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PASSING ON

Options for reforming inheritance taxation

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Contents

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Executive Summary

Over the past 18 months research for the Intergenerational Commission has illustrated that, in a range of areas, the assumption that each generation will do better than the one before it is under pressure.

This paper is one of a series that moves beyond the diagnosis of these problems to consider what action is needed to address generational living standards challenges. The Intergenerational Commission's final report will recommend a specific suite of reforms across a broad range of policy areas. In this paper, we present policy options that incorporate ideas from leading thinkers, history and abroad, and set out the strengths and weaknesses of different policy approaches. Here we look at options for reforming or replacing inheritance taxation.

Inheritance Tax is not set to keep pace with the growth of inheritances or with the UK's fiscal pressures

Bequests are a key way in which older generations seek to help those who come after them, with inheritances and other gifts totalling an estimated £127 billion in 2015-16. That's an average of £4,600 for every household in the UK. And the scale is growing rapidly. Inheritances have more than doubled over the last 20 years and are estimated to do so again over the next 20 as larger, wealthier cohorts pass through retirement. These inheritances will boost the wealth of younger generations like millennials (born 1981-2000) as a whole. And high home ownership rates among the baby boomers (born 1946-65) mean that the coming wave of inheritance is set to be spread more widely than in the past. This is particularly welcome given that younger cohorts have been less successful in accumulating assets in other ways.

But the silver spoon of inheritance will not be a silver bullet. For one, we have previously noted that inheritances are likely to come late in life for today's young people, with an average age at receipt of 61. And second, this wealth will continue to be shared unequally within generations. Of 20-35 year olds who don't own a home, around half have parents who are also non-homeowners, for example.

The forecasts for inheritances should be seen in the context of existing high wealth inequality, particularly among young people. Among older millennials (born 1981-1985), for example, the top 10 per cent owned 54 per cent of the group's net wealth at age 30. What's more, with the growth of wealth having outpaced that of income in the UK, wealth gaps have become even harder to bridge through work alone. The fact that some have far more luck in this birth lottery than others is one of the reasons why the UK has long taxed inheritances in one form or another.

Inheritance Tax, however, is now limited in scale. For every £100 raised in taxes nationally (£708 billion in all), only 77p comes from Inheritance Tax (£5 billion) and only 4 per cent of estates are now subject to it. Compared to the £127 billion of inheritance and gifts, that Inheritance Tax revenue represents an effective tax rate of only 3.5 per cent. It is also failing to keep pace with the growing importance of wealth transfers. Between 2006-07 and 2022-23, Inheritance Tax receipts are roughly forecast to grow less than a quarter as fast as inheritances.

This means that more of the strain in responding to the UK's ageing population and health needs must be picked up by other taxes, with clear implications for basic equity.

In 2018-19 someone can inherit £900,000 tax-free from their parents (and this will rise to £1 million in 2020-21). In contrast, someone working 40 hours a week on the National Living Wage from age 18 to 70 would only earn £753,000 in their entire life (in today's money), and would pay almost £100,000 in tax.

The reason why Inheritance Tax has raised relatively little is partly because the tax is especially unpopular, with this political pressure leading to large tax cuts – particularly in 2007-08 (via the nil-rate band transfer between partners) and from 2017-18 (via the residence nil-rate band). If inheritance taxation in some form is to play more than a negligible role in funding spending on Britain's big challenges in a fair way, it is clear that major reform is needed.

Inheritance Tax is unpopular and unfixable

Indeed, polling shows that Inheritance Tax is considered to be the most unfair of the major taxes, with only 22 per cent seeing it as "fair". Its unpopularity can be ascribed to three reasons:

- *Taxing giving*: It is negatively perceived as a tax on the dead (rather than the living); on giving (rather than receiving); and as double taxation of those who have earned the wealth (rather than a tax on the income of the lucky recipients).

- *A high rate*: Its flat marginal rate of 40 per cent sounds high, particularly to basic rate taxpayers used to paying 20 per cent, even if most people's effective Inheritance Tax rate is far lower or zero.

- *Ease of avoidance (for some)*: It is perceived as being 'voluntary' for the rich and well-advised.

What makes Inheritance Tax avoidable? The finger is often pointed at trusts, but reforms in 2006 have ensured that taxes are relatively high on trusts, with an entry charge, a charge every 10 years, and an exit charge. The number of trusts in 2015-16 was 25 per cent smaller than a decade earlier, and 31 per cent smaller than in 2001-02.

More problematic are the uses of Business Property Relief and Agricultural Relief – including by trusts. While these reliefs may be seen as ways to help small businesses stay in families, the current reality is far removed from this. For example, anyone can invest money in relevant AIM (originally 'Alternative Investment Market') shares – with no personal relation whatsoever to those companies – and thus avoid Inheritance Tax. And the price of farmland has been pushed up by investors similarly seeking to find an asset free of Inheritance Tax. In addition to these reliefs, the tax-free treatment of 'normal gifts out of income' in the years before death, and of some pension inheritances, are notable holes in the current system.

However, the main flaw in Inheritance Tax is that those with substantial, liquid assets and long lives can plan to avoid it by giving more than seven years before death (including via trusts and family investment companies). This is an option generally not available to those with limited wealth that is usually concentrated in a single property. More fundamentally, there is no obvious reason why money given far in advance of death should be taxed more favourably than transfers at or around death. The current 'seven year rule' means that lifetime gifts within that period before death can be taxable (though there are various allowances). One option would be to expand this period (say to 10, 15 or 30 years) but this would require more administration and uncertainty – given that it is not known at the time of giving whether tax will be payable or not, and gifts need to be accounted for retrospectively – and would in turn be circumvented by the wealthiest.

The 'ease of avoidance' and 'taxing giving' aspects of Inheritance Tax are therefore both fundamental to it. And there is little fiscal scope for fixing its 'high rate' problem in isolation. What is needed is reform that addresses all three problems at once by replacing Inheritance Tax.

Inheritance Tax should be abolished and replaced by a Lifetime Receipts Tax

In line with public feeling about Inheritance Tax, it would be better to tax the lucky recipients of large inheritances rather than those who decide to give rather than spend their money – and this is a distinction with both perceptual and practical benefits. In addition, to close off opportunities for avoidance (and to deliver basic fairness between recipients) it is important to tax all (large) gifts equally regardless of whether they are near the time of the donor's death or not.

Inheritance Tax should therefore be replaced by a Lifetime Receipts Tax. This would keep track of a person's cumulative receipts, excluding gifts of £3,000 or less (except where the recipient receives multiple gifts from the same person in the same year) and excluding transfers between spouses. A key element would be a Lifetime Receipts Tax Allowance allowing the first £125,000 of inheritances and gifts received over a person's life to go tax-free. This would exclude the great majority of inheritances, and the tax would not apply retrospectively so gifts and inheritances before the date of introduction would not be included. The UK can also look to its nearest neighbours – Ireland and France – for good examples of a tax on gifts and inheritances received.

