

Simplifying the design of IHT

(Lectures P1153/1154 – 19.32/15.00 minutes)

Introduction

As part of their review of IHT, following a wide-ranging consultation project, the Office of Tax Simplification (OTS) have now published their second report on the tax. This 103-page report focuses on substantive aspects of the design of IHT, with particular reference to the main reliefs. It follows an earlier report issued in November 2018 which examined the administrative aspects of the tax.

The aim of this latest report is summarised by the OTS as follows:

‘It is surely a fundamental requirement for the legitimacy of a tax that its framework should be reasonably clear to the majority of those potentially liable to it.

The OTS’s extensive consultation exercise revealed many areas where IHT is either poorly understood, counter-intuitive, requires substantial record-keeping, creates distortions or where the application of the law is simply unclear.’

The OTS make nine principal recommendations in their report. These concentrate on three key areas of IHT:

1. Lifetime gifts, including the liability for paying any tax due on such gifts;
2. The interaction with CGT; and
3. Businesses and farming activities.

Lifetime gifts

The first three chapters of the report deal with the treatment of gifts made during a person’s life and the correlation of such gifts with those made on death under the deceased’s will.

The OTS are aware that the present array of IHT gift exemptions is complex and creates unnecessary confusion. For example, there are several monetary thresholds to be considered and each applies in a slightly different way. Another concern is that the exemption for regular gifts from disposable after-tax income can require detailed record-keeping and the scope of the exemption is sometimes disputed.

Their first recommendation (Recommendation 1) is that the Government should:

- replace the annual exemption of £3,000 and the various exemptions for gifts in consideration of marriage (or civil partnership) with an overall personal gifts allowance which would operate on a yearly basis;
- review the level of the small gifts exemption (the OTS suggestion is to increase the limit from £250 to £1,000 per donee); and
- reform the exemption for normal expenditure out of income by removing the need for the expenditure to be 'regular' and possibly limiting the quantum of the relief to a fixed percentage of the donor's income (alternatively, the exemption could be abolished and replaced by a higher annual personal gifts allowance which would cover gifts made out of both income and capital).

Consultation responses to the OTS indicated that the current seven-year period during which a lifetime gift may become subject to IHT is too long. It can be difficult for personal representatives to obtain records going back that far and it is understood that the latter part of this seven-year period raises very little tax. The record-keeping problem is even greater for individuals who have made gifts into trust where the relevant period can sometimes be as long as 14 years – for example, when working out how much tax is payable on a gift to an inter vivos settlement (which could have been made nearly seven years before the settlor's death), it is necessary to take into account any chargeable lifetime transfers made by the same individual during the seven years prior to the creation of that settlement.

The seven-year period requires substantial amounts of record-keeping, but in fact does not give rise to much tax. An additional complication is that the rate of IHT on chargeable gifts made more than three years before death is reduced by way of a special taper relief. However, it is known that the operation of the IHT taper is widely misunderstood. Most people do not appreciate that this taper is only relevant for taxpayers who make large lifetime gifts totalling more than the nil rate band – it is a relief of tax, and not a relief of value.

Recommendation 2 is that the Government should:

- (i) reduce the seven-year period to five years so that gifts to individuals made more than five years before the donor's death are IHT-exempt; and
- (ii) abolish taper relief.

Recommendation 3 is that the Government should dispense with the '14-year rule' referred to above.

In their document, the OTS set out two alternative means of changing the way in which the tax operates:

1. on lifetime gifts to individuals; and
2. on chargeable lifetime transfers such as gifts into trust.

They address various issues where aggregate taxable gifts exceed the transferor's nil rate band. Of the two alternatives set out, the most practicable idea is what the OTS call the 'reform option'. This suggests that any IHT due in relation to lifetime gifts to individuals should generally be payable out the estate (and not by the donee) and that the nil rate band should no longer be allocated to lifetime gifts in chronological order but rather should first be allocated pro rata across the total value of all the deceased's taxable lifetime gifts, with the remainder (if any) then being available to the death estate.

