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Briefing document

Inheritance tax – Office of Tax Simplification review

Introduction

On 5 July 2019 the Office of Tax Simplification (OTS) published its second report containing suggested reforms to Inheritance Tax (IHT). The first report contained largely administrative suggestions whereas the second report contained wider ranging suggestions for reform.

The OTS made recommendations in several areas. It views these changes as interconnected, due to the potential knock-on effects of making them, and therefore grouped its recommendations into packages; i) lifetime giving, ii) interaction with Capital Gains Tax (CGT) and iii) businesses and farms.

Implementing the OTS' recommendations

The OTS is an independent office of HM Treasury, which gives independent advice to the government on simplifying the UK tax system. The OTS does not set policy, though the OTS report does contain data that the OTS considers may *"inform this important wider [policy] debate".*

The IHT review was conducted at Former Chancellor Phillip Hammond's request. The OTS' recommendations may be taken into account by the government, which could in turn choose to legislate none, some or all of the OTS' recommendations. On 23 March 2021 the Right Honourable Jesse Norman MP, Financial Secretary to the Treasury, wrote to the OTS on behalf of Chancellor Rishi Sunak and commented that the government will respond to the recommendations the OTS made in its second report "*in due course*."

Lifetime gifts

Exemptions

At present, gifts made in the seven years before death are taken into account when determining the amount of IHT payable on an individual's death. However certain gifts made within this period are exempt whether or not the donor lives for seven years after the death. Changes are proposed to these exemptions, as set out below.

<u>Normal expenditure out of income</u>
The OTS recommended that this exemption be reformed or replaced.

The existing exemption provides an immediate exemption from IHT (there is no minimum period over which the individual must survive in order for the gift to be tax-free) on an unlimited amount of income given away as part of a settled pattern of normal expenditure, providing this leaves sufficient income to maintain the donor's standard of living. The OTS suggested removing the requirement for gifts to be 'regular' in order for the exemption to apply and possibly capping the amount of relief at a percentage of an individual's income. Alternatively, the OTS suggested including the exemption in a single personal gifts allowance (see below).

<u>Annual exemption and gifts in consideration of marriage</u>
The annual exemption provides an immediate exemption for gifts of up to £3,000 per annum which are not already exempt under the small gifts exemption (see below). The previous year's annual exemption can be used if not used in the previous year, which means that up to £6,000 could be eligible for exemption due to the annual exemption in a given year. The marriage exemption applies to gifts on marriage of up to £5,000, depending on the relationship between donor and donee.

The OTS suggested that these exemptions should be replaced with a single personal gifts allowance for each year with no rollover of unused amounts. The OTS did not suggest a figure for the allowance, though did suggest that inflation should be taken into account. It is notable that the annual exemption has not increased since 1981 and the marriage exemption has not increased since 1975. By way of illustration, had the £3,000 annual exemption increased in line with inflation, the OTS calculated that in the 2019/20 tax year it would be £11,900.

Small gifts exemption
The OTS noted that the exemption for small gifts to individuals which provides for an immediate exemption for gifts of up to £250 per recipient individual per annum is useful, though again commented that this limit has not increased in line with inflation. Had it done so, it would have been £1,010 per annum in 2019.

The cost of the Exchequer of increasing this exemption in line with inflation would be minimal (less than £100,000 per annum, compared to total IHT receipts of £5.2billion in 2017/18, per figures included in the OTS' first report on IHT simplification).

Gifting period and taper
At present, gifts made in the seven years before death are taken into account when determining the amount of IHT payable. The OTS recommended that this seven year period be reduced to five years, to ease the administration necessary to ascertain more distant gifts. It also recommended the abolition of IHT taper relief which reduces the IHT payable on gifts made in the three to seven years before an individual's death.

Furthermore, the OTS noted that the '14 year rule' should be abolished. This is relevant where gifts have been made into trust during a person's lifetime, followed by a gift to an individual within seven years of death, and means that gifts made in the fourteen years before an individual's death need to be taken into account in some circumstances.

IHT on lifetime gifts
The OTS recommended that the government should consider simplifying and clarifying the rules concerning who is liable to pay IHT due on lifetime gifts and the allocation of the nil rate band to lifetime gifts.

