Grant Thornton and Lombard Street Research

An analysis of UK inheritance tax and its changing dynamic

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How many people will be trapped in the inheritance tax net in 2009?

To whom do people leave their assets on death?

What are the alternatives to inheritance tax?

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Part of the Grant Thornton **thinking** series

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Ian Johnson, Head of Private Client Services at Grant Thornton

Welcome to Grant Thornton's new analysis of inheritance tax (IHT), published in association with Lombard Street Research.

Benjamin Franklin once said: "There are only two certainties in life, death and taxes." And death has long been deemed a convenient way to raise tax on the value of a deceased person's assets or estate. Not only is the tax easy to collect but complications arising from valuations are also less likely to be contested. In this publication, we explore the changing dynamic of this tax and consider whether its role and format are due for review.

Since Labour came into office, IHT legislation has remained largely untouched. Indeed, the last major change occurred back in 1986, when capital transfer tax (CTT) was renamed IHT, to reflect the new rules on lifetime giving. Yet, against this backdrop of IHT inertia, the overall tax regime has become more complex and the Chancellor has earned himself a reputation for tinkering in other areas of tax legislation. Why then, has IHT been left alone?

Each year, more and more people fall into the IHT net. This is largely owing to house price inflation and overall growth in individual wealth. Both have outpaced available IHT reliefs that tend to increase in line with the retail prices index.

For example, between 1997/98 and 2005/06, average house prices rose by 142%. In the same period, the IHT threshold increased by 28%. As a consequence, since the present Government came to office, IHT receipts have more than doubled (1997/98 – £1.68 billion and 2005/06 – £3.4 billion projected), despite there being no change to the IHT rate.

Ian Johnson, Head of Private Client Services

There has been plenty of debate about IHT. In 1968, then Labour Chancellor Roy Jenkins famously described estate duty, a forerunner to IHT, as: “a voluntary levy paid by those who distrust their heirs more than they dislike the Inland Revenue.” Is this still the case, and is IHT now due for reform? Should individuals, who may have been basic rate taxpayers during their lifetimes, be expected to pay a “higher rate of tax” of 40% on death? Interestingly, when the Conservatives were last in power, they made a pledge to abolish IHT completely, as soon as they could afford to do so.

Our analysis begins with a detailed study of who pays IHT across different wealth distributions, as well as looking at the broader economic and demographic context of the tax.

With the increasing relevance of IHT, both in terms of receipts to HM Treasury and its effect on individuals, we outline a number of alternatives, some borrowed from other countries’ regimes, others based on parallel ideas from other forms of direct taxation.

As there are already several valuable tax reliefs available, we outline some simple steps that can help individuals to mitigate their IHT bill.

Our intent is to stimulate debate on IHT which, to date, neither the Government nor the opposition parties have addressed in any detail.

Inheritance tax developments – too few feathers, too much hissing

Brian Reading and Gabriel Stein, Directors,
Lombard Street Research

"The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing."
Jean-Baptiste Colbert 1619-1683

IHT is the ultimate envy tax. It is paid by a relatively small, but growing, number, brings in little revenue, is difficult to collect and painful for those who are caught by it. IHT "obtains the smallest amount of feathers with the largest amount of hissing". It also involves some double taxation, since savings that accumulate wealth have usually been taxed as income.

Moreover, it is illogical. The first aim of saving is to gather wealth for the individual's and family's future needs. The second is to pass on a safety cushion to one's heirs. The authorities regard personal saving as a "good thing". But this tax penalises the provident.

IHT used to be not so much a tax as a voluntary contribution. There was no need for anyone to pay it. A modest amount of planning easily enabled the wealthy to avoid leaving their heirs with a tax burden.

In the UK, some 600,000 people aged 18 and over died in 2002, the last calendar year for which full wealth data is available. About 46,000 left estates worth more than £250,000, the threshold above which IHT could be levied at up to 40% in 2002. Therefore, about one in thirteen deceased people had estates potentially liable to IHT. The total value of these estates was probably around £35 billion.

However, only 24,000 estates paid IHT, which equates to 4% of the total number of deceased in 2002. We know they paid almost £2.4 billion in tax. So, despite a 40% marginal tax rate, the average tax rate was less than 10%. We can calculate that this was on bequests worth £12 billion in total. Only £12 billion out of £35 billion was liable to IHT, owing to the fact that legacies to spouses are exempt, certain other reliefs are available and gifts before death offer a way of avoiding IHT within prescribed limits, as do trusts.

There is no doubt that, if the future is anything like the past, the number of estates potentially liable to IHT will explode. The threshold for IHT liability is set to rise roughly in line with product price inflation (also known as the consumer price index (CPI)). For the past 20 years, asset prices (shares, houses and bonds) have risen three times faster.

If the historic rate of asset price inflation continues over the next five years and the tax threshold is not increased commensurately, an extra 32,000 estates in total will become potentially liable to IHT each year. But the number of people, whose estate would be potentially liable were they to die, would rise from 2.1 million in 2002 to 3.6 million in 2009, which is when the next general election is expected. Consequently, 1.5 million more people would have to consider the tax implications of their deaths.

Will asset prices continue to rise faster than product prices? Short term forecasts are bedevilled by the timing of boom and bust. But, if the rate of return on capital is unchanged (PE ratios for stocks), and the share of profit in income is constant, asset prices must rise in line with nominal gross domestic product (GDP). If real GDP growth is positive, CPI must be slower than nominal GDP growth. So asset prices must rise faster than product prices. If the IHT threshold is indexed to product prices, the number of people with wealth in excess of the IHT threshold must increase exponentially (given the shape of the wealth distribution – see Chart 4).

The analysis that follows looks at the numbers in more detail. The message is clear: many more people are going to die with estates potentially subject to 40% tax on wealth over the IHT threshold. It will be up to people, during their lifetime, to determine whether their heirs must pay the price after they die. Leaving all of the assets to the spouse passes the parcel.

The projections assume unchanged behaviour. But this analysis could, in itself, change that. As increasing numbers of people (1.5 million more at least) face the possibility that their estates will be taxed on death, more and more will do something to avoid this tax. But even more will remain victims of inertia – or, more accurately, leave their nearest and dearest as victims.

Many wills are made or changed on retirement. Many more are forgotten. Most older peoples' wills were probably made 10 to 20 years ago, if not before. Many people dislike thinking about their inevitable demise. They may not willingly look at their wills again. Many will not believe that they could be rich enough to leave an estate subject to tax. They are "ordinary folk" (like us). But "ordinary folk" are certain to be caught in the IHT trap, unless they are warned and willing to escape.