Our modelling shows that such a tax would allow significantly lower rates than Inheritance Tax's flat 40 per cent rate while still raising money. Beyond a £125,000 Lifetime Receipts Tax Allowance, a basic rate of 20 per cent should apply, with a top rate of 30 per cent (paid by relatively few) above £500,000 of lifetime receipts. If introduced in 2020-21, such a system would bring in an estimated £11 billion, compared to Inheritance Tax's projected £6 billion. Revenue would then rise further, driven by a forecast increase in inheritances and because in future years some people may no longer have any Lifetime Receipts Tax Allowance remaining due to earlier inheritances. Over the 2020s as a whole it would raise an additional £7 billion a year on average to help address the country's revenue needs.

A progressive recipient-based tax such as this would also give donors an incentive to target their bequests on those who have not received large amounts before. In our costing we assume (for simplicity) that for every three people currently set to receive an inheritance, one extra person would receive one due to that extra incentive to split estates – with the average inheritance being lower as a result. So while the state can redistribute inheritances directly, it can also encourage donors themselves to spread wealth wider.

By moving away from being a 'death tax' to capturing all lifetime gifts, a Lifetime Receipts Tax would reduce many of the current opportunities for avoiding Inheritance Tax. However, questions of how to treat inheritances of businesses and farmland would remain, as would the thorny issue of how trusts should be taxed. As part of any reform, Business Property Relief (costing £710 million a year) and Agricultural Relief (costing £515 million) should be focused far more on family businesses and farms and far less on encouraging particular assets to be held purely for tax reasons. This could be done through introducing a cap, increasing the minimum ownership period and clawing back the relief if the asset is sold soon after death, and introducing a 'farmer' test and 'family business' test. In the case of Agricultural Relief, consideration of its cost should form part of any post-Brexit redesigning and retargeting of agricultural subsidies.

In addition, the extraordinarily generous treatment of some pension inheritances since 2014 should be changed to avoid significant perverse incentives and avoidance risks that could become very large over time. And, regardless of what changes are made to inheritance taxation, the forgiveness of capital gains tax on death should be ended (though tax could be delayed until the recipient sells the asset). This relief costs an estimated £1.2 billion in 2018-19, and leads to assets (including non-main homes) being held onto until death to avoid tax. At least, this relief should be removed for additional homes and where Business Property or Agricultural Relief has applied.

This package of recommendations would be a significant change to the tax system. But with private inheritances set to become even more important, it is crucial that the way we tax inheritances and gifts works well and commands public confidence. Replacing Inheritance Tax with a broader tax with lower rates and levied on recipients is the way to do this.

Summary of key policy recommendations

- Abolish Inheritance Tax and replace it with a Lifetime Receipts Tax, paid by the beneficiary
- Give each person a Lifetime Receipts Tax Allowance of £125,000 (indexed to inflation)
- Beyond the Lifetime Receipts Tax Allowance, apply a progressive rate schedule with a basic rate of 20 per cent and a higher rate of 30 per cent above £500,000
- Lifetime gifts would be included in the tax, excluding those of £3,000 or less (per donor per year) with the current additional exemption for 'normal gifts out of income' abolished
- Transfers to spouses and charities would be exempt
- Restrict Business Property Relief and Agricultural Relief (including within trusts) to small family businesses by:
    - Introducing a cap (e.g. £5 million) for the value that can receive relief
    - Increasing the minimum ownership period from two years (e.g. to five), and introducing a period after receipt in which tax relief can be clawed back if the inherited assets are sold on
    - Introducing a 'farmer' test for Agricultural Relief, as in Ireland and France, whereby the overall assets of the beneficiary (including the inheritance) must comprise at least 80 per cent agricultural property; and a 'family business' test for Business Property Relief whereby the beneficiary must receive at least 25 per cent of the business and the donor must have had a demonstrable working relationship with the company
- Redesign the trusts tax regime to reflect the Lifetime Receipts Tax
- Remove the tax-free treatment of pension pots inherited on deaths before 75, and for recipients other than spouses levy both the Lifetime Receipts Tax and Income Tax on pensions to give parity with other assets
- Scrap forgiveness of Capital Gains Tax upon death, at least for additional residential properties and assets qualifying for Business Property Relief or Agricultural Relief

Section 1

Introduction

Previous reports for the Intergenerational Commission have shown that the norm over the 20th century was for remarkable living standards progress from generation to generation – helped by overall economic growth, housing policy and more. But this work has also shown that for the youngest generations this progress has now ground to a halt, and has even reversed in terms of housing and wealth.

Of course, private inheritances are one way in which each generation endeavours to help its successors. An earlier paper, analysing the prospects for inheritance,[1] showed that such inheritances should indeed provide a welcome boost to younger generations. Inheritances are expected to continue to grow rapidly in scale as large, wealthy cohorts move through retirement, with the total value of bequests projected to be twice as high in 2035 as in 2018, having already more than doubled since the mid-1990s. These substantial flows of wealth will have a big impact in aggregate.

However, this boost will generally not come at the times when it is most needed. Based on their parents' life expectancies, today's 20-35 year olds can most commonly expect to inherit when they are themselves 61 – too late to help with the challenges of home buying, child rearing and most labour market risk-taking.

And the benefits from inheritance will be unevenly shared. Those millennials (the generation born 1981-2000) who already own a home are the ones most likely to inherit a (further) home, for example. And unequal prospects for inheritances should be seen in the context of wealth inequality that is already very high, particularly within younger generations.[2] For example, among the older millennials (born 1981-1985), at age 30 the top 10 per cent of that cohort owned 54 per cent of the group's net wealth.

Although more people can now expect to receive inheritances than in the past, the potential effects of inheritance on wealth gaps within generations should be concerning. It is well known that a person's income as an adult can be strongly predicted simply by looking at their parent's income in the UK.[3] And their wealth is strongly affected by what their family had even five generations ago.[4] If the country is to become one of greater social mobility – where an individual's circumstances are not simply determined by their parents and grandparents – relying entirely on family based transmissions of wealth is unlikely to be desirable.

At the same time as inheritances are set to become more important, the UK is set to face some significant fiscal challenges. An ageing population together with broader health

1 L Gardiner, The million dollar be-question: inheritances, gifts, and their implications for generational living standards, Resolution Foundation, December 2017

2 C D'Arcy and L Gardiner, The generation of wealth: asset accumulation across and within cohorts, June 2017

3 P Gregg, L Macmillan & C Vittori, Moving Towards Estimating Lifetime Intergenerational Economic Mobility in the UK, The Centre for the Analysis of Social Policy, University of Bath, December 2014

4 G Clark & N Cummins, Intergenerational Wealth Mobility in England, 1858–2012: Surnames and Social Mobility, June 2014

pressures means that the cost of the welfare state is set to grow by £24 billion by 2030 and £63 billion by 2040.[5] This will force hard choices about how the decent cradle-to-grave welfare state that all generations expect can be funded.