The current system is that, unless the deceased's will otherwise specifies, in cases where the value of lifetime gifts is sufficiently high that IHT is due on an individual's death (bearing in mind that the £325,000 nil rate band is offset against lifetime gifts in priority to the death estate), it is the recipient of the lifetime gift who has primary liability to pay the IHT due. The executors to the estate become jointly liable if the IHT due is not paid within 12 months of the individual's death, in which case the IHT due is paid out of the assets in the estate, the post-tax amount of which may, depending on the terms of the will, be payable to other parties.

The OTS suggested this system should be reformed, and instead 1) any IHT due on lifetime gifts to individuals should be payable by the estate and 2) instead of being allocated to lifetime gifts in chronological order, oldest first, the nil rate band should be applied proportionately across all lifetime gifts. As now, any nil rate band not offset against lifetime gifts would then be available to the death estate.

Alternatively, the OTS suggested an amendment to the existing system, such that, if HMRC have been unable to collect the IHT due from a gift recipient, the executors should only be liable to pay IHT due on lifetime gifts to individuals up to the value of assets handled by the executors which would be distributed to the same individual(s) who received the lifetime gift.

Interaction with CGT
At present, when an individual dies the value of their assets is rebased to market value on the date of death. Broadly, the executors to the estate, or individuals to whom the asset(s) is distributed, have a base cost for CGT purposes equal to the market value of the asset on death (known as probate value). On any eventual disposal of the asset CGT is payable, or losses can be claimed, based on movement from probate value.

This tax-free uplift to the base cost of assets for CGT purposes applies whether or not IHT is payable on death. For example, bequests to spouses may be exempt (depending on domicile) and bequests of eligible business property may be fully relievable, such that no IHT is payable on death. The OTS recommended that this CGT uplift should be removed if no IHT is payable, such that the person who inherits the asset has a base cost for CGT purposes equal to the historic base cost of the deceased. CGT would then be payable (or a loss claimable) on an eventual disposal by the beneficiary. Consideration would need to be given to the position where an asset is only partially exempt or relievable.

Businesses and farms
Business / trading activity
Business Property Relief (BPR) can provide up to 100% relief from IHT, provided the asset on which IHT would otherwise be payable is a business asset. For BPR purposes, this is based on a 50% test (e.g. where unquoted shares are held, more than half of the company's activities must be business activities). In other areas, such as entrepreneurs' relief, an 80% test applies. The OTS recommended that the trading activity tests for BPR and other areas of legislation, such as business asset disposal relief (formerly entrepreneurs' relief), should be aligned.

BPR is restricted in relation to assets which are not used for business purposes (excepted assets). The OTS did not comment on how the excepted assets rules would need to or should change if this reform were adopted.

Alternative Investment Market (AIM) shares
As noted, 100% BPR may be available on unquoted shares in companies carrying on a business. Shares listed on AIM are regarded as unquoted for this purpose. The OTS notes that this is at odds with the understood purpose of BPR, which is to prevent family companies being broken up on an individual's death. The OTS therefore recommended that the government consider whether or not AIM shares being eligible for BPR is within the scope of the policy intent of BPR, particularly where the shares are no longer held by the family or individuals who originally owned the business.

Indirect non-controlling shareholdings
The OTS recommended that the BPR position of non-controlling (less than 50%) shareholdings in trading companies where the balance of shares are held by a third party should be reviewed. If an individual holds shares directly in the trading company they may be eligible for BPR whereas if the minority shareholding is instead held by an intermediary holding company, BPR is unlikely to be available (on the basis the individual holds shares in an investment company). This fact pattern may occur in, for example, joint ventures.

The OTS recommended that this point should be reviewed, to ensure that using a holding company structure does not inappropriately affect the scope of relief.

Limited Liability Partnerships (LLPs)
In general, LLPs are treated as transparent for tax purposes, such that, broadly, the partners are treated as carrying on the underlying activity personally. While BPR may be available to partners with an interest in an LLP which is itself trading, BPR may be unavailable if the LLP is a holding entity (e.g. holding shares in unquoted trading companies – such holdings would typically be eligible for BPR if an individual either held the shares directly or held their interests in a holding company rather than a partnership). The OTS recommended that this be reviewed.

