12th July 2019

The OTS's second report: Simplifying the design of Inheritance Tax

The Office of Tax Simplification ("OTS") has now published its long-awaited second report following the "call for evidence" in April 2018 and the publication of its first report addressing the administration of the tax. The second report addresses the substance of the current IHT regime, and makes a series of recommendations for the government to consider. There is no guarantee that all (or any) of these will be followed, but we outline the key recommendations of which those considering undertaking any succession planning, and their team of professional advisors, will need to be aware.

Lifetime giving

Encouraging lifetime giving goes to the very heart of the reason for the introduction of IHT, enabling individuals to pass assets on to others outright and free of IHT.

The current "7 year rule" is very well known. If an individual survives for a full 7 years after making a gift, it will be completely exempt from any IHT charge. Death within 7 years may trigger an IHT charge (subject to the individual's available IHT free nil rate band and any other exemptions), but taper relief is available to mitigate that if the individual survives for at least 3 years. The application of taper relief can be confusing.

A complicated exception to the 7 year rule arises where the donor dies within 7 years of a gift to an individual (often referred to as a "failed PET") having also made a transfer into trust within 7 years prior to the failed PET. To determine the amount of the donor's IHT free nil rate band available, the executors will need to look back a further 7 years from the date of the failed PET to take account of any gifts into trust; the so-called "14 year rule" is complex and often misunderstood.

Recommendations: Reduce 7 years to 5 years, abolish taper relief and consider removing the 14 year rule.

Liability to pay any IHT on failed PETs falls first and foremost on the recipient. This was noted as unfair and counter intuitive. If the recipient is unable to pay, the burden falls to the executors to pay out of the deceased's residuary estate.

The current rules operate by allocating an individual's IHT free nil rate band allowance (currently £325,000) chronologically, first against failed PETs and next the death estate. This can operate unfairly in some instances, for example where there may have been a number of marriages or civil partnerships, and the estate has been carefully divided between different branches of a family during lifetime and through a Will. That said, chronological application gives certainty and an ability to plan.

Recommendation: Explore options for simplifying and clarifying the rules on liability for payment of tax on lifetime gifts to individuals and the allocation of the nil rate band.

There are also a number of smaller value IHT gift exemptions, but together these can be overly complex. The OTS heard that this could be a barrier to lifetime gifting. The level of these exemptions has not kept pace with inflation. For example, the OTS refers to the annual IHT free allowance of £3,000 which if increased to reflect inflation, would now be £11,900.

The often overlooked but valuable exemption whereby individuals can make gifts out of surplus income was criticised for being confusing and burdensome for executors.

<u>Recommendations:</u> Replace the annual exemption, gifts in consideration of marriage or civil partnership, and possibly also gifts out of surplus income, with one overall personal gifts allowance. The OTS does not suggest a value as that will depend what exemptions are replaced, but recommended that the levels are reviewed and the impact of inflation acknowledged. Alternatively, if the gifts out of surplus income exemption is not replaced by a new and increased personal gifts allowance, then the need for expenditure to be "regular" should be removed and replaced by a fixed percentage of income, to make this exemption more intuitive, accessible and reduce record keeping requirements.

Interaction with Capital Gains Tax

The OTS received some submissions that IHT should be abolished and replaced with a Capital Gains Tax ("CGT") charge on death, but rebutted this, pointing out that unless the current CGT allowances are changed, such a charge would catch more people on death than IHT currently does.

CGT charges are currently calculated with reference to the base cost of the asset in question, most commonly being the open market value of that asset at the date of acquisition. The base cost is currently "uplifted" free of CGT on death, wiping out prior capital gains.

Although the CGT uplift does not apply to lifetime gifts, holdover relief can often be claimed to defer the CGT charge, for example on the transfer of assets attracting business property relief ("BPR") or agricultural property relief ("APR") from IHT.

Is there a need to improve or change the interaction between CGT and IHT? The OTS noted that the CGT uplift may encourage individuals to retain assets until death, when that may not necessarily be the most practical decision in the context of the individual's business; an unwelcome distraction and an example perhaps of the tax tail wagging the dog.

The OTS also recited that some had argued the CGT uplift undermines the policy intent behind APR and BPR. That is to ensure farms and other businesses can be passed on to the next generation intact without needing to be sold to fund IHT. As the rules currently stand, those assets can be sold immediately after death with no CGT payable and no IHT clawback, and the OTS alleges that the policy rationale for this resulting zero taxation is not clear.

<u>Recommendation:</u> Where a relief or exemption from IHT applies (e.g. APR or BPR), consider removing the CGT uplift on death and instead provide that the recipient is treated as acquiring the assets at the historic base cost of the person who has died.