IHT projections

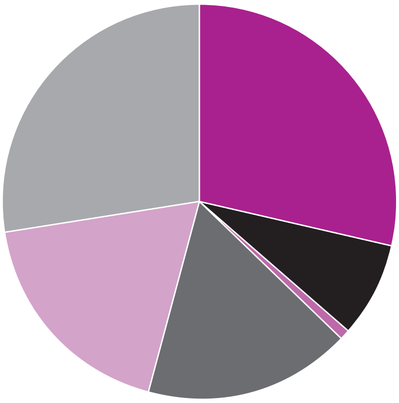
This paper projects IHT developments to 2009. The base date for comprehensive wealth statistics is 2002. Only partial statistics are available for later years. The situation in 2002 was as follows:

- British net personal wealth in round numbers was £5,000 billion – nearly seven times household disposable income
- based on HM Revenue & Customs (HMRC) wealth data, we estimate that some 2.1 million people aged 18 and over had net wealth in excess of the £250,000 threshold in 2002/03
- around 600,000 people died during 2002, out of a population of 59 million. The death rate for those aged 18 and over was 1.3%
- some 46,000 people left estates worth over £250,000
- 38% of estates, worth a total of £1.2 billion, involve a spouse still living (2002/03)
- the amount of net wealth in above-threshold estates was probably in the order of £35 billion
- we know (from HMRC statistics) that there were 24,000 IHT taxpayers in 2002
- we also know that the amount of IHT paid in 2002 was £2.4 billion. (Tax liabilities for 2002 were higher than tax paid in that year, as IHT is paid with a lag)
- IHT at 40% yielding £2.4 billion gives the taxable portion of legacies (the amount above the threshold) as £6 billion
- thresholds of £250,000 each for 24,000 taxpayers give another £6 billion in bequests subject to IHT
- IHT was thus paid on bequests worth only £12 billion in total (ignoring timing effects) out of £35 billion of above-threshold estates (about 34%)
- the IHT actually paid, of £2.4 billion, was less than 10% of the £35 billion above-threshold estates.

So much for 2002.

In future, many more people are likely to leave estates that exceed the IHT threshold. It has been raised in the past and is planned to increase further by 2007. But, while it has been increased rather faster than CPI, it has not risen as rapidly as asset price inflation – which is the relevant yardstick. Nor are future threshold increases (2008/09) likely to catch up with asset price inflation. In the current budgetary situation, the scope for raising direct taxes is limited.

Chart 1 – Total tax revenues by tax 2004/05



	%
Income tax	28.7
Corporation tax	7.9
Inheritance tax	0.7
VAT	17.1
NICs	18.3
Other	27.3

Chart 2 – IHT payers by financial year (000s)

The Chancellor has already been reduced to changing the parameters of his "golden rule" to avoid breaking it. In addition, the British budget deficit (2005) is in excess of the Stability and Growth Pact (SGP) rules[1]. Despite the fact that IHT revenues constitute only a small part of total tax revenues – no more than the amount mistakenly overpaid in working families' tax credits – and generosity would be cheap, don't expect it. A Government that claws back the latter is unlikely to give away the former.

IHT revenues have averaged 1.5% of total Inland Revenue receipts over the past ten years and never exceeded 1.7%. When taxes collected by the former Customs & Excise (VAT and other excise duties on products such as alcohol, tobacco, cars, etc) as well as national insurance contributions are included, the share of IHT drops to around 0.7% – ie about 70 pence for every £100 collected. Chart 1 illustrates these statistics.

As noted above, IHT is currently paid by relatively few individuals. But the number has been rising sharply. In 2005/06, approximately 30.5 million people are expected to pay UK income tax (according to budget projections). In the same period, 180,000 could pay capital gains tax. Only 37,000 may pay IHT, yet this is up more than half from the 24,000 in 2002. Chart 2 shows that the number of people paying IHT has increased steadily over the past 10 years.

1 The UK's position vis-à-vis the SGP is somewhat peculiar. Strictly speaking, the SGP is binding on all EU governments – not just those sharing the single currency. But, for those outside the euro-zone, there is no enforcement mechanism.

Table 1 – Estates above the £250,000 IHT threshold in 2002

	Sample size	Of which above IHT threshold in sample		Population size	Sample number % of population*
Males (M)	**000s**	**%**	**000s**	**000s**	**%**
18-44	3,372	7.4	250	11,240	2.2
45-64	3,260	15.2	496	8,150	6.1
65+	1,972	17.5	345	3,944	8.8
Females (F)					
18-44	2,406	8.2	197	8,020	2.5
45-64	2,840	13.6	386	7,100	5.4
65+	2,564	16.5	423	5,128	8.3
Total M+F	**16,414**	**12.8**	**2,097**	**43,582**	**4.8**

Source: HMRC, LSR calculations

* Those missing from sample assumed to have estates below the IHT reporting threshold (£220,000 in 2002/03)

This clearly shows the effects of asset price inflation – primarily housing but also financial assets. If we assume that the IHT threshold will continue to be raised by less than the rate of asset price inflation, the number of estates potentially hit by IHT must continue to rise sharply. But by how much? HMRC data indicates that, in 2002, nearly 5% of the population aged over 18 had estates above the then £250,000 IHT threshold (see Table 1).

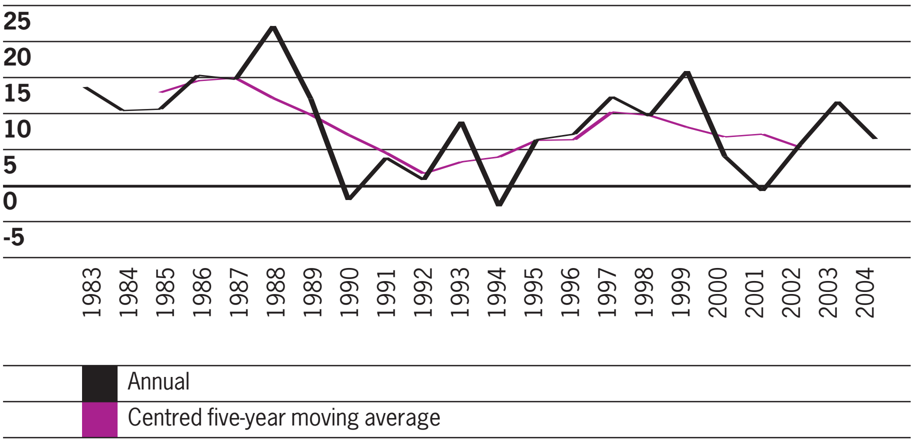
Looking to the future, we already know that the IHT threshold will be increased to £300,000 in 2007. When we project to the end of the current Parliament, we assume that, in 2008 and 2009, the threshold will be raised in line with CPI inflation, which, in turn, we assume will be held at the Bank of England's mandated target of 2%. This gives us an IHT threshold in 2009 of £312,000.

The next variable to consider is asset price inflation. Forecasting five years ahead (2004 to 2009) is fraught with difficulty. Asset prices are volatile, subject to boom and bust. It is better to examine the consequences of different assumptions than pick on one decimal point inaccurate forecast. These assumptions are based on past average asset price inflation. We have stock market indices, bond and house prices to go on. But each asset class must be weighted by the (changing) composition of wealth. Fortunately, there is a short cut.

Official UK annual household net wealth estimates are available from 1982 to 2004. These estimates are calculated from asset price movements, coupled with the asset composition of wealth. Weighted average asset price inflation can therefore be deduced from the increase in household wealth after subtracting the contribution from annual savings. This is what might be called retro-engineering, as it reveals the assumptions made by the officials compiling wealth statistics.