Furnished Holiday Lets (FHLs)
The FHL regime refers to residential property let for short-term holiday accommodation within specific limits. The BPR position of FHLs depends on the specific facts of each case but, generally, FHLs are unlikely to be eligible for BPR unless services are provided as well as the property itself. This contrasts with the income tax and CGT position of FHLs, which is that FHLs are generally treated as trading assets. The OTS recommended that the government consider whether it would be appropriate to align the BPR position of FHLs with their income tax and CGT position.

Farmhouses
Agricultural Property Relief (APR) may be available on farmhouses which are occupied as part of the farming activities. The OTS noted that the APR position can be uncertain, particularly where a farmer moves out of the farmhouse in order to receive medical treatment or go into care. The OTS therefore recommended that this area be reviewed.

Valuations
The OTS also recommended that clarity should be provided as to when a valuation of agricultural or business assets is required and, where this is the case, whether the valuation needs to be formal or if it can be informal (the latter not requiring the appointment of professional valuers).

Insurance
Payments on term life assurance policies are exempt if the policy is written in trust, but are part of the death estate if the policy is not so written. The OTS recommended that the government should consider ensuring that death benefit payments from term life insurance are IHT free on the death of the life assured without the need for them to be written in trust.

Pre-owned assets tax
Broadly, pre-owned assets tax applies an annual income tax charge where assets are given away in a way in which an individual continues to enjoy the donated asset, but in a way which is not within the scope of the gift with reservation of benefit rules (which mean that a donated asset remains within the donor's estate while the donor continues to enjoy the asset they have given away). The OTS noted that the pre-owned assets tax rules are complicated anti-avoidance rules, and suggested that the government review whether the rules function as intended and are still necessary.

More time needed
The OTS noted that they received more comments about the recently introduced Residence Nil Rate Band (RNRB) than any other matter. The RNRB is relevant, broadly, when individuals bequeath their home to their direct descendants. The OTS comment that "*The [RNRB] is too complex and people struggle to understand it*" and that "*even some solicitors choose not to advise clients about the [RNRB] because it is so complicated*". The OTS considered several possible alternatives, but ultimately conclude that more time is needed to evaluate the RNRB's effectiveness before simplification recommendations can be made.

The OTS also touched on the 36% IHT rate that applies where at least 10% of an individual's estate is left to charity, but, as with the RNRB, considered that further time is needed to evaluate its effectiveness before simplification recommendations can be made.

The OTS also published various comments that they received in the context of trusts but, as HMRC closed a consultation on this point in early 2019 and at the time of the writing were considering the responses they received, the OTS did not make any recommendations on reform of trust taxation in their second IHT simplification report.

HMRC published their response to the trust consultation on 23 March 2021 and commented that the responses they received "*did not indicate a desire for a comprehensive reform of trusts at this stage*." HMRC added "*The government will keep the issues raised under review to ensure that its long-term approach to the taxation of trusts meets its objectives. In the shorter term, the government will continue to review specific areas of trust taxation on a case-by-case basis…*"

Finally, the OTS commented on the fact that cohabiting couples and siblings cannot benefit from the spouse exemption, which means that in some cases the survivor may need to sell a shared home in order to pay the IHT due. The OTS did not make any recommendations in this regard, since any such recommendations would most naturally form part of a wider response to social change, rather than being driven primarily by IHT considerations.

Find out more…

This note reflects the law in force as at 26 March 2021 and in particular comments on the report published on the Office of Tax Simplification on 5 July 2019 entitled "Inheritance Tax Review – second report: Simplifying the design of Inheritance Tax" which can be viewed at https://deloi.tt/2S8IOsY. Please be aware that it does not cover all aspects of this subject. To find out more about any aspect of the above, please discuss with your usual Deloitte contact. If you do not have a usual contact, please contact Michelle Robinson (michellerobinson@deloitte.co.uk). For further information visit our website at www.deloitte.co.uk.