In a previous paper we looked at the options for reforming property taxes. Here our focus is on Inheritance Tax. This paper looks at the unpopularity – largely justified – of the existing system and concludes that a complete overhaul is urgently needed if Inheritance Tax is to contend with the coming rise in the importance of inherited wealth.

- **Section 2** sets out the basics of the current Inheritance Tax system, and why it is so unpopular despite raising relatively little.
- **Section 3** looks in more detail at how the avoidability and unpopularity of Inheritance Tax may be beyond repair.
- **Section 4** then explores how to abolish Inheritance Tax and replace it entirely with a whole-lifetime tax on recipients, including modelling a range of revenue-raising options.
- **Section 5** concludes.
- The **Annex** provides details of the data and methodology used in our tax modelling.

5 Resolution Foundation, *A new generational contract: the final report of the Intergenerational Commission*, May 2018 (forthcoming)

Section 2

Inheritance Tax is small but unpopular

This section looks at the basic structure of Inheritance Tax and its history, and why a tax that raises only £5 billion a year and is set to shrink further relative to inheritances is nonetheless so unpopular. First, it is seen by many as fundamentally unfair to tax those giving and to have a tax explicitly linked to death. Second, its high, flat rate is unattractive to many. And, third, it is seen as voluntary for the super-rich because of wide-ranging exemptions.

But despite these objections, this section notes that there is a strong case for some form of inheritance taxation on the grounds of basic fairness between earned income and inherited income. To command public confidence, raise revenue, and keep pace with growing volumes of inherited wealth, however, inheritance taxation will need substantial reform.

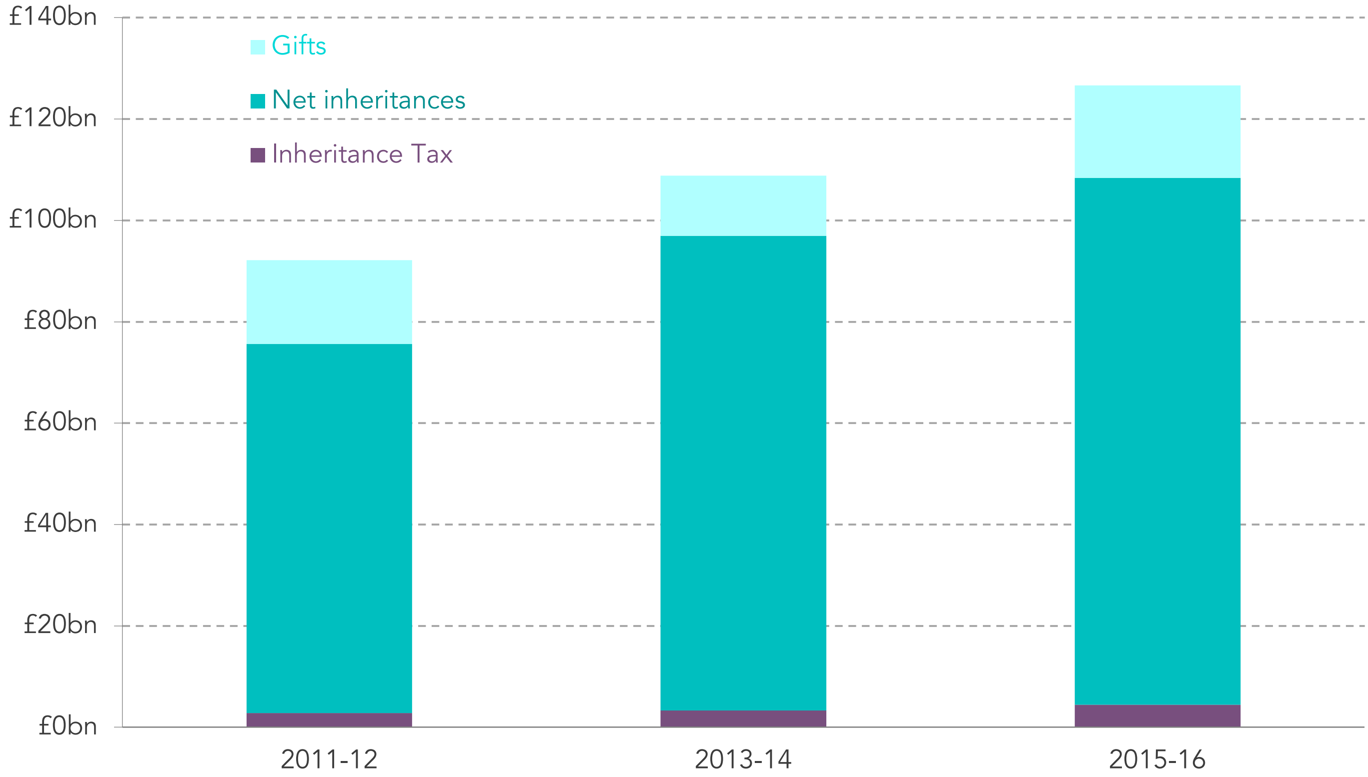
Inheritances are large but Inheritance Tax is not

Thanks to historical increase in home ownership, house prices, private pensions and other wealth increases, cohorts are increasingly dying with substantial unspent wealth. Data from the *Wealth and Assets Survey* (see Annex), together with Inheritance Tax receipts, suggests that inheritances and gifts totalled £127 billion in 2015-16 – an average of £4,600 for every household in the UK and equivalent to 7 per cent of GDP.[6] Figure 1 shows this, along with the figures from two and four years previously.

6 As noted in L Gardiner, The million dollar be-question: inheritances, gifts, and their implications for generational living standards, Resolution Foundation, December 2017, this survey data likely underestimates the scale of transfers between spouses.

Figure 1: **Over £100 billion was inherited in 2015-16**

Value of total inheritances and gifts received (nominal)



Notes: UK. Excludes trusts. WAS data are annualised figures around 2-year period, e.g. 2014 to 2016, and HMRC figures are based on when tax is received.

Sources: RF analysis of ONS, *Wealth and Assets Survey* and HMRC

Inheritance Tax, however, is limited in scale. This is despite its high rate of 40 per cent on the value of estates at death, above certain tax-free allowances.