Chart 3 shows the results for 1982 to 2004. The long term annual average asset price inflation is 7.5%. Compounded over seven years, this equates to 66% growth (2002 to 2009). Annual savings also add to wealth but not as much as inflation. With 2002 wealth about seven times disposable income, it takes savings of 7% of income to add 1% to wealth.

Chart 3 – UK asset price inflation, % change



We have looked at four scenarios for asset price inflation and, allowing for savings in all cases, the consequent levels of household net wealth in 2009. We have calculated the number of individuals with estates above the wealth threshold for each of these scenarios (based on the wealth distribution, by age and sex, in 2002).

This is based on the distribution of wealth amongst the "living" who could die, not amongst the many fewer who do die in a year. But as the figures are derived from the distribution of wealth at death it basically involves a bit of retro-engineering. However, allowance has to be made for the coverage of the sample statistics. This is around 30% of the 18 to 44 age group, 40% of the 45 to 64 year olds and 50% of those aged over 65. Almost all those missing from the IHT data for estate size on death are missing because their estates are below the reporting threshold in 2002/03 (£220,000).

The most striking scenario, a 70% increase – 2009C below, which is based on the long term average asset price inflation, points to the number of estates (of the living) above the threshold rising from 2.1 million in 2002 to 3.6 million in 2009.

A comparison of the scenarios is outlined below:

- **2009A** – a 20% increase from 2002. This translates into no increase after 2004. Given the contribution from savings, it implies a small fall in asset prices as the house price bubble deflates and possibly share prices mark time. This puts 400,000 estates back above the 2009 threshold, restoring 2.1 million as in 2002
- **2009B** – a 40% increase in nominal wealth between 2002 and 2009. This is based on average 1982 to 2004 asset price inflation, minus one standard deviation. It pushes 2.7 million estates above the 2009 threshold, up 600,000 from 2002, despite the higher threshold
- **2009C** – a 70% increase, based on the long term average asset price inflation. The number of estates in 2009 above threshold rises to 3.6 million, up 1.5 million on 2002
- **2009D** – a 100% increase (average asset price inflation plus one standard deviation). Above-threshold numbers reach 4.5 million.

Chart 4 – Wealth distribution (number of estates at each value, millions)

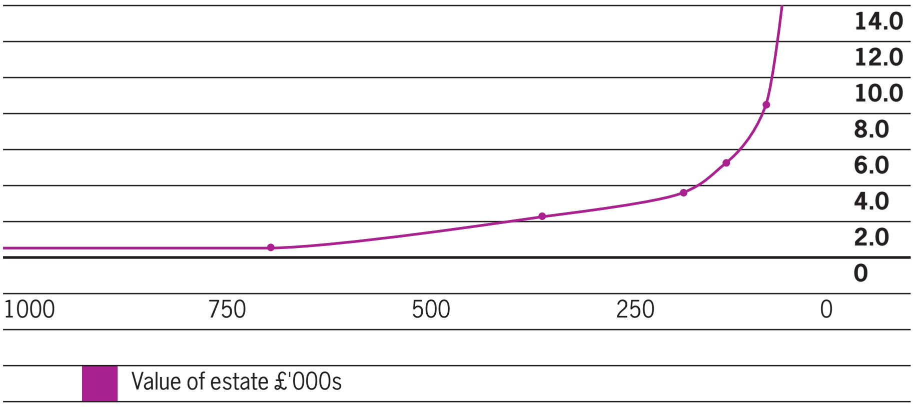


Table 2 – IHT tax payments

Case	Threshold 2002 constant asset prices £'000s	Estimated deaths with estates over threshold 000s	Wealth above threshold of those dying £billion	Wealth liable to IHT £billion	Numbers paying IHT 000s	Estimated IHT tax yield £billion
2002	250	46	35.3	12.0	24	2.4
2009A	260	48	42.7	14.5	23	3.0
2009B	223	59	54.5	18.5	28	3.9
2009C*	184	78	71.9	24.4	37	5.2
2009D	156	99	96.7	32.9	47	7.3

* This is the expected number who will pay IHT in 2005/2006. The reason why this figure is low in 2009 is because the wealth data on which this table is based only covers around 27% of the population, and as the effective value of the nil rate band threshold is reduced we start moving into the "missing population" of unreported estates in 2002.

Chart 4 shows the wealth distribution in the UK, with some assumptions being made concerning the wealth of those missing from the wealth data.

The conclusion is obvious. **Unless asset prices increase significantly less rapidly than they have in the past, the number of people living in the United Kingdom with wealth in excess of the IHT threshold will surge.**

The likely failure to raise the threshold faster than asset price inflation to 2009 will increase the proportion of people who leave estates above it when they die.

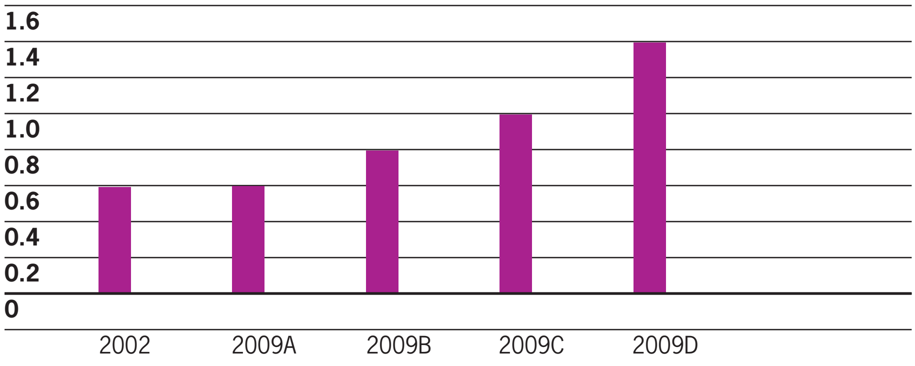
But will the number of people dying increase or diminish? The level of disaggregation in this study is limited by that of the wealth distribution on which it is based. This has only six sub-classes, three by age and two by sex.

Applying unchanged death rates at this level of disaggregation to the projected 2009 population aged 18 plus gives a 9% increase in deaths (from 600,000 in 2002 to 653,000 in 2009 or 1.3% to 1.36% of the 18 and over population). Other published estimates for the whole population with projected death rates for 2010 give lower numbers. On our sums, more people will die in 2009 than in 2002 and more that die will leave estates over the threshold.

Owing to our estimated rise in mortality, the number of people dying with estates over the thresholds will rise proportionately more than the numbers living. The total value of estates at death exceeding the various scenario thresholds can also be estimated from the wealth distribution of the living.

In the event of no further wealth increase from 2004 onwards (2009A), the numbers dying with wealth over the threshold is down a bit between 2002 and 2009, but their total wealth is slightly increased. Asset price inflation less one standard deviation (2009B) produces a significant increase in both numbers and wealth. Faster asset inflation produces a dramatic rise in both.

Chart 5 – IHT as % of total tax revenues under different scenarios



It is assumed that the same proportion of wealth is taxed as in 2002 and the same percentage of estates, among those left at death, pay the tax. IHT payments are then calculated by deducting numbers times the current price threshold (£312,000 in all cases) to obtain the taxable amount. The tax rate is assumed to remain at 40%.

