OFFICE OF TAX SIMPLIFICATION REPORT ON IHT ISSUED

A view from Rachael Griffin, Head of Trusts & Technical Solutions.

The long-awaited **report** published by the Office of Tax Simplification (OTS), outlining proposals to simplify the UK's inheritance tax (IHT) system has finally been published. This article takes a look at the key proposals and the potential impact they could have.

Simplification was the name of the game for this report, which is certainly a welcome goal. However, further tinkering to the system may do just the opposite. Before the Government jumps feet first into making these changes, they need to step back and reflect on the purpose and vision of inheritance tax.

If its purpose is to tax people based on how much wealth they have then the research is pointing to the necessity of reform. However, there needs to be proportionate reform. IHT makes up less than 1% of the total raised by the Exchequer and so would cover just one week's worth of the cost of tax relief on pensions. It's undeniably an issue, but Government clearly has bigger and more expensive fish to fry, so we may be waiting a while longer for any meaningful changes to take effect.

1. Gifting allowance

The current annual gifting allowances are no longer fit for purpose, having remained frozen at the same rate since the early 1980s. While the Office of Tax Simplification (OTS) has observed they are outdated and acknowledges a need to increase them, they've ducked pinpointing the figure. They've merely highlighted what it would be if it was in line with inflation.

Today's personal annual gifting limit of £3,000 doesn't go far, while the buying power of nearly £12,000, which is what it would be had it risen in line with inflation, could make the difference when it comes to paying school fees or putting down a deposit on a house.

There is no way to avoid inflation in day to day life – it eats away at our savings; it increases the cost of daily expenses and much more. Bringing the gifting allowance in line with the modern day is a no-brainer and will help to increase the flow of money through generations.

2. Lifetime gifting - potentially exempt transfers (PETs)

Lifetime gifting is a clear area of complexity. The interplay of surviving seven years or your loved ones having to navigate how taper relief may or may not apply, depending on whether the nil rate band had been utilised, is ripe for reform.

The OTS recommends reducing the timespan for PETs from seven to five years. On the face of it this appears beneficial. The OTS identified that gifts made beyond five years pay little IHT due to the effect of taper relief but are adversely impacted because the gifts reduce the nil rate band available and so in general increase the IHT paid by estates.

One of the most complicated areas of the gifting policy is: what happens when someone who has been given a gift that was potentially exempt now has IHT to pay?

The OTS has acknowledged there are significant challenges with the current system. It currently means the recipient of the gift will have some of it clawed back. This is complex in terms of administration, and many people gifting or receiving the gift may not be aware of the rules. The OTS has recommended, sensibly, that this should instead be paid from the estate.

They also suggest changes to the way the nil rate band is applied to such gifts. At the moment when an estate is added up it works chronologically, starting from seven years prior to death. That means gifts made in the seven years prior to death use up the nil rate band of £325,000 before the rest of the estate has been considered.

If you have already used your nil rate band of £325,000 – through gifts or otherwise – and you continue to gift above this allowance, then die within seven years, how much tax has to be paid depends on a tiered structure linked to when you die.

This is as clear as mud to most people and so simplification is both welcome and sensible.

However, the OTS also recommends removing the taper relief which, while complicated and confusing, does have its place as it reduces the amount of tax people pay depending on how long they lived. The real problem with the taper rule is how it interacts with the nil rate band. Removing the taper seems like an extreme response to the problem which introduces a cliff edge and increases tax. Simplification should not equal an increase in tax.

3. Lifetime gifting - normal expenditure out of income

The OTS raised a number of issues with the 'normal expenditure out of income' rule (which allows individuals to gift excess income free of IHT). As there is no statutory definition of the terms of the allowance, it creates a grey area around which gifts qualify, making it hard to claim and requiring good record keeping.

One of the OTS's recommendations is to completely scrap the exemption and have it and other exemptions replaced with a single annual gifting allowance. On the face of it, this seems like a double win, with a larger, simpler allowance. However, the reality could be very different.

Whilst normal expenditure out of income wasn't well understood, it was hugely beneficial. It allowed people to gift as much as they wanted as long as it was out of their regular income – a threshold would obviously cap this exemption. This may not encourage the flow of wealth through the generations and may do the exact opposite by limiting it.