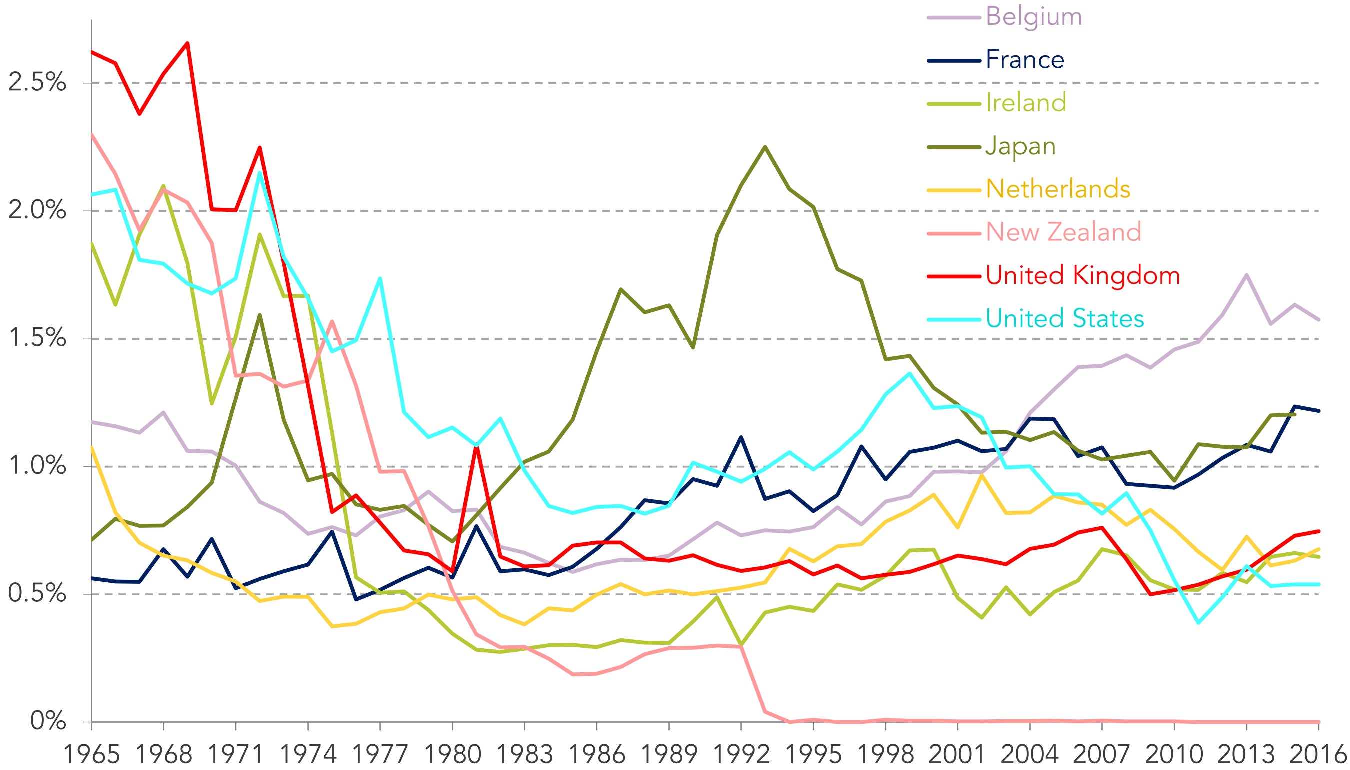
For every £100 raised in taxes nationally (£708 billion in all), only 77p comes from Inheritance Tax (£5 billion).[7] This compares to £190 billion raised by Income Tax (£26 in every £100). And of around 600,000 deaths each year, only around 23,000 (4 per cent) of estates are subject to Inheritance Tax. Compared to the £127 billion of inheritance and gifts in Figure 1, that revenue represents an effective tax rate of only 3.5 per cent.

This small scale is not unusual by international standards. Figure 2 compares the proportion of taxes that come from estate and gift taxes, both across countries and across time. There is a wide range of international experience. Some countries – such as New Zealand, Australia, Sweden and Canada – having abolished their estate duties (though often with partially offsetting capital gains taxes), whereas Belgium, for example, gets 1.6 per cent of its tax revenue from these sources. The UK is therefore in the middle of the pack.

7 OBR, *Economic and Fiscal Outlook*, March 2018

Figure 2: **UK Inheritance Tax as a share of tax revenues is typical by today's international standards, but far lower than it once was**

Estate, inheritance and gift taxes as a per cent of total taxation



Source: OECD stat

But, like many other countries, the UK raises far less from these taxes in relative terms than it used to. In 1965, 2.6 per cent of all revenue came from estate and gift duties (in part due to taxation of spousal inheritance).

The UK's history of estate duties is described further in Box 1.

Box 1: The history of UK Inheritance Tax

The *Stamps Act 1694* introduced 'Probate Duty'.[1] This (like stamp duty) levied a tax at a point when it was relatively easy to do so due to the necessary legal process.

By 1894 there were a number of related taxes, and a new Estate Duty replaced many of these. This had a progressive rate structure and at its peak in 1969 the top rate of Estate Duty was 85 per cent. The ability to leave bequests to spouses tax-free was only introduced in 1972, and even then it was limited. Remarkably (from today's perspective), until World War II, more people were liable for Estate Duty than for Income Tax.[2]

From 1910, some lifetime gifts had been included, including those within three years of death. By 1969 this period had been extended to seven years, but (like today) this still left great scope for avoidance. To tackle this, Capital Transfer Tax was introduced in 1975, with rates that varied from 10 to 75 per cent. It included separate taxes on lifetime gifts and gifts at or near death. And it was still a tax on the donor, intended to cover all gifts made in a person's life. However, it raised less revenue than estate duty, principally due to an unlimited spouse exemption and a lack of credibility that the tax would persist long beyond a change of government. Business Property Relief was introduced in 1976 (reducing tax liabilities when businesses are inherited).

In 1986, the government abolished tax on lifetime transfers and renamed the system as 'Inheritance Tax', reverting to taxing only transfers on – or within seven years of – death. At first rates varied between 30 and 60 per cent, but since 1988 there has been a single rate of 40 per cent.

Over the last 30 years, the main changes have been the introduction in 1992 of 100 per cent relief for some businesses and agricultural land; changes in the size of the nil-rate band; a tightening of the trusts tax regime in 2006; the ability from 2007 for unused nil-rate bands to be transferred within a couple; and the introduction from 2017 of an additional tax-free allowance if main residences are transferred to direct descendants.