While this part of the projection is distinctly unsatisfactory, it is of little importance to the conclusions.

The increases in the number of estates that could potentially become liable to IHT, on any reasonable assumption concerning asset price inflation, is so large that either more people will be caught out unexpectedly than in 2002 and pay IHT and/or more people will discover how to prevent their heirs from suffering it.

Without knowing the answers to these questions, the number of taxpayers and the total IHT take are unpredictable. Moreover, this research could change the answers. Our analysis shows how many more people could potentially fall into the IHT trap. We cannot know how many will escape it.

We noted above that, in 2004/05, IHT amounted to slightly less than 0.7% of total tax revenues. Under the scenarios above, we find that IHT as a share of total tax revenues could range from 0.6% (assuming a 40% increase in nominal wealth between 2002 and 2009) to 1.6% (assuming above-average asset price inflation between 2002 and 2009).

What are the alternatives to an inheritance tax?

Mike Warburton, Senior Tax Partner and Ian Luder, Tax Partner, Grant Thornton

IHT stirs strong public emotions that far exceed its importance to the Exchequer. Public attitudes to IHT can be largely grouped under three sentiments:

- some consider that: "IHT is an unfair tax because it penalises the prudent who save for their old age so not to be a burden on others. It is also a tax on savings which have already borne tax"
- others think: "We need schools and hospitals. Somebody has to pay. It's only fair that it should be the rich who have made their money largely through increases in house prices rather than their own hard work"
- and a sizeable category of the public say: "We have no intention of leaving our hard-earned money to the Chancellor. But, frankly, the kids aren't getting it either. We plan to have a good time and spend the lot in our lifetimes."

The IHT kitty

For 2005/06, receipts from IHT are projected to be £3.4 billion. This is broadly equivalent to 1p on the basic rate of income tax. So, although the sums involved are not large in overall terms, IHT is not something that the Chancellor can give up without making an impact on taxation elsewhere. Chart 6 shows how IHT and CTT receipts have increased compared to increases in average earnings.

As discussed elsewhere in this paper, IHT is a levy which is growing rapidly – up almost £1 billion in two years. Even so, the majority of families are either not affected or, with relatively straightforward planning, need not be affected.

Chart 6 – Index of increases in IHT and CTT receipts compared to increases in average earnings (index of increases (1978/79 = 100))

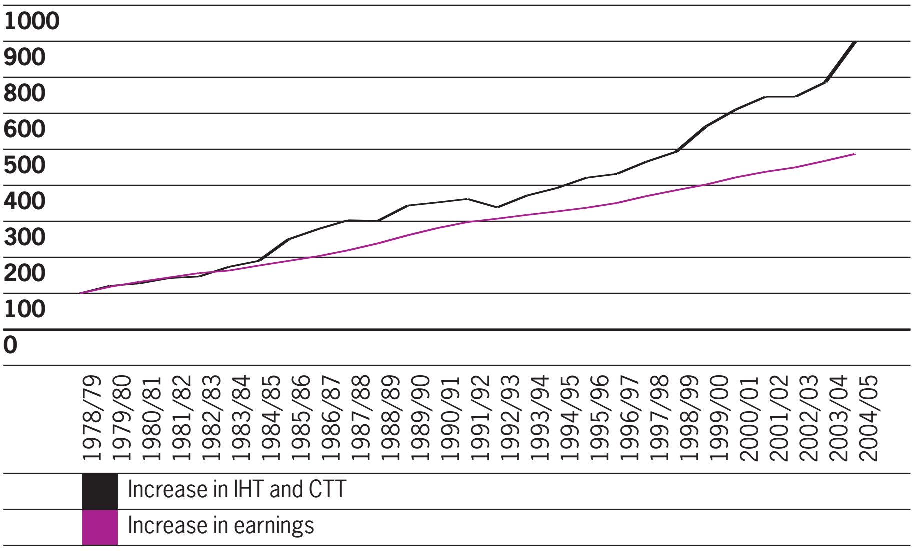
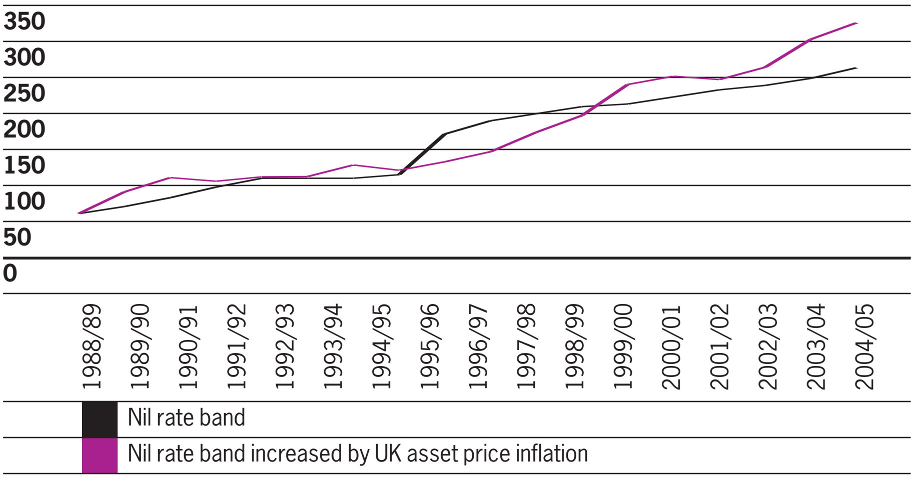


Chart 7 – IHT nil rate band (actual increase compared to asset price inflation increase) (£'000)



There are around 600,000 deaths each year – broadly 1% of the population. In 38% (230,000) of cases, the deceased is survived by a spouse eligible for a spouse's IHT exemption. That leaves 370,000 estates potentially caught by IHT. This year, just 10% (37,000) of these estates are expected to fall into the net. Chart 7 illustrates what the IHT nil rate band would have been if it had increased in line with asset price inflation – the failure to keep pace is part of the reason why more people are falling into the IHT net.

Is IHT a political hot potato?

IHT is, as recognised by all political parties, inherently unfair. In his last Budget Speech in November 1996, then Chancellor Kenneth Clarke commented that: "Inheritance tax is a penalty on thrift, independence and enterprise. It is a growing anachronism. It is largely paid by people of modest means who either cannot, or simply do not make careful plans to avoid it. This Government is committed to reducing and then abolishing capital gains tax and inheritance tax, but we have always said that we will cut these taxes only when we can afford to do so."

Mr Clarke's comments came at a time when IHT raised only £1.5 billion a year and capital gains tax (CGT) a mere £900 million. The Labour Party, in opposition in 1994, issued a paper that commented: "It is unacceptable that inheritance tax can be operated by tax planners as a voluntary tax. If society is to have inheritance tax, it must be operated fairly. Yet, at present, whilst the very wealthy avoid the tax, many others are being drawn into it. It is not the very wealthy who pay most of the inheritance tax. They are very effective at exploiting loopholes to avoid it."[1]

Despite this, since Labour came to power, IHT remains one of the few areas of taxation to receive relatively little attention. So, while both of our largest political parties regard the current system as unfair and unsatisfactory, it has changed in no significant way for 19 years. What, then, are the alternatives to reform?