APR and BPR – farms and businesses

These are key reliefs on which we regularly advise, and which are very valuable to many of our clients. The OTS cites HMRC's estimate that the total cost of APR and BPR to the Exchequer will be £5.85 billion over the next five years (compared to HMRC's projected IHT receipts of £30.4 billion over the same period). It was submitted to the OTS that scrapping the reliefs entirely would fund a halving of the overall rate of IHT, but the OTS rebuts that, saying that according to HMRC, doing so would only fund a reduction of the main IHT rate from 40% to around 33.7%.

Align the trading test for BPR with the CGT test?

One of the conditions that must be met to secure BPR is that the business must not consist "wholly or mainly" of holding investments. "Wholly or mainly" is taken to mean at least 50% based largely on capital values, profit, turnover and time spent, as set out in the *Farmer* case.

Many of those reading this note will be aware of the *Balfour* case, which provided an example of how the "wholly or mainly" rule can be applied to a well-diversified rural estate that included a mixture of in-hand farming, lettings and other activities, in order to secure 100% BPR.

The OTS has suggested that the government "consider why the level of trading activity for BPR is set so much lower than the comparable reliefs from CGT" and that aligning the two would be simpler, reducing the potential for individuals' decision making to be distorted by the tax position.

The OTS does not explicitly suggest that the "wholly or mainly" test for trading under BPR should be increased in line with the CGT trading test (currently an 80% threshold), but given the current climate that would seem more likely than the CGT threshold being reduced.

Recommendation: *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 holdover relief or entrepreneurs' relief from CGT.*

APR on farmhouses

APR on the farmhouse can often be a point of negotiation with HMRC. It can be particularly difficult to qualify for relief when, as is not uncommon, the farmer moves out of the farmhouse to receive medical treatment or move into care, and does not return. The farmhouse may not then be eligible for APR as it would not then be used for the purposes of agriculture on the date of death. HMRC currently looks at this on a case by case basis, but the OTS submits this should be more transparent.

Recommendation: *Review the current approach to the eligibility of farmhouses for APR in sensitive cases e.g. where the farmer needs to leave the farmhouse for medical treatment or to go into care.*

Furnished holiday lets

It is worth highlighting this recommendation separately, as it could, if implemented, be a marked change from the current case-law based position, which sets a very high threshold for achieving BPR. That is in stark contrast to the treatment of furnished holiday lets under Income Tax and CGT, where they are regarded as trading.

Recommendation: *Consider whether to align the IHT treatment of furnished holiday lets with that of Income Tax and CGT, where they are treated as trading, providing that certain conditions are met.*

If any changes are made to the BPR wholly or mainly test, a simultaneous change to the current treatment of furnished holiday lets (as the OTS envisages – a "package") could partly help composite businesses reach that higher threshold.

Did the OTS miss anything?

There had been some concern amongst landowners and their advisors as to whether APR on let land may be scrutinised, but that is not discussed in the OTS's report.

Neither were heritage property reliefs (e.g. conditional exemption from IHT), save for citing these as an example of where the interaction of IHT and CGT can result in zero tax.

Two IHT reliefs which were covered in submissions to the OTS but on which the OTS has declined to make recommendations, on the basis that they are relatively new, are the residence nil rate band (the complexity of the rules are often criticised) and the reduced rate of IHT where part of an estate is left to charity on death.

Any change to the definition of spouse for IHT purposes to include a cohabiting partner or sibling was deemed to be something which should not be driven primarily by IHT considerations. No recommendations were made.

What now?

The 11 recommendations are just that. They will not necessarily be taken on board and implemented, in whole or in part, by this government or any future government.

The OTS has acknowledged that if implemented, some of the recommendations could prompt people to change their Wills. It submits that any changes should only be brought in having given sufficient time for individuals to consider any impact on their affairs e.g. in relation to deaths only after a certain date and without the complexity of a transitional period.

There is certainly the potential for change to come and, if it does, some of those changes, including to the BPR regime, could significantly impact many of our clients. We would therefore advocate acting now to implement succession planning under the current, arguably relatively benign, capital tax regime.

Many of our clients have landed, farming or business assets (or a combination of all three), and we advise in depth on maximising the availability of inheritance tax reliefs such as agricultural property relief and business property relief, where possible.

It is important to view succession planning as part of a long-term exercise. Deciding which assets to hand on or retain, and when to do so, can be an important part of this. Succession planning is frequently coupled with maximising available inheritance and capital gains tax reliefs, to ensure that assets can be passed on intact without an onerous tax liability.

We can help put together a tailored and tax efficient succession plan, working with individuals and their team of professional advisors to do so, and to implement that plan for the benefit of our client, their family, and future generations.

If you would like to discuss any aspect of this note further, please contact Lucy Hargreaves or any other member of the Private Client team 0113 244 6100.

The information in this note is necessarily of a general nature. Specific advice should be sought for specific situations.