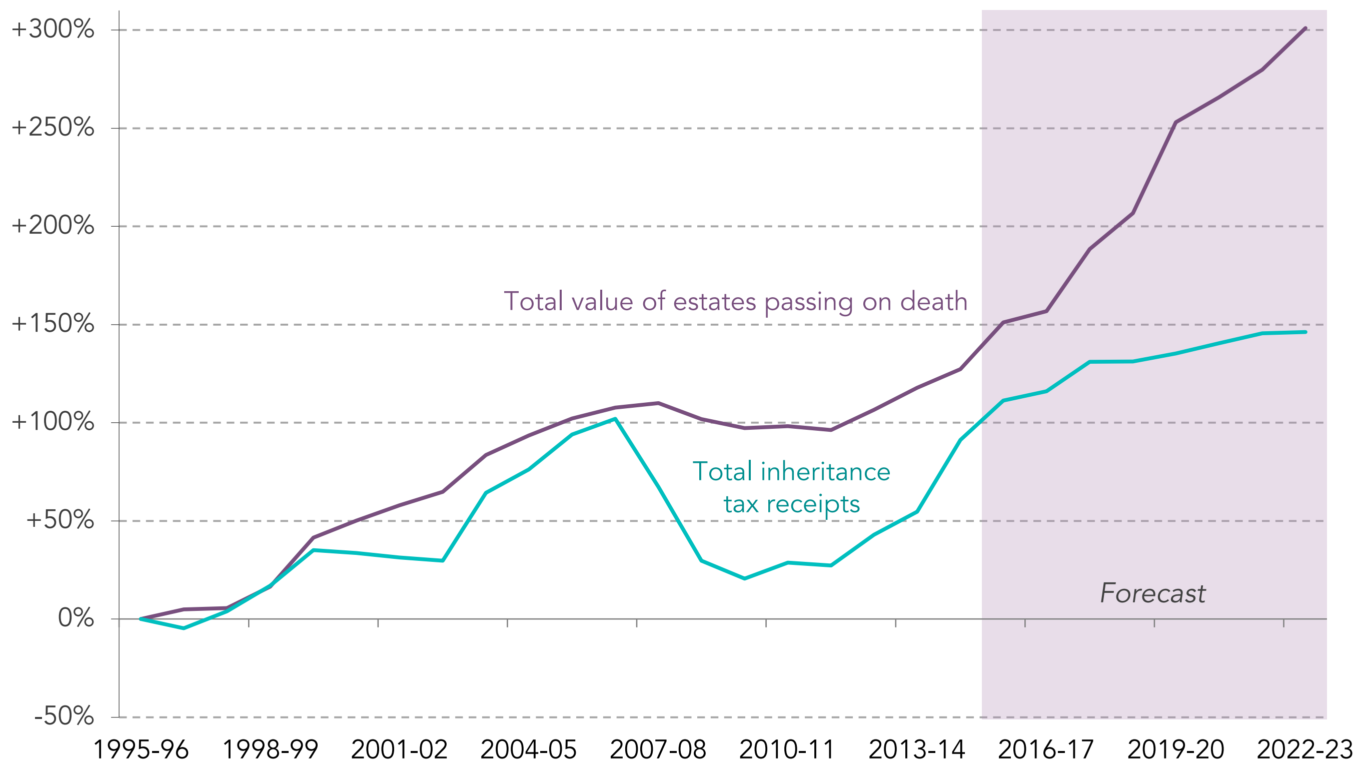
1. R Boadway, E Chamberlain & C Emmerson, Dimensions of Tax Design, *Taxation of Wealth and Wealth Transfers: Appendices*, Institute for Fiscal Studies, September 2010
2. A Atkinson, *Wealth and Inheritance in Britain from 1896 to the Present*, LSE, November 2013

Inheritance Tax is not keeping up with the growing importance of inheritances, reflecting its unpopularity

Not only is the level of Inheritance Tax small compared to total taxation and by some historical standards, it is becoming yet more insignificant compared to the scale of capital transfers. As Figure 3 shows, tax receipts are forecast to grow less than a quarter as fast as inheritances between 2006-07 and 2022-23.

Figure 3: **Inheritance Tax receipts are growing far more slowly than inheritances themselves**

Growth in real value of estates passing on death and inheritance tax receipts since 1995-96



Notes: CPIH-adjusted. Projected values of estates are estimated using tax receipt projections together with the forecasts done in L Gardiner, *The million dollar be-question: inheritances, gifts, and their implications for generational living standards*, Resolution Foundation, December 2017

Source: Inheritance tax values from HMRC and OBR.

In part this is the direct result of policy, in turn responding to public opinion about Inheritance Tax.

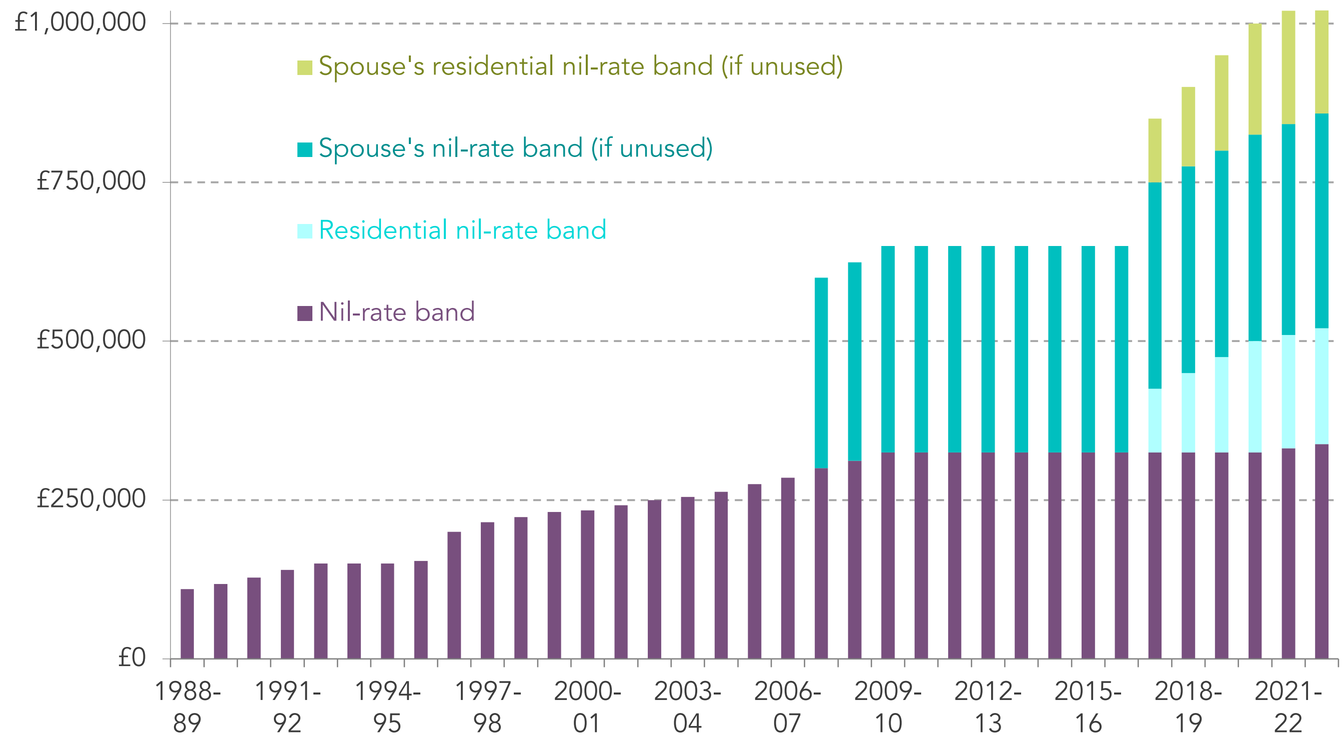
Unlike Income Tax, with its progressive rate schedule, Inheritance Tax is charged at a flat 40 per cent on the value of estates at death (excluding transfers between spouses).[8] However, this only applies above a generous tax-free band. The first £325,000 is excluded. And, since 2007, this £325,000 allowance can be passed to spouses if unused – to give an effective threshold of £650,000 for many couples. This significant tax cut came in response to political pressure about the tax.