Alternative thinking

Of course, IHT could be abolished completely. But that would leave the Chancellor at risk of breaking his "golden rule", as the IHT revenues would have to be replenished from elsewhere. This could be achieved by one of the following measures:

- an extra 1% on the basic rate of income tax
- 0.5% on employees' and employers' national insurance
- 1% on either employees' or employers' national insurance
- a 1% increase in VAT.

None of these scenarios is politically attractive and it is highly unlikely that the abolition of IHT could take place at one go. This may be achievable over the lifetime of a Parliament, but only if there is a political will to do so.

Treat IHT like CGT?

Rising house prices is one of the principal reasons for the increase in estates caught by IHT. Houses are treated favourably for CGT purposes where they are the principal residence, and it would seem logical to take a similar approach with IHT. However, the current application of IHT to houses presents a problem where people live together in a house and are unmarried, such as elderly sisters or children who still live with their elderly parents. On the death of the owner, IHT applies on what is essentially an illiquid asset.

If the Chancellor were to treat IHT like CGT, he would run the risk of stoking up house price inflation through tax changes, and leave himself exposed to criticism that the nation's resources were being diverted into expensive, unproductive properties rather than productive assets.

Therefore, it is much more likely that any such reform would incorporate an exempt amount on the principal residence, possibly in line with the £150,000 exemption for stamp duty land tax (SDLT). However, for IHT, this would not need to operate on the "slab" system that applies to SDLT.

1 Tackling tax abuses - tackling unemployment, the Labour party, November 1994

Geographic balancing act

Economic growth in the UK is concentrated in specific regions, notably London and the South East. This has pushed house prices in these locations to well above the national average. Yet IHT takes no account of such regional variations.

One way of rebalancing IHT liabilities, although it would add complexity, is to create geographic thresholds. Alternatively, it may be possible to link any increase in an exempt band for house prices with house price inflation, rather than general inflation.

Staggered rates

One particular criticism of IHT is that when it cuts in, it does so at a very high rate. When CTT, the forerunner to IHT, was first introduced in 1975, it had a starting rate of 10% above a threshold of £15,000. The rate climbed at 5% intervals right up to 75% for estates greater than £2 million.

While no-one is advocating the resurrection of such penal rates, there are good arguments for introducing a lower starting rate for IHT, at perhaps 10% or 20%, similar to the starting rate for income tax. It seems inherently unfair that an individual who has paid basic rate income tax throughout his or her life should pay tax at 40% on death. A 10% starting rate, followed by a maximum rate of 20% would, in the absence of abolition, be a helpful compromise.

Flat tax

Given the recent debate about a flat tax, it is interesting to note that IHT actually is such a tax. If a universal flat tax were introduced, IHT would fall into line overall with the flat rate. It is difficult to predict what the flat tax rate might be, but it would certainly be below 40%, probably in the 25% to 30% band.

Legitimate planning

One of the Labour Party's criticisms of the current IHT structure is that the very wealthy are able to avoid it by exploiting loopholes. In practice, it is not loopholes that allow the wealthy to avoid tax, rather the availability of very straightforward potentially exempt transfers (PETs).

Take a man worth £20 million. He may be able to afford to give away 90% of his wealth in his lifetime (specifically more than seven years before he expects to die), leaving a house and savings worth £1 million respectively. This may be sufficient to see him through his retirement years, especially if bolstered by a well-funded pension. The effective tax rate on death would be about 3.5% of his original wealth.

Mike Warburton,
Senior Tax Partner

On the other hand, a man worth perhaps £1 million, with half invested in a house and the rest in savings, may not be able to afford to make gifts during his lifetime. As a consequence, his estate would suffer an effective tax rate on death of almost 30%.

Admittedly, the position is less harsh for married couples. But, as noted elsewhere in this paper, they do not always take advantage of the relatively straightforward ways in which to reduce the IHT burden. (See page 15 onwards for more information).

Transfers during lifetime

The relief for PETs, introduced in 1986, is a powerful planning tool for those who can afford to take advantage of it.

The problem is that it is impossible for anyone to predict when they are likely to die, and the final years, with the costs of private medical care, can be expensive. Few want to end their days financially dependent upon their children.

Taper relief on IHT currently acknowledges these difficulties by reducing the amount of tax on a PET made between three and seven years of death (see page 16 for the rates which apply). However, the problem is that it is a taper relief on tax, not on the amount of the gift. Therefore, if lifetime gifts are made within seven years of death and are within the amount of the IHT nil rate band at the time of death, no tax arises on those transfers and no taper relief is due. This is commonly misunderstood.

We believe it would be both fairer and more logical to apply IHT taper relief to the value of the gift. So, for instance, a gift of £100,000 made six or seven years prior to death, would obtain an 80% taper, leaving £20,000 to bring back into the estate for IHT purposes on death.

Nil rate band

As explored on page 18, a husband and wife can take advantage of their nil rate bands by establishing nil rate band discretionary trusts on their deaths.

However, the majority fail to do so. This is not because they don't care about providing for their families, but because they have not taken professional advice. This is precisely the point made by Kenneth Clarke in 1996. It is inherently unfair that some families should lose out through ignorance.

A better approach would be to allow for the transfer of nil rate bands between spouses where they have not otherwise been used. For example, a husband who leaves all his assets to his wife on death should be able to transfer his nil rate band to his wife to be used on her ultimate death.

Intestate estates

A mark of a civilised society should be protection of the poor, the ill-informed and the disadvantaged. Such people may not feel that they have access to professional advice and half of the population never make a will. Intestacy creates particular problems.

At present, 57,600[1] of the annual deaths that are required to be reported to the Probate Office have no will to direct where assets should flow. The intestacy rules attempt to overcome this. They lay down a legal framework, broadly in accordance with government thinking at the time they were introduced, of what a typical will might look like.

However, the intestacy rules were never intended to be tax-efficient. They serve a different purpose – future provision for one's spouse or family, predominantly. Although tax considerations are not everything with IHT planning, complications have arisen as the allowances stipulated in the intestacy rules have failed to keep pace with asset price inflation.

The unfortunate consequence of the intestacy rules means that those with more modest estates are often forced to sell their home, as this is usually the prime asset in their estate. However, for estates worth in excess of £1 million, a forced sale is less likely on the death of the first spouse, as there may be other liquid assets in the estate to meet the intestacy rules.

It would seem more effective if the intestacy rules, instead of being based on restrictions on transfers to the beneficiary, took account of the size of the estate of the deceased. In addition, under the current rules, the intestate estate of a deceased with a living spouse usually results in the waste of the nil rate band. There is no reason, in principle, why the statutory trusts created under the intestacy rules should not be tax-efficient in the same way as outlined above.

A consultation process is currently underway on the statutory legacy limits, which may help alleviate some of these anomalies.