Recommendation 4 is that the Government should explore options for simplifying and clarifying the rules dealing with:

- the payment of tax liabilities for lifetime gifts to individuals; and
- the allocation of the deceased's nil rate band.

Interaction with CGT

The scope of this review specifically included looking at the interaction of the tax with CGT and the OTS's conclusion was that the interaction is indeed complex and can certainly distort decision-making. It should be borne in mind that there is normally no CGT charge on death. For CGT purposes, the person inheriting an asset is treated as having acquired it at its market value on the date of death rather than at the amount originally paid for it. This situation is referred to as the 'tax-free uplift on death' and it means that an asset can be sold shortly after death without any CGT being due. Where an asset is exempted or relieved from IHT (e.g. because it passes to a spouse or represents relevant business property), it can be sold shortly after death without either IHT or CGT being payable. With reference to this latter point, the OTS make the following comment:

'This can put people off passing on assets to the next generation during their lifetime. It distorts and can complicate the decision-making process around passing on assets to the next generation. The OTS have concluded that this distortion would be best addressed by amending the CGT rules rather than changing IHT.'

Recommendation 5 is that, where a relief or exemption from IHT applies in connection with a death estate, the Government should consider removing the tax-free uplift on death and instead provide that the recipient is treated as acquiring the asset at the historic base cost of the person who has died.

Businesses and farming activities

Trading businesses and farming assets typically qualify for full relief from IHT under the business and agricultural relief provisions. Business relief also extends to the shares of most companies traded on AIM. It is understood that the policy rationale for business and agricultural relief is to prevent the sale or break-up of businesses and farms that might otherwise be necessary in order to finance the payment of IHT following an owner's death.

The IHT requirements about the level of trading activity needed to qualify for business relief are different from the comparable conditions for the main CGT reliefs relating to the disposal of businesses (e.g. entrepreneurs' relief and holdover relief).

As the OTS point out:

‘It is unclear why there are different tests for different tax reliefs relating to the same business, potentially distorting decision-making between transferring a business during one’s lifetime or on death. It could simplify decision-making about when to hand assets on to the next generation if the tests were standardised.’

Indirect non-controlling shareholdings in trading companies are another area where complexities in the application of business relief were identified. Two aspects may be problematic from an IHT perspective:

1. joint venture structures; and
2. arrangements where a corporate trading group has an LLP rather than a company as its holding vehicle.

Furnished holiday lettings are not treated consistently because, unlike other sources of income relating to residential property, they are deemed to be trading entities for income tax and CGT purposes but are not regarded as carrying on a trading activity for IHT – however, in this situation, see the interesting decision in *Graham v HMRC* (2018).

Recommendation 6 is that the Government should:

- consider whether it continues to be appropriate for the level of trading activity for business relief under IHT to be set at a lower level than for the CGT reliefs;
- review the treatment of indirect non-controlling holdings in trading companies in the context of many modern joint venture structures; and
- decide whether to align the IHT treatment of furnished holiday lettings with the income tax and CGT rules which treat such arrangements as trading provided that certain requirements set out in ITTOIA 2005 are met.

Recommendation 7 is that the Government should review the treatment of LLPs to ensure that they are treated appropriately for the purposes of the business relief trading requirement.

Finally, there are two areas of HMRC guidance or practice that would benefit from legislative change covering cases where:

- a farmer has to leave his farmhouse for medical treatment or to go into care; and
- valuations of businesses or farms are needed.

Questions of valuation will become rather more important if the Government decide to increase the level of trading activity needed to qualify for business relief, given that a greater number of business will then become subject to IHT.

Recommendation 8 is that HMRC should review their current approach around the eligibility of farmhouses for agricultural relief purposes, particularly in sensitive cases such as where the farmer needs to leave the farmhouse for medical treatment or to go into care.

Recommendation 9 is that HMRC should be clearer in their guidance as to when a valuation of a business or a farm is required and, if it is required, whether this should be a formal valuation or merely an estimate.

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