8 We take the view in this paper that this spousal exemption is reasonable and desirable, though noting that this can be considered unfair on couples who are not married or civil partnered.

Another large tax cut began to be introduced in 2017-18, with a new 'residence nil-rate band'. By 2020, each spouse will be allowed to also give £175,000 tax-free to direct descendants if in the form of a main residence or the proceeds of its sale (but this allowance is tapered away for estates worth more than £2 million). This will effectively take the threshold to £1 million for many, as Figure 4 shows. And from April 2021 all these thresholds will rise in line with CPI inflation.[9]

Figure 4: **The new residential nil-rate band will take the maximum amount that can be bequeathed tax-free to £1 million**

Total tax-free threshold, nominal



Source: IFS, *Fiscal facts*

If the goal were simply to raise extra revenue from Inheritance Tax, one straightforward way would be to freeze the threshold(s) – e.g. at the 2020-21 total of £1 million – as has been done for the nil-rate band since 2009-10. Another approach would be to cancel the new residential nil-rate band. This £1 billion tax cut, while reducing the number of people affected by Inheritance Tax (particularly in the South of England), may also be expected to push up house prices,[10] and requires that wealth be left to direct descendants (if any) rather than others. However, it is safe to say that neither of these measures would turn around negative perceptions of Inheritance Tax.

9 HMRC, *Inheritance Tax: main residence nil-rate band and the existing nil-rate band*, June 2017

10 OBR, *Economic and Fiscal Outlook*, July 2015

Inheritance Tax is seen as unfair

In a 2015 poll, Inheritance Tax was seen as the least fair of 11 major taxes, with 59 per cent considering it 'unfair' and 22 per cent 'fair'.[11] Focus group research has also shown that the tax is seen by many as fundamentally unfair, despite general support for heavier wealth taxation.[12]

This unpopularity – which has helped drive those large tax cuts – can be ascribed to three factors:

1. *Taxing giving:* Fundamentally, it is negatively perceived as a tax on the dead (rather than the living); on giving (rather than receiving); and as double taxation of those who have earned the wealth (rather than a tax on the income of the lucky recipients).

2. *A high rate:* Its flat marginal rate of 40 per cent sounds high – 'almost half' – particularly to basic rate taxpayers used to paying 20 per cent.

3. *Ease of avoidance (for some):* Wide-ranging exemptions mean it is perceived as being 'voluntary' for the rich and well-advised who have the incentive and liquidity to plan around it, with the very rich therefore being hit less hard than the merely quite rich.

The fact that it is inevitably paid at a time when people are grieving and often also overwhelmed by the practical implications of death and estate management only adds to its unpopularity. And the fact that it is a large one-off charge makes it more noticeable than taxes such as Income Tax and VAT that largely operate only in the background for most people.

Despite these objections, which are discussed in further detail throughout this paper, there is a strong case that some form of inheritance taxation is desirable.

Despite the unpopularity of Inheritance Tax, inheritances are taxed far less than other income

Some view Inheritance Tax as 'double taxation'[13] while others view it as extremely fair – both with some justification. The seminal Mirrlees Review of the tax system puts it well, in saying that these criticisms of Inheritance Tax depend on how you view the tax:[14]

> Views about the appropriateness of inheritance taxation remain sharply polarized. Those who are instinctively hostile to this form of taxation typically look at it from the perspective of the donor. They consider that individuals should have the right to leave their assets to whomever they choose without suffering a tax. If asset accumulation occurs from income that has already been subject to tax, inheritance taxation is seen to constitute 'double taxation'...
>
> On the other hand, those who favour significant inheritance taxation often tend to look from the perspective of the recipient, arguing that it is anomalous to tax

11 YouGov, *Voters in all parties think inheritance tax unfair*, March 2015

12 D Srblin, *The tax detox: winning public consent for radical tax reform*, Fabian Society, December 2015

13 Though the 'double taxation' argument can in fact be applied to almost all taxes in one way or another, and is therefore not persuasive in itself.

14 J Mirrlees et al., *Tax by design*, Institute for Fiscal Studies, September 2011

people on money they have earned while exempting from taxation money that comes to them through no effort of their own (except perhaps the effort expended in being kind to elderly loved ones).

Looked at from the point of view of recipients, there seems a strong argument for taxing inherited income just as any other. Indeed, comprehensive theoretical definitions of 'income' do include inheritance and gifts.[15] As a Canadian tax review suggested, "a buck is a buck".[16]

But the tax system certainly does not treat money inherited equally to money earned through labour.

Figure 5 shows some illustrative examples of people receiving money from either earnings or inheritance. If 'Person A' earned the National Living Wage and worked 40 hours a week, every week from age 18 to age 70, with no time out of the labour force, they would

Figure 5: **The amount that can be inherited tax-free is roughly equivalent to a lifetime of low or middle income work**

Illustrative total in April 2018 terms

Notes: Uses the 2018-19 tax thresholds and National Living Wage. Assuming these rise in line with earnings over the long-term, this is equivalent to projected incomes being in 2018-19 earnings terms.

15 See the Haig-Simons definition, and the interesting US debate resulting from the Sixteenth Amendment's granting of power to tax 'incomes'.

16 Reportedly stated by Kenneth Carter, who chaired the Royal Commission on Taxation ('Carter Commission'), published in 1966.

earn £849,000 in total – and would pay £47,000 in Income Tax and £49,000 in employee National Insurance (not to mention travel and childcare costs). In contrast, 'Person C' could tomorrow inherit £900,000 from their parent and pay no tax at all (and this will rise to £1 million in 2020-21). Finally, if 'Person D' received £900,000 in wages in 2018-19, they would pay £412,000 in tax. Looked at this way, the ability to inherit what for many would be an entire lifetime's income, tax-free, appears generous to say the least.

Indeed, many have suggested that inherited income should be subject to *higher* taxation than earned income. The famous Meade Committee on taxation took this view:[17]

> Inherited wealth is widely considered—and we share the view—to be a proper subject for heavier taxation on grounds both of fairness and of economic incentives. The citizen who by his own effort and enterprise has built up a fortune is considered to deserve better tax treatment than the citizen who, merely as a result of the fortune of birth, owns an equal property; and to tax the former more lightly than the latter will put a smaller obstacle in the way of effort and enterprise.