1 Source: http://www.dca.gov.uk

The global picture

Some countries, notably Australia, New Zealand and Canada, have abolished IHT entirely. Others operate a lifetime tax as an alternative. This effectively becomes a form of wealth tax.

For example, a wealth tax can be levied on the owner of an asset each year during his or her lifetime. A liability can arise from the ownership of any property, or title to any rights to an asset. Taxpayers are typically liable on their personal assets if they are resident for tax purposes in the relevant jurisdiction. Where taxpayers are not resident in the jurisdiction, their obligation is typically limited to their property in the territory.

The obvious problem with this approach is that tax is applied to individuals who have typically not realised their wealth and may not have the liquidity to pay the tax. It is, in effect, a penalty on initiative, enterprise and saving during lifetimes. Whatever the criticisms of tax on death, this is generally preferable to a penalty during lifetime.

In Spain, the tax depends upon the donor/donee relationship and the asset base of the recipient. The rate of tax suffered is lower for close relatives, such as a spouse or children, than it is for distant relatives or unrelated persons. In the UK, we have a complete exemption for transfers between spouses domociled in the UK, but no protection for other transfers (apart from transfers to charity and certain political parties). One logical approach would be to extend the principles of the spouse exemption to assets passing directly to children and siblings who live together.

This could be, say, a 50% exemption up to a ceiling, with perhaps a lower exemption for transfers to other relatives, including grandchildren.

A full exemption applies to gifts to charities and, rather surprisingly, to most political parties. There would be logic in extending the exemption to gifts made to other tax favoured savings plans such as the Child Trust Fund.

Conclusion

Politicians and the public at large recognise that IHT operates unfairly and is ripe for reform. It is, as Kenneth Clarke said, "a growing anachronism" and the position can only get worse without reform. It is time for serious debate on the issue. We live in interesting times politically: the current Prime Minister is due to stand down during this Parliament and there's a leadership election underway in the Conservative Party. Now would be a perfect time for the leadership contenders of each of those parties to set out their plans for reform of this unfair tax.

Ian Luder, Tax Partner

Legitimate steps to avoid inheritance tax

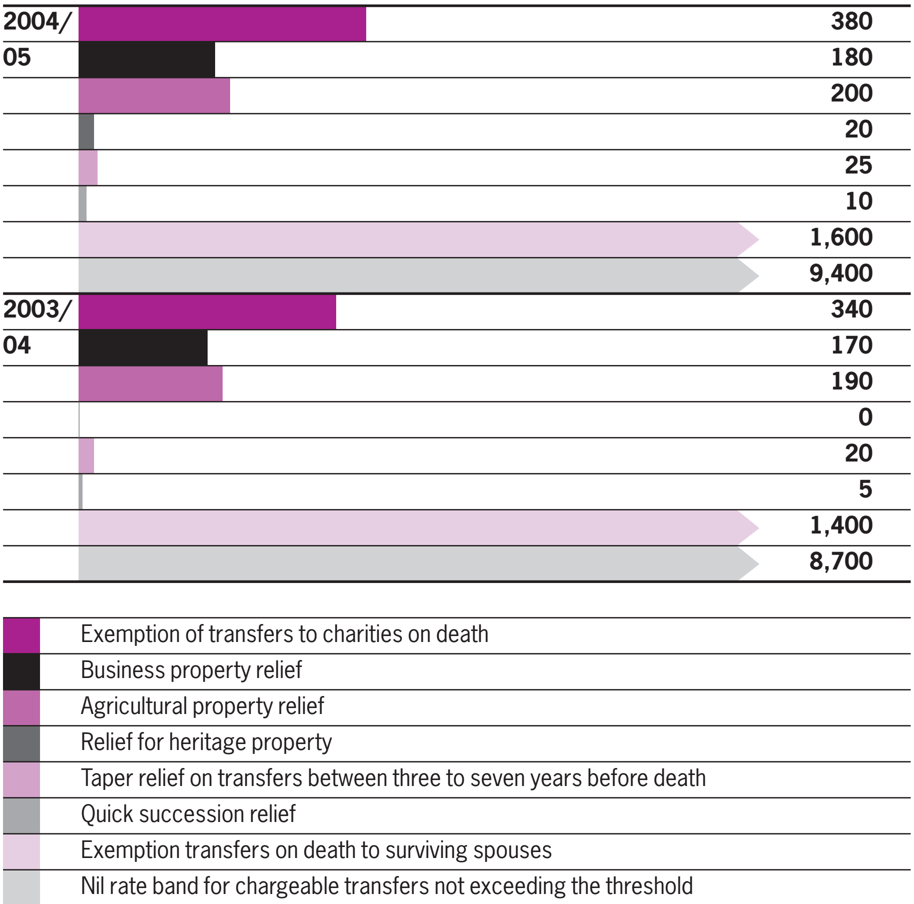
Ian Miles, Client Service Director and Sheena Hay, Senior Tax Manager, Grant Thornton

IHT, once dubbed a voluntary tax, applies to an ever growing number of the population. The tax was called voluntary because actions can be taken to reduce the eventual liability, although many people are unaware of how simple some of these steps can be. So how does the tax work?

The first slice of any individual's estate on death (including gifts made in the past seven years and their share of certain trusts) is generally free of IHT. This slice, referred to as the nil rate band, was increased to £275,000 from 6 April 2005. The Government has already announced thresholds for the next two tax years: £285,000 in 2006/07 and £300,000 in 2007/08. IHT is charged at 40% on the amount which exceeds the nil rate band.

The following, relatively straightforward, actions can be taken to reduce IHT liabilities. Chart 8 illustrates what some of these reliefs cost in terms of reduced IHT revenues.

Chart 8 – Estimated cost of reliefs to the Government (£million)



Make gifts during your lifetime

The most basic way to reduce IHT is to give assets away. Gifts to individuals or to trusts reduce the value of the individual's taxable estate on death, provided that the donor survives for seven years after the date of the gift.

Gifts to individuals and some trusts (broadly, non discretionary trusts) are known as PETs. Gifts to discretionary trusts are known as chargeable lifetime transfers (CLTs). Seven years from the date of the gift, it can generally be ignored for the purposes of calculating IHT on later lifetime transfers and is not added to the rest of the estate on death.

What if I don't survive seven years?

The value of gifts made in the previous seven years are added to the assets held by the deceased at the date of death. IHT is assessed by reference to this amount. The nil rate band is applied to lifetime gifts first and then to the death estate. Where tax becomes due on lifetime gifts (by virtue of a death within seven years of making the gift) the tax is normally paid by the recipient. Otherwise, the gift is grossed up to include the IHT due.

IHT is due where the value of the gift at the time it is made, together with any preceding gifts within seven years of death, are not covered by the nil rate band. In such cases taper relief rates (not to be confused with taper relief for CGT purposes) kick in, reducing the rate of tax for gifts made more than three years prior to death. Table 3 illustrates these rates.

Table 3 – Taper relief rates for IHT purposes

Years since gift made to date of death	% rate of IHT on the gift	% reduction IHT due
0-3 years	40	0
3-4 years	32	20
4-5 years	24	40
5-6 years	16	60
6-7 years	8	80
7 years +	0	100

What should I give away?

