



Will the gift keep on giving?

Office of Tax Simplification: inheritance tax review - second report

What is new?

On 5 July, the Office of Tax Simplification (OTS) published a report that made recommendations to the government to reform inheritance tax (IHT).

The proposal that has received the most attention is the reduction (from seven years to five) of the period during which a lifetime gift remains subject to IHT in the hands of the person making the gift (the “donor”).

A number of other changes have been suggested – including in relation to agricultural property relief (APR) and business property relief (BPR). We discuss the most significant recommendations below.

Where has it come from?

This is the second report from the OTS, following the announcement of its IHT review in Spring 2018. The first report, published in November 2018, dealt mainly with administrative matters, and made suggestions for streamlining probate and other IHT-related processes.

The stated purpose of the second report is to reduce the complexity of the IHT rules.



What is proposed?

The main recommendations relate to:

- lifetime gifts
- the interaction between IHT and capital gains tax (CGT)
- businesses and farms (BPR and APR).

Lifetime gifts

The report suggests that some of the existing IHT exemptions and reliefs for lifetime gifts are poorly understood, and makes recommendations for their reform. These include the following:

- to replace the existing annual gift exemption (£3,000) and the exemption for gifts in consideration of marriage or civil partnership (the permitted value of which is £1,000, £2,000 or £5,000 depending on the relationship between the donor and donee) with a single annual “**personal gifts allowance**”
- that this new exemption and the existing small gifts exemption (£250) should be reviewed to ensure that they reflect current asset values
- to reform the exemption for normal expenditure out of income (**NEOI**), which is regarded as being complex and often difficult to claim. The OTS suggests that the need for regularity of expenditure could be abolished and a limit of a fixed percentage of income introduced, potentially based on the most recent tax return
- alternatively, to replace NEOI with a higher personal gift allowance. £25,000 is suggested, which the report suggests would cover the value of 55% of all NEOI claims.

The seven-year rule

The report recommends reducing the existing period after which lifetime gifts cease to be subject to IHT in the hands of the donor, from seven years to five.

This is not as generous as it first appears. The proposed reduction in the run-off period is coupled with a recommendation to abolish “**taper relief**”. Currently, taper relief gradually reduces the amount of tax payable if an individual dies more than three years after making a gift, until the gift becomes exempt after 7 years.

The OTS recognises that its proposals would lead to a “cliff edge”, in that a gift made five years before death would escape IHT, whereas a gift made a day later would attract a 40% charge. Simplicity is a worthy ambition, but it does not always produce equitable results. This part of the proposal is likely to attract discussion.



Interaction between IHT and CGT

Currently, CGT is not payable on death. Instead, assets are treated as being acquired by the individual who inherits them at their then market value. This is known as the “CGT uplift”. Where inherited assets are also exempted or relieved from IHT (for example, because of the spouse exemption, BPR, or APR) the result may be that the assets can be sold shortly after death free of both IHT and CGT.

The report suggests that this may influence decision making, by encouraging individuals to retain assets which are exempt or relievable from IHT until death, as opposed to passing them on during their lifetimes. To rectify what seems to be regarded by the OTS as an undesirable distortion, the report recommends that, where an IHT exemption or relief is available on death, the CGT uplift should not apply.

Under the proposals, assets which are exempt or relievable from IHT on death would be treated as inherited at the deceased’s original acquisition cost, rather than at the market value on death. This simplification may well be attractive to the government. Those with trading or farming businesses will be less enthusiastic.

Businesses and farms

The rules for BPR and APR are complex. Eligibility for relief is often subject to fine distinctions. HMRC makes determinations on a case by case basis, and aspects of both reliefs have given rise to a body of case law.

In its report, the OTS draws attention to aspects of BPR and APR that, in its view, give rise to complexity or other difficulties. The most notable recommendation relates to a recalibration of the level of trading activity required for a business to qualify for BPR. This is currently based on a ‘wholly or mainly’ test, which is generally considered to mean that an interest in a business will qualify for relief if trading activity accounts for more than 50% of the business as a whole. The suggestion is that this should be brought in line with the 80% trading requirement that applies to CGT trading reliefs.

If the thresholds for the IHT and the CGT trading reliefs are aligned, this would have a significant impact on many businesses and rural estates. It may be ambitious to expect the thresholds to instead be aligned in favour of the more generous IHT rules.

Other proposals

These include:

- providing that death benefit payments from life insurance policies are exempt from IHT, thereby ensuring that there is no need to write death benefits into trust
- reviewing the pre-owned assets tax rules that were introduced in Finance Act 2004 in relation to planning involving the family home.

Notably, the report does not make any suggestions in relation to the recently introduced residence nil rate band, which has received significant criticism for being inaccessibly complicated.



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What will happen next?

The OTS is tasked with making recommendations for the simplification of tax rules, for the government to consider. It is now for the government to consider those recommendations. We and other professional bodies will submit our views on the proposals.

Changes to tax legislation require parliamentary time. Given current distractions, it may be a while before any of the recommendations in this report are taken forward. The Government may also wait for the outcome of its own consultation on the taxation of trusts before making any substantial changes to IHT rules.

IHT is an emotive tax, splitting opinion politically. The recommendations made by the OTS come at an interesting point, following announcements by the Labour Party that it is considering proposals to abolish IHT and instead treat lifetime gifts and inheritances (above a greatly reduced tax-free threshold) as taxable income in the hands of the recipients.

Over the next few months, political developments are both certain and uncertain. The well advised should stay in close contact with their advisors.

What should I do?

It is encouraging that the OTS clearly recognises the value and importance of retaining IHT reliefs and exemptions. In our experience, the availability of trading reliefs encourages activity both from UK residents and the owners of internationally mobile businesses who are considering relocating and have a choice of jurisdictions available to them.

In certain circumstances, those considering making a lifetime gift or a transfer of a business or other asset in the near future may wish to do so sooner rather than later to avoid the impact of some of the recommendations, should they be introduced.

Considerations include the withdrawal of taper relief for lifetime gifts, which is not wholly mitigated by the reduction of the seven year period to five years. Similarly, businesses that might be affected by a change in the required level of trading activity for BPR purposes, may wish to consider whether restructuring or other changes are needed in order to preserve relief.

The benefits or otherwise of taking action will depend on the circumstances, and ultimately what comes of the OTS recommendations. As always, taking advice is crucial.

We will report on any further developments as they take place. In the meantime, if you would like to discuss any of the matters raised in the OTS report, please get in touch with your usual Forsters contact.



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