In fact, just as some worry about the effects of income taxes on work incentives and therefore on the economy as a whole, there is evidence that the receipt of inheritances can actively reduce labour market participation or hours worked.[18] On the other hand, some recipients may be more likely to take entrepreneurial risk as a result of their windfalls.

Other taxes should not take the strain while letting off Inheritance Tax

So although inheritances will of course help younger generations like millennials who have faced particular challenges – from a tough market for housing and jobs to reduced support from the state – inheritance taxation should play a role in meeting the UK's substantial fiscal challenge over coming decades. As the OECD notes, a well-designed inheritance tax is supported "on efficiency, equity and administrative grounds".[19] The winners of the birth lottery within each generation should contribute both for reasons of equity and economic efficiency, and insofar as inheritance taxation does not pull its weight in future, the burden of taxation on earned income would have to increase to avoid the welfare state falling below expectations.

Inheritance taxation must rise to the fiscal challenge and ensure wealth gaps within generations do not grow ever larger. But to do so it needs reform, given its flaws and deep unpopularity. As Section 3 will show, however, the prospects for fixing these within the current system are limited. Its 'high rate' cannot easily be tackled while maintaining revenue, and 'taxing giving' and 'ease of avoidance' are fundamental parts of Inheritance Tax.

17 IFS, The structure and reform of direct taxation: report of a committee chaired by Prof. Meade, 1978

18 See for example D Cox, Inheritance, bequests, and labor supply, IZA articles, 2014; K Doorley & N Pestel, Labour Supply after Inheritances and the Role of Expectations, IZA, March 2016; and J Brown et al., The effect of inheritance receipt on retirement, Review of Economics and Statistics, May 2010

19 OECD, The Role and Design of Net Wealth Taxes in the OECD, April 2018

Section 3

Inheritance Tax is beyond repair

One of the key problems with Inheritance Tax is that there are many exemptions or reliefs allowing people to avoid it, with a popular perception that it is a voluntary tax – at least for the richest. This section explores some of the most important methods of reducing Inheritance Tax liabilities – including Business Property Relief, Agricultural Relief and lifetime gifts. Although some changes could be made within the existing system, it concludes that a lifetime tax is needed to truly prevent avoidance. Coupled with the unpopularity of 'taxing giving', this points clearly to scrapping and replacing Inheritance Tax.

Trusts are not in themselves the root of Inheritance Tax avoidance

As noted in Section 2, one of the main causes of Inheritance Tax's unpopularity – and perhaps its relatively low revenue – is that it is seen as voluntary for the richest. Part of the perception is that this is facilitated by the use of trusts. Trusts are an important part of UK law with many uses, but it is true that they have been used by many to reduce inheritance taxation.

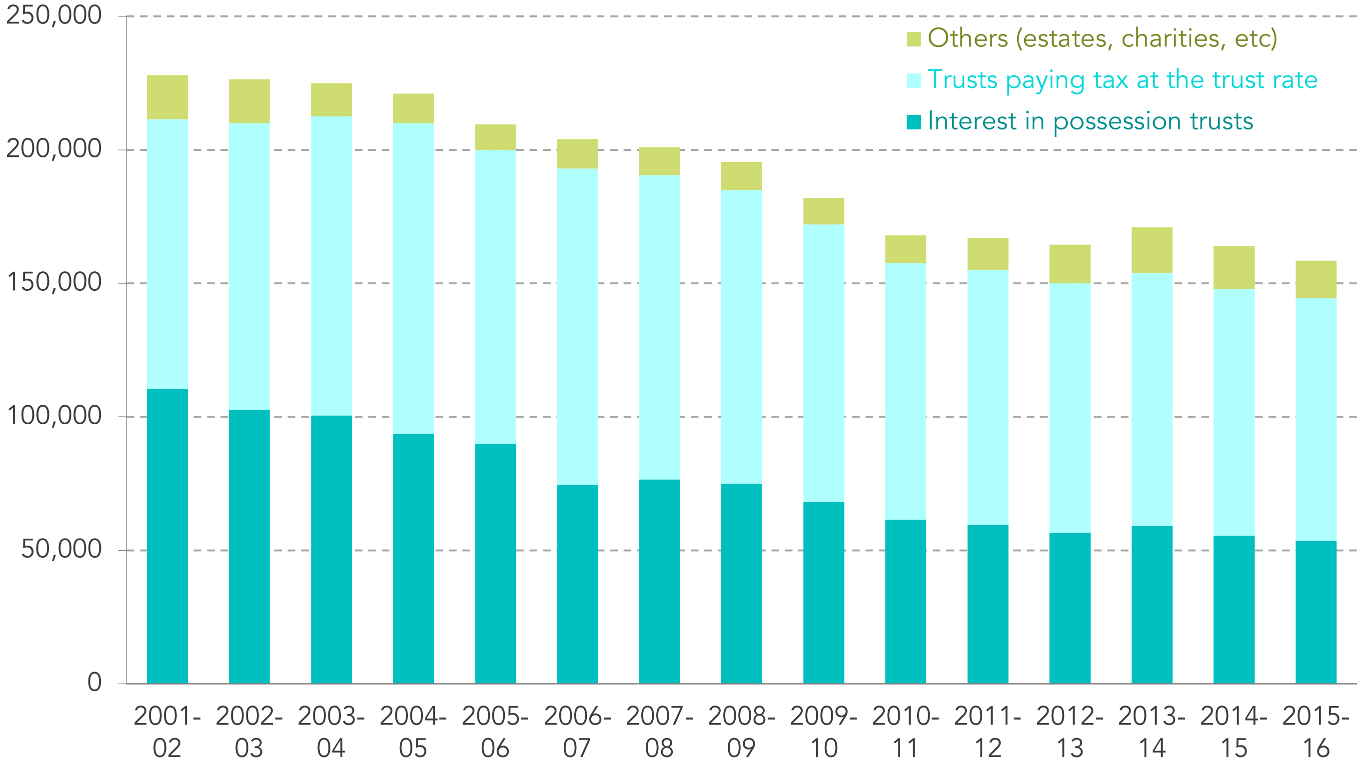
However, tax policy has recently tried to ensure that funnelling money through trusts is taxed as heavily – if not more – than direct inheritances by individuals. Following changes made in 2006, trusts face an entry charge of either 40 per cent or (for lifetime gifts) 20 per cent; a charge of up to 6 per cent every 10 years; and an exit charge when the trust ends or assets are distributed. The system is intended to roughly approximate Inheritance Tax paid every generation on death – though trusts (at least those set up by UK doms) are now likely to be taxed more harshly than individuals.[20] In addition, the administrative costs can be prohibitive for smaller sums.

As a result, the number of trusts has been in decline, as Figure 6 shows. In 2015-16 (the most recent data) there were 159,000 trusts in total – 25 per cent fewer than a decade earlier and 31 per cent fewer than in 2001-02.