Gifting assets, either to individuals or to trusts, may result in a capital gain, even though there may be no proceeds. Cash is often the best asset to give away as it is not subject to CGT.

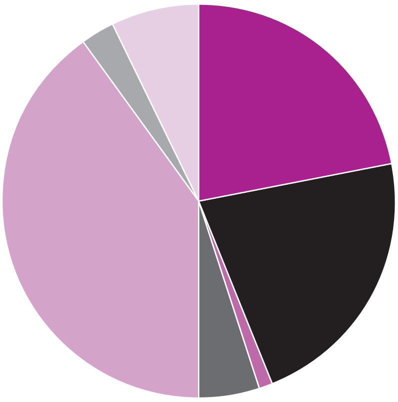
If the asset itself does not qualify for any CGT reliefs, it may be possible to gift assets without paying tax at the time of making the gift. This could be achieved by using up available capital losses or by making gifts to discretionary trusts.

As stated above, a gift to a discretionary trust during the lifetime of a person is known as a CLT. This gift is chargeable to IHT at a rate of tax of 20% at the time of the gift on amounts where the nil rate band is not available or is exceeded. Again, if the donor does not survive seven years, further tax could be payable on death.

Discretionary trusts are subject to further IHT charges on their 10-year anniversaries and when assets are distributed (to the extent that the value of the trust assets exceeds the nil rate band). However, this could still give rise to a much lower overall tax charge than leaving the asset in the individual's estate.

Ian Miles, Client Service Director

Chart 9 – Proportionate value of assets passing on death 2001/02



	%
Securities	22
Cash	22
Loans, etc	1
Insurance policies	5
UK residential buildings	40
Other buildings and land	3
Other assets	7

If you are giving money to a company or trust and there is tax to pay, it can be paid by either you, the donor (or transferor) or by the recipient (or transferee). If the trust or company receiving the money pays the tax, it is known as a gross gift. If the donor pays the IHT, it is known as a net gift. If this is the case, the IHT liability is counted as part of the gift.

Can I continue to use the asset?

Gifts may not be effective in reducing the value of your estate for IHT purposes, particularly if you continue to use or benefit from the assets you have given away, which is prevented under the gift with reservation rules.

Notable difficulties can arise where you want to give away your house and continue to live in it, or where you give away a share portfolio but continue to receive dividends. In such cases, the beneficiaries could be worse off. They could incur a CGT liability on the disposal of the asset as well as an IHT liability.

With effect from 6 April 2005, and subject to certain exemptions, an individual may be chargeable to income tax on previously owned assets, which have been transferred anytime after 17 March 1986, but from which the individual continues to benefit. The pre-owned assets tax should not apply in cases where the asset is already in the IHT net by virtue of the gifts with reservation rules.

Where an asset is to be transferred, and the donor is not specifically excluded from benefiting from it in the future, specialist advice should be sought.

The most important planning tool: your will

As the bulk of many people's estates are tied up in their most valuable assets – often the family home or business – they simply do not have available funds to make substantial lifetime gifts to reduce their IHT liabilities. Therefore, careful drafting of your will is essential to minimise any potential liabilities. Chart 9 details the split of assets which were passed on death in 2001/02 and shows that over 80% were tied up in UK residential buildings, cash and securities.

Don't leave it all to your spouse!

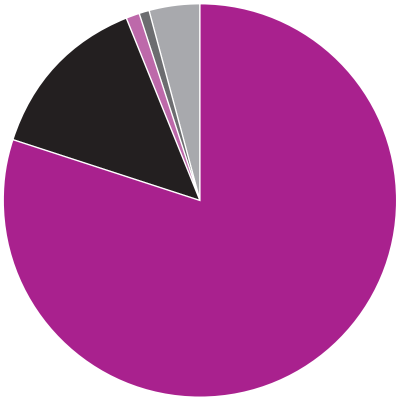
Many married couples choose to leave all of their estates to the surviving spouse on the first death. A standard will might say: "I leave all of my estate to my wife provided that she survives me…" This may be to ensure that the surviving spouse has sufficient assets for the rest of his or her life – or simply because it is perceived to be the "done thing".

Transfers between spouses, including transfers on death, are exempt from IHT (subject to a limit of £55,000 if the surviving spouse is not domiciled in the UK and also subject to double tax agreements with the surviving spouse's country). There are only a few double tax agreements between the UK and other jurisdictions which cover estate taxes (or their equivalent) in other countries.

This spouse exemption will extend to civil partners once legislation is fully enacted but there are no plans for unmarried, heterosexual couples to enjoy the same IHT benefits. Charts 10 and 11 illustrate the recipients of bequests in 2000/01. It is clear that the majority are the surviving spouse, regardless of whether it is the husband or wife who dies first.

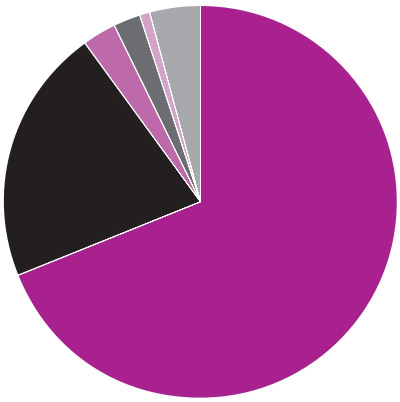
Although there is no tax to pay when the first spouse from a marriage dies and leaves all their assets to the survivor, the downside for beneficiaries is that the combined estate will be taxed on the second death.

Chart 10 – Destination of bequests – male married 2000/01



	%
Spouse	80
Children	14
Grandchildren	1
Other relatives	1
Charities etc	4

Chart 11 – Destination of bequests – female married 2000/01



	%
Spouse	69
Children	21
Grandchildren	3
Other relatives	2
Strangers in blood	1
Charities etc	4

Where all of the estate is left to the surviving spouse, the deceased's nil rate band is not used except, perhaps, where the individual made certain gifts during his or her lifetime. So, unless provision is made in the will to use the nil rate band, it could be wasted on death if the whole of the estate passes to the surviving spouse. Currently, an extra tax charge of £110,000 (the amount of IHT payable on £275,000) on the death of the surviving spouse can be saved if the nil rate band is used on the first death.

A tax effective solution is to use up both spouses' nil rate bands by creating a discretionary trust in the will. This kind of trust is called a nil rate band discretionary trust. Ideally, the will includes wide powers to enable the executors to satisfy the value going into the trust in a manner suitable to what is comprised in the estate.

A discretionary trust is a very flexible type of trust. The trustees own the trust property on behalf of the beneficiaries. They can pay out income or capital to any one or more of the beneficiaries entirely at their own discretion. The surviving spouse can be included as one of the beneficiaries and the trustees can be empowered to pay out income or the underlying capital to the surviving spouse.

It is usual for the deceased to have written a letter (known as a letter of wishes) giving the trustees guidance as to how the discretionary trust should be used – usually to benefit the surviving spouse and other family members.

In this way, the surviving spouse can enjoy both the income and capital of the trust. However, with this kind of trust (unlike life interest trusts) the capital is not added to the estate of the surviving spouse, nor charged to IHT on his or her death. Discretionary trusts can give rise to ongoing IHT charges depending on the value of the assets held in trust, but this liability is never greater than 6%.

