DIXON WILSON
CHARTERED ACCOUNTANTS

IHT – OTS second report

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BACKGROUND

The Office of Tax Simplification (OTS) recently published its second report on inheritance tax. The first review was published in autumn 2018 and focussed on administration of the tax. The second review concentrates on the application of inheritance tax reliefs and other technical aspects. The government has not yet responded to the report so it is unclear if any of the recommendations will be implemented but it provides an indication of changes that could be made in future. A summary of the main recommendations is outlined below.

LIFETIME GIFTS

The existing regime exempts gifts from being chargeable to inheritance tax if they are made more than 7 years before the donor's death. Despite this rule there are some circumstances where gifts made in the 14 years before death can have an impact on the inheritance tax payable. These can arise when an individual makes gifts into trust followed by gifts to individuals.

The report highlights the administrative burden placed on executors who have to identify gifts made by the donor over a 14-year period and also the small proportion of inheritance tax payable on gifts made over 5 years before death.

The report recommends reducing the scope of inheritance tax on lifetime gifts to include only gifts made in the 5 years before the donor's death. Any gifts made outside this period would not be considered when calculating the inheritance tax payable.

The report also argues the application of taper relief, which seeks to reduce the tax paid on gifts made between 3 and 7 years before death, is not well understood and introduces unnecessary confusion. The report recommends that taper relief be abolished despite this introducing a "cliff edge" into the tax system. This could result in an increase in the inheritance tax charge paid by estates when gifts were made between 3 and 5 years before the date of death, but if combined with a reduction in the exempt period from 7 to 5 years may provide a fair compromise.

EXEMPTION FOR LIFETIME GIFTS

The current inheritance tax rules provide several different exemptions from inheritance tax for gifts made by a donor during their lifetime. Where gifts qualify for an exemption they are not subject to inheritance tax on the donor's death.

The report argues that the range of different exemptions and their interaction was confusing. It recommends that some of these reliefs should be simplified by replacing the annual gift exemption and the exemption for gifts made on occasion of marriage into a single annual personal gift allowance. It suggests the level of this allowance and of the small gift allowance should both be increased to reflect inflation since the current thresholds were set in the early 1980s.

The OTS also recommends that the exemption for normal expenditure out of income should be reformed. It argued this relief is poorly understood, there is a lack of clarity regarding its application and the record-keeping requirements it entails are too burdensome. It suggests this exemption could be reformed by removing the requirement for a gift to be "regular" but introducing an annual cap on the exemption based on a percentage of an individual's taxable income. An alternative suggestion made was to abolish this exemption and replace it with a higher annual allowance for gifts.

The exemption for normal expenditure out of income can be very valuable for the estates of individuals with high levels of surplus income. Any change to limit or abolish this relief could result in increased inheritance tax exposure for some estates.

INTERACTION WITH CAPITAL GAINS TAX (CGT)

The report examines the interaction between CGT and inheritance tax, which are both taxes on capital. Under current rules, chargeable assets that are inherited on death are treated as being acquired by the beneficiaries at their probate value. This often results in a capital gains uplift for the recipient by reducing the amount of CGT payable on any subsequent sale.

The report recommends that where no inheritance tax is payable assets should be inherited on a "no gain, no loss" basis and should not benefit from any capital gains tax uplift. This would mirror the tax treatment applied when business assets are gifted during the donor's lifetime and gift hold-over relief is claimed. The report argues this would remove the current disincentive to making lifetime gifts of business assets, which do not benefit from capital gains tax uplift.

If implemented, this change could remove the benefit of common tax planning strategies such as leaving chargeable assets to a spouse in order to benefit from capital gains uplift.

BUSINESSES AND FARMS

The current inheritance tax rules allow business property relief (BPR) to be claimed when the activities of an entity are wholly or mainly trading in nature, which is generally taken to mean more than 50%. The report suggests the rules for BPR be aligned with the rules for CGT gift hold-over relief and entrepreneurs' relief, which generally require trading activities to be greater than 80%. This would mean BPR would only be available if the activities were more substantially trading in nature. If implemented, this would mean BPR would no longer be available for companies, estates and partnerships which included significant non-trading activities. This would have a particular impact on businesses which are greater than 50% trading but with significant non-trading assets included and on which relief is currently claimed.

The report also suggested a change to the availability of BPR for Furnished Holiday Lets (FHL). HMRC have been successful in recent tax cases at severely restricting the ability to claim for BPR for FHLs. The OTS recommends the inheritance tax treatment of FHLs be aligned with their income tax treatment, which would make more FHLs eligible for BPR.

OTHER RECOMMENDATIONS RELATING TO APR AND BPR

The other recommendations made by the report seek to address inconsistencies and anomalies within the current rules, including:

- Reviewing the treatment of indirect non-controlling holdings in trading companies. These are currently treated as investments and are not eligible for BPR despite the underlying company being trading.
- Review the treatment of Limited Liability Partnerships (LLPs) to make sure they are treated appropriately for the purposes of BPR. In some cases BPR may not be available to LLPs undertaking the same activities as a company.
- Further consider the eligibility of farmhouses for APR where the farmer needs to leave for medical treatment or social care. The report suggests HMRC should publish guidance to provide clarity in this area, which is currently judged on a case-by-case basis.
- Suggesting that HMRC produce guidance on when a valuation of a business or a farm is required and whether this needs to be a formal valuation or just an estimate. It is currently unclear whether this is required where BPR or APR is being claimed.

OTHER RECOMMENDATIONS

The report also made several further recommendations, including:

- That the rules on liability for the payment of tax on lifetime gifts to individuals be simplified and clarified, for example by all tax being payable by the estate and the nil rate band being allocated to gifts pro-rata rather than chronologically.
- That death benefit payments from term life insurance be exempt from inheritance tax on death. This would align with the current inheritance tax treatment for policies that are written into trust.
- That HMRC provide detailed guidance regarding what transfers between pension funds would constitute a gratuitous benefit that would potentially be subject to inheritance tax.
- That the current anti-avoidance provisions for pre-owned assets charged to income tax should be reviewed to determine whether they are still necessary given the complexity for taxpayers in applying these rules.

The report outlined many concerns regarding the additional complexity created by the introduction of both the residence nil rate band and the 36% rate for estates making sufficient charitable donations. It did not make any recommendations of changes in these areas given how recently they have been introduced.

The OTS also briefly commented on the inheritance tax treatment of trusts. It did not make any recommendations because HMRC are currently conducting a wider consultation into these rules.

The report suggested that if any of its recommendations were implemented that they should apply for deaths from a specific date onwards and advised against introducing transitional arrangements, which would add further complexity to the rules.

DIXON WILSON
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Dixon Wilson
22 Chancery Lane
London
WC2A 1LS

T: +44 (0)20 7680 8100
F: +44 (0)20 7680 8101
DX: 51 LDE

www.dixonwilson.com
dw@dixonwilson.co.uk