4. Getting rid of the capital gains tax (CGT) uplift

The OTS suggests the Government should get rid of the CGT uplift on death. In other words if the person inheriting an asset sells it, they will be subject to CGT on any gains based on the asset's 'base cost' (the cost to the original owner) rather than the 'uplifted base cost' (which includes any gains made on the asset by the original owner before their death). This will drastically increase the number of people who inherit things they can't afford and means that someone who was responsible enough to buy a property, and hold on to it until death, will not be able to let their loved ones benefit fully from the growth of that property.

Again, the rationale behind scrapping the CGT uplift seems sound in that the CGT uplift encourages people to hold onto assets until they die (rather than gifting during their lifetime), restricting the flow of assets through generations. However, changing the rules on CGT isn't the way to tackle this issue. If anything, it exacerbates intergenerational inequality.

5. Residence nil rate band (RNRB)

The main residence nil rate band was a prime area for simplification. The OTS report highlighted that even some solicitors choose not to advise clients on it due to its complexity.

The OTS took into consideration recommendations to scrap this complex allowance and increase the nil rate band. The report details calculations that show the cost savings of scrapping the RNRB would lead to a £51,000 increase to the nil rate band to £376,000. They calculate this would mean that 5,370 more estates would have paid IHT by 2023-2024 than if the residence nil rate band is left as is.

Increasing the nil rate band to £500,000 would have a dramatic effect and, if implemented today, would mean 34,400 fewer estates paying IHT by 2024. However, the Exchequer would have to stomach around £7.5 billion in costs. The Government should consider whether it can find some middle ground where it would cost them slightly more and impact the same number of people, so the public doesn't risk paying more tax than necessary due to the complexity of the rules.

The report notes that the RNRB was the most common topic of correspondence that the OTS received. They found that the rules place certain groups at a disadvantage including those who don't have children, elderly siblings who live and own a home together and those who don't own a home. The OTS to some extent wipes its hands of all this saying it is not an issue of simplification, but one of policy. But these issues can't be ignored and provide further rationale for reform.

6. Spousal exemptions

The OTS rightly understands that changing the definition of spouse to include a cohabiting partner or a sibling would be dramatic and not just impact inheritance tax but the whole tax landscape. While this may not be in scope for the OTS, it should be high on the Government's agenda and they should not shy away from tackling this societal issue.

Figures from the Office of National Statistics show that marriage rates remain at historical lows – in 1941 there were 471,000 marriages in the year compared to 243,000 in 2016 - a drop of nearly 50%. Tax rules no longer reflect the behaviours of the nation which mean that unmarried couples and their children are often treated unfairly and not afforded the same rights.

7. Pensions

Pensions are given a cursory nod in the OTS paper and they rightly call for pension rules to be amended so that no pension policies are subject to inheritance tax. At the moment there are older style pension plans which are written in a way that means they are subject to inheritance tax.

While the report is not explicit on the bizarre rules about pension transfers during ill health, it would be both simpler and just to remove the rule that anyone who transfers their pension in ill health and dies within two years could see the remainder of their pot taxed at 40%.

8. Death benefits from life insurance policies

The OTS has noted that there are many advantages to writing a life insurance policy in trust and many people don't do this. So, to simplify it, they are recommending that all death benefits are inheritance tax free regardless of being placed in trust.

This is welcome and of course ideal in the spirit of simplification. However, there remains the problem of probate. A trust means loved ones can benefit without waiting for the delays that probate brings and paying probate fees which, with the proposed steep fee rises, is going to be an increasing issue.

In general, when it comes to trusts the OTS took a light touch approach and noted the HMRC trust consultation will have a wider remit.

9. Anti-avoidance rules

Naturally we need a system of taxation that makes sure people pay what they owe and is also robust enough to penalise people who knowingly avoid tax. However, the current set of rules has so many layers that you need specialised knowledge to even come close to understanding them. The consequence is that people shy away from making important inheritance tax plans as they simply don't want to fall foul of the overcomplicated rules. The inheritance tax system should motivate the right behaviours such as encouraging inheritance tax planning, which in turn stimulates the flow of intergenerational wealth, not the opposite. Therefore, examining whether the anti-avoidance rules are still fit for purpose is a welcome recommendation.