OTS recommendations on Inheritance Tax

The OTS has published its second (and somewhat more interesting) report to the Government on measures to simplify inheritance tax (IHT). As you will see, while some of their recommendations represent simplification it is difficult to argue that some do not actually create complexity. Indeed, one is about capital gains tax (CGT) and not IHT – while several others might start alarm bells ringing for some taxpayers.

Recommendation 1

The government should, as a package:

- replace the annual gift exemption and the exemption for gifts in consideration of marriage or civil partnership with an overall personal gifts allowance;
- consider the level of this allowance and reconsider the level of the small gifts exemption;
- reform the exemption for normal expenditure out of income or replace it with a higher gift allowance.

Comment:

There are a number of different annual gift allowances, which creates confusion, and some have not increased in value for over 30 years. It makes sense to tidy these up. HMRC had concerns that those with high incomes could make substantial "gifts from income" (which are exempt) and save considerable amounts of IHT. Effectively the suggestion here is to have fewer allowances, but of greater value, benefitting the "average" person, but reducing the relief available to those on higher incomes. Certainly, this package should simplify the position somewhat.

Recommendation 2

The government should, as a package:

- reduce the 7 year period to 5 years, so that gifts to individuals made more than 5 years before death are exempt from Inheritance Tax, and
- abolish taper relief

Comment:

Reducing the period that an individual has to survive after making a gift in order for it to fall outside of their estate would certainly simplify matters – not least as there is two years' less information to be retained. Taper relief was not well understood and, in any event, only applied to lifetime gifts in excess of the nil rate band (£325,000). It will not be missed by many.

Recommendation 3

The government should remove the need to take account of gifts made outside of the 7 year period when calculating the Inheritance Tax due (under what is known as the "14 year rule").

Comment:
This is a technical point that could potentially impact those who create a trust and then, within 7 years of that, make a potentially exempt gift to an individual and die within 7 years of that later gift. The creation of the trust will impact the tax that becomes due on the gift to the individual, even though the trust was set up more than 7 years before death.

Certainly, removing this legislation would simplify matters and is unlikely to have much of an impact on the tax take.

Recommendation 4

The government should explore options for simplifying and clarifying the rules on liability for the payment of tax on lifetime gifts to individuals and the allocation of the nil rate band.

Comment:
There are two points here – and only one is simplification.

Clarifying the rules as to who is liable for tax which becomes due on a gift to an individual (because the donor did not survive 7 years) would be helpful. Few gift recipients realise that they are liable in the first instance.

The allocation of the nil rate band is actually already very simple, it is merely allocated to the earliest gift. That does, however, create "unfair" situations as the person who receives the first gift will get the full nil rate band allocated to it and possibly pay no tax, whereas the next gift recipient will be taxable in full.

While I welcome the logic and "fairness" of this recommendation, it appears to have little to do with simplification.

Recommendation 5

Where a relief or exemption from Inheritance Tax applies, the government should consider removing the capital gains uplift and instead provide that the recipient is treated as acquiring the assets at the historic base cost of the person who has died.

Comment:
And this is just adding complexity. Currently there is no CGT on death and all values are uplifted. While this is very simple the OTS appear to have taken offence to the fact that an individual inheriting an asset which benefitted from a relief (and therefore had no IHT liability) could immediately sell it and pay no CGT on sale because the value has just been uplifted.

Again, while there is a logic behind this proposal, it is very difficult to see the simplification. As things stand there is no need to consider the CGT position on death and no need to retain historic information. If the uplift were to be removed where a relief has restricted the IHT liability there would not only be some complex legislation needed (e.g. what if there was only partial IHT relief?) as to which assets do not get the uplift, but also records of base costs of assets might need to be passed on from generation to generation until an asset is sold.

Recommendation 6

The government should, as a package:

- consider whether it continues to be appropriate for the level of trading activity for BPR to be set at a lower level than that for gift holdover relief or entrepreneurs' relief;
- review the treatment of indirect non-controlling holdings in trading companies, and
- consider whether to align the Inheritance Tax treatment of furnished holiday lets (FHLs) with that of Income Tax and Capital Gains Tax, where they are treated as trading providing that certain conditions are met.

Comment:

While the middle bullet point is something of a technical issue, the other two are of rather greater impact.

