from the donor. The OTS report estimated that if no exemption was given for a principal private residence, abolishing the tax-free uplift on death would raise £2.8 billion in tax annually.

The report also suggests a change to how trusts pay inheritance tax - with an annual charge for discretionary trusts and a move back to the previous position for interest in possession trusts, where the property of the trust is treated as forming part of the individual’s estate. It also suggests that trusts set up by non-UK domiciled individuals should be subject to the annual tax once the individual has been resident for 10 out of the previous 15 years.

Which way now?

The new Chancellor undoubtedly has a decision to make on the future of inheritance tax. Does he accept the OTS more limited recommendations to reform the existing inheritance tax regime, or does he take a more radical approach and rethink the system - either as a gift tax or as a reformed estate tax like that envisaged by the APPG. A way forward may be a tinkering first (along the lines suggested by the OTS) and a consultation on more wide-ranging changes to be considered later on.

What does seem clear is that the existing system is poorly understood and unpopular with taxpayers. Furthermore, the funds raised by the existing system are small and the tax applies only to a small minority of taxpayers. The more major reforms proposed would be likely to increase the proportion of the population subject to some form of inheritance/gift tax and such a move may not find much favour with voters. Even with the Government's large majority, the Chancellor may be unwilling to take on the challenges of major reform at this stage.

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