Assets held jointly (under joint tenancy) automatically pass to the survivor on death. It may be prudent to sever joint tenancies on assets by, for instance, changing ownership of the house to tenants in common. In this way, assets do not automatically pass to the surviving spouse on death, negating any such planning.

Beware of valuations

The charge to IHT is made on the reduction in the value of the estate of the person making the gift. In the case of family company shares, this can lead to disproportionate results where the shares gifted break a control threshold. This is because the IHT measure of the gift is the difference between a valuable controlling interest and the remaining, less valuable, non-controlling interest.

However, when looking at a married couple's holdings, voting rights, etc are aggregated for IHT purposes. Therefore, one spouse may be able to relinquish control without the gift being disproportionately valued. This is subject to the couple retaining overall control between them.

Business property relief and Agricultural property relief

Two of the more generous IHT reliefs are business property relief (BPR) and agricultural property relief (APR), available at either 50% or 100% on qualifying assets.

These reliefs reduce the value of transfers on death, as well as lifetime gifts, so there are implications when drafting wills. Skilled advice should be sought. It may also be worth considering whether any financial planning should be undertaken to protect assets that currently qualify for such reliefs from future changes in legislation. If, for instance, the rates of BPR and/or APR relief were subsequently reduced, there could be a significant impact on the IHT liability.

For BPR, such assets include shares in unquoted trading companies. For APR, the assets must generally be used in farming businesses. Again, these reliefs should not be wasted by gifting these assets to your spouse (as gifts to your spouse will be covered by the spouse exemption).

The value of most business property, whether gifted during lifetime or passed on at death, is exempt from IHT, as the relief is at a rate of up to 100%. For assets to qualify for BPR, the donor must have owned the asset for two years immediately prior to the date of gift. Ownership periods of spouses are added together for this purpose. Shares in an unquoted trading company (including those quoted on AIM) are usually regarded as business property. But the value of any non-trading assets (eg cash and/or investments) held by the company may restrict this relief.

IHT planning becomes crucial when, for instance, a business is sold. In such circumstances, the seller can potentially end up exchanging assets that currently qualify for these valuable reliefs (eg shares) for assets that do not (eg cash and/or other investments).

When BPR is combined with the tax-free uplift from CGT on death, the value of a business can be passed to the next generation entirely free of tax, if the qualifying conditions are met.

The interaction of BPR and the transfer to spouse exemption can be used to make a specific legacy on death that exceeds the nil rate band, but is free from IHT. Take, for instance, an estate worth £3 million of which £2 million qualifies for 100% BPR. It is possible that a legacy (for instance, to a discretionary trust), of £750,000 will qualify for £500,000 BPR, with the remainder covered by the nil rate band.

Life assurance

You can provide for future IHT liabilities by taking out life assurance policies. The proceeds of such policies should be written in trust so that they do not form part of your estate on death and worsen the IHT position. If the proceeds go directly to the beneficiaries, there is no tax to pay, but if they fall into the estate they could be charged to IHT. Chart 9 on page 17 highlights the fact that, in 2001/02, 5% of such policies were passed on death, needlessly incurring IHT.

Sheena Hay, Senior Tax Manager

Other simple planning ideas

Use your annual exemption

Everyone has a £3,000 annual exemption for IHT which can be set against gifts that they make in any tax year. Amounts covered by this exemption will not be subject to IHT, even if the donor dies within seven years of making the gift. In view of the transitory nature of the annual exemption, it should be used whenever possible. This exemption can be carried forward for one tax year only.

For instance, if no gift was made in 2004/05, up to £6,000 could be gifted in 2005/06. However, if only £4,000 is gifted in 2005/06, this would use up all of the current year's exemption in priority to the £3,000 brought forward from 2004/05. The unused allowance of £2,000 from 2004/05 would be lost.

Small gifts

This covers outright gifts, provided the total to any one person in a tax year does not exceed £250.

Gifts out of income

Gifts made as part of normal expenditure will be exempt from IHT, provided they are habitual in nature and made out of income and not capital. The gift must leave the donor with sufficient income to maintain their usual standard of living. There is no monetary limit to the amount of such gifts, providing that these three tests are satisfied.

A boost to the wedding list

Gifts made on the occasion of marriage are exempt from IHT. The exempt amount varies from £1,000 to £5,000 depending on the relationship, if any, between donor and recipient.

Feeling charitable?

Gifts made either outright or to be held in trust for charitable purposes are exempt from IHT, whether they are made during a person's lifetime or at the time of death. Gifts to most political parties are exempt from IHT.

Funded Unapproved Retirement Benefit Scheme (FURBS)

FURBS are a pension fund trust, where trustees make investment decisions for the members.

The accumulated fund does not normally form part of the estate on death, provided that it is a scheme to provide retirement benefits, and some part of the costs of the scheme were borne by somebody other than the person benefitting from the FURBS. The advantage of using a FURBS as an IHT shelter is that, unlike other planning, it does not prevent access to the fund in the future if required (eg via retirement benefits).

The simplification of pensions, primarily through the Finance Act 2004, will see a number of changes to the pensions system. These take place on 6 April 2006, which is known as A-Day. Some of the changes will make a FURBS less attractive after A-Day. But funds that have accumulated before this cut-off date are expected to retain most of their current benefits. It should be noted that pension benefits cannot be paid to an entity not in existence on death, for instance, to will trusts.

Pension schemes

Pension schemes offer a wide range of investment opportunities and bring three tax advantages:

- payments into such schemes get tax relief
- the funds can grow largely tax-free (but no reclaim of the 10% tax credit on dividends)
- part of the benefits can be taken as a tax-free lump sum.

Payments into pension schemes are not usually deemed chargeable transfers for IHT. This is because pension schemes are set up to provide for your future retirement and not to reduce the value of your estate.

However, you should review your pension scheme to ensure that it is structured correctly and is not caught by IHT. If you die before you retire, all the money in your pension scheme passes to whoever you choose, IHT-free, provided that the scheme is subject to a suitable trust arrangement.

While many pension plans are automatically set up so that their value is not included in the individual's estate for IHT purposes, it may be prudent to review other schemes (such as some Section 32 and retirement annuity arrangements) and to set up a suitable trust.

Care must also be taken when benefits are withdrawn. HMRC may challenge someone who defers pension payments after reaching normal or contractual retirement age and who does not continue to work. It may be deemed that this deferral is solely to avoid IHT.

Conclusion

As the number of people with estates that exceed the IHT threshold continues to grow, it is important to be aware of the IHT planning options. Taking a few simple steps, as outlined above, can help avoid an unpleasant tax bill at what is a traumatic time for all.

Action points

- Ensure your will is drafted in a tax efficient manner – don't waste the nil rate band by making gifts to your spouse and make best use of assets that qualify for BPR or APR.
- Ensure that death benefits are written in trust.
- Make use of the exemptions available for lifetime gifts (eg annual exemption, small gifts, marriage, regular gifts out of income).
- Make lifetime gifts and survive for seven years.

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