The qualification for a business to qualify as "trading" for CGT purposes is that 80% of "what it does" must be trading. In order to qualify for IHT business property relief a business needs to be "mainly" (more than 50%) trading. On the basis that the Chancellor is unlikely to make it easier for individuals to get CGT reliefs, aligning the two would presumably mean that the threshold to obtain business property relief would increase to 80%.

My immediate reaction is that this could lead to a complete loss of business property relief for many farms and agricultural estates which have diversified and obtain, for example, rental income from unused farm buildings and cottages or solar panels.

The test for the 50/80% qualification level looks at the business activities "in the round" – taking account of income, profit, asset values and time spent . However, we know that many businesses, particularly in the agricultural sector) have been striving to qualify under the 50% test – clearly they will face issues if the target now moves to 80%.

The IHT treatment of FHLs has been the subject of much disagreement in recent years and the subject matter of a number of tribunal decisions. Certainly, some clarity is needed. There is sense in aligning the treatment of IHT, income tax and CGT for these properties, but I would not be optimistic this would get Government approval. That said, the OTS recommendations would likely boost tax revenues considerably there would be some scope for a "giveaway".

Recommendation 7

The government should review the treatment of limited liability partnerships to ensure they are treated appropriately for the purposes of the BPR trading requirement.

Comment:

A technical point to put LLPs on the same footing as other trading entities as regards IHT. It would amount to a simplification on the basis that logic dictates that there is no reason to treat LLPs differently so the inconsistent treatment does cause confusion.

Recommendation 8

HMRC should review their current approach around the eligibility of farmhouses for APR in sensitive cases, such as where a farmer needs to leave the farmhouse for medical treatment or to go into care.

Comment:

The proposal is to have more certainty from HMRC as to when a farmhouse would cease to qualify as such for APR purposes if the owner is forced to leave – for example to go into care or to have medical treatment.

Greater certainty on this point would certainly be useful as the issue has proved troublesome for professionals advising in this unfortunate, but increasingly common, situation.

Recommendation 9

HMRC should be clear in their guidance as to when a valuation of a business or farm is required and, if it is required, whether this needs to be a formal valuation or an estimate.

Comment:

Formal valuations can be expensive, particularly if there is a substantial estate to be valued. Therefore, if a relief (e.g BPR or APR) is to be claimed that will reduce the taxable value to nil, is there a need to pay for full valuations? Clear guidance would certainly simplify the position.

Recommendation 10

The government should consider ensuring that death benefit payments from term life insurance are Inheritance Tax free on the death of the life assured without the need for them to be written in trust.

Comment:

This would represent a very useful simplification. If an individual takes out a life insurance policy to pay out on their death then it is best to write this in trust in order to ensure that the policy pay-out on death does not get included within the deceased's estate and taxed to IHT. Legislation taking such policy payments outside of the deceased's estate would not only simplify the position but would be a win-win for a Government that is looking to introduce new legislation that will see all trusts having to register online and is looking at massive non-compliance from those with such policies who are unlikely to realise they have a requirement to register.

Recommendation 11

The government should review the Pre-owned Asset (POAT) rules and their interaction with other Inheritance Tax anti-avoidance legislation to consider whether they function as intended and whether they are still necessary.

Comment:

POAT was an "overkill" reaction to tax avoidance issue that, while it dealt with the avoidance, also created issues in a number of innocent situations. It is arguable that to the extent it originally worked as intended, it is no longer needed as other legislative changes mean the avoidance that was taking place is now blocked anyway. If the rules are no longer needed there would be a considerable simplification if they could be removed. POAT is a complex tax to get to grips with and it is likely that a number of people who are caught within its framework have no idea that it applies to them.

Overview:

There are measures above that represent real simplification and are likely to have only a marginal impact on the net tax position.

But, there are also measures in here that are likely to represent a considerable tax hike for the Government – in particular;

- the removal of the capital gains tax uplift on death where a relief has applied such that no IHT was due;
- the increase (to 80%+) in the threshold for a business to be trading in order to qualify for BPR.

Against this there are some measures that would result in less IHT being due, for example:

- allowing all furnished holiday lets to qualify for BPR;
- a reduction from 7 years to 5 years for the period required for a gift to fall outside of the estate.

The Chancellor is in the happy position of, if he so wishes, being able to accept some simplification measures that can be dressed as a "giveaway" while knowing that accepting others will increase the overall tax take considerably.

We are, of course, happy to talk through and offer advice as necessary. Please speak to your usual Ensors contact or Danny Clifford on 01473 220083 or danny.clifford@ensors.co.uk