20 R Boadway, E Chamberlain & C Emmerson, Dimensions of Tax Design, Taxation of Wealth and Wealth Transfers: Appendices, Institute for Fiscal Studies, September 2010

Figure 6: **Trusts have been declining in popularity**

Number of trusts in operation



Source: HMRC

This tax structure is undoubtedly complex, and will be the focus of a forthcoming government review (which sits alongside one by the Office of Tax Simplification looking at inheritance taxation more broadly). But there are no easy ways to ensure exact parity between trusts taxation and other inheritance taxation, particularly when circumstances can differ from trust to trust.

For example, the 2006 tax changes did not apply retrospectively, so some trusts created before March 2006 did not pay an entry charge. In one sense, then, there is some horizontal inequity between trusts (and 10-year anniversary charges could be adjusted for those older trusts to account for that). But any change would involve a degree of retrospection and would not alter future incentives. In time, the old trusts will lapse into the new regime.

One possible change would be to combat Excluded Property Trusts, used by foreign domiciled persons to ensure that no Inheritance Tax is due even after they become deemed domiciled in the UK.[21] The Government has recently eroded some of the privileges of Excluded Property Trusts by imposing Inheritance Tax on trusts that hold 'enveloped' UK residential property (i.e. houses held in offshore companies) and this approach could be extended further. But the revenue-raising potential from the small pool of internationally-mobile super-rich is hard to assess.

21 Prudential International, *A guide to the Excluded Property Trust*

Other Inheritance Tax policies are perhaps more important for reducing tax bills, with trusts merely facilitators. In particular, trusts allow people to give early in their lives (rather than at death) while still retaining some control of their assets, and although they now pay a 20 per cent entry charge on such lifetime transfers, this is lower than the 40 per cent paid at death or within seven years of it. (A similar motivation can apply to the use of Family Investment Companies.) This is explored further below.

Trusts – like individuals – may also take advantage of reliefs for business and agricultural property. This is particularly the case where a trust's 10-year charge is approaching. As (unlike death) the date of this charge is known in advance, trusts can potentially move into assets that benefit from these tax reliefs and then move back to other assets afterwards. The underlying problem, however, is the breadth of exemptions available rather than trusts using them.

Business Property Relief and Agricultural Relief are significant exemptions

Business Property Relief was introduced in 1976 to prevent "a small business, a solely-owned business or a business predominantly owned by one person having to be sold and smashed up to pay the tax"[22] – or to "support business continuity" as the National Audit Office puts it.[23]

Since 1992, 100 per cent relief for Inheritance Tax has been available for full or partial ownership of unlisted companies, where the donor has owned it for at least two years and where the company is mostly (i.e. more than 51 per cent) involved in (broadly) trading activities rather than investment. Only 50 per cent relief is available in some other circumstances. Where tax is due, it can be paid over a 10 year period, generally without interest.

Altogether Business Property Relief costs an estimated £710 million in 2017-18 (13 per cent of actual Inheritance Tax receipts).[24]

While the original purpose for BPR is perhaps understandable, the economic case for Business Property Relief is less clear, given that family-managed businesses are known to typically be less productive than others.[25] In any case, there are no restrictions on the size of business it applies to – it is not just for small businesses. It is unconditional – meaning that a business can be sold the day after being inherited without affecting the tax treatment.[26] And there is no requirement that the owner have any real relationship or minimum stake in the company – indeed the relief also applies to some traded shares, as explored in Box 2. And it is also unclear from an equity perspective why someone inheriting ownership of a £1 million business from their parents should be treated differently by the tax system from someone inheriting £1 million in cash or quoted shares in large companies, beyond mechanisms for recognising the lower liquidity of business inheritances.

22 David Howell MP, Hansard, 17 May 1976

23 NAO, The effective management of tax reliefs, November 2014

24 HMRC, Estimated costs of principal tax reliefs, January 2018

25 ONS, Management practices and productivity among manufacturing businesses in Great Britain: Experimental estimates for 2015, 2017

26 R Boadway, E Chamberlain & C Emmerson, Dimensions of Tax Design, Taxation of Wealth and Wealth Transfers: Appendices, Institute for Fiscal Studies, September 2010

Box 2: Tax-free bequests of AIM shares

The AIM market (originally 'Alternative Investment Market') is part of the London Stock Exchange specialising in medium-sized firms. The largest companies traded there, however, are worth over a billion pounds each.[1]

Although Business Property Relief only applies to unlisted firms, AIM shares are regarded as unquoted for this purpose and can therefore be free of Inheritance Tax. There is no minimum share in a company, and no requirement of any personal relationship with it.

There are some exceptions. Shares must have been held for two years to qualify for full relief, and businesses must not be wholly or mainly involved in holding or dealing in assets like securities or property.

To deal with these complications, financial providers can try to select AIM companies that will meet these requirements and so are potentially free of Inheritance Tax, and create financial products around these. As AIM shares can – since 2013 – be held in ISAs, these can also be crafted to avoid Inheritance Tax. For example, Octopus Investments reportedly manage £1.2 billion through their AIM Inheritance Tax Service and AIM Inheritance Tax ISA schemes on behalf of 9,200 investors – implying average investment per customer of £130,000 and a potential loss to the Exchequer of £0.5 billion in Inheritance Tax receipts.[2]

Both the financial providers and their customers are simply taking advantage of tax reliefs created by the government (partly with the intention of encouraging just such investment), but their use is a prime example of how Business Property Relief may be far removed from the goal of keeping small businesses in the family.

1 https://uk.webfg.com/index/FTSE_AIM_100

2 https://octopusinvestments.com/investor/investor-centre/document-library/octopus-aim-inheritance-tax-service-brochure/

Similar to Business Property Relief, Agricultural Relief reduces Inheritance Tax for agricultural property, at a rate of either 100 per cent or 50 per cent. Agricultural Relief cost £515 million in 2017-18, equivalent to 10 per cent of actual Inheritance Tax receipts (or 17 per cent of current Common Agricultural Payments, for comparison).

Often it is investors and trusts who benefit, having purchased agricultural land because of this favourable tax treatment, rather than active farmers. In fact, by pushing up the value of agricultural land, such reliefs make it harder for those who want to become farm owners for reasons other than tax minimisation – such as tenant farmers who would like to own instead – to do so.

These two broad reliefs are therefore an important contributor to Inheritance Tax's 'leakiness'. What to do about them is explored further in Section 4.

Charitable tax reliefs are not a part of the problem

Transfers to charities are exempt from Inheritance Tax, at a cost to the Exchequer of £820 million a year.[27] However this does not itself benefit the donor. And the income of charities from other sources is also not taxed. Indeed, income given to charities before death receives Gift Aid (i.e. transfers are treated as being made before income tax) whereas those after death do not, so it is difficult to argue that the exemption from Inheritance Tax is excessively generous.[28]

A more recent tax break specifies that where at least 10 per cent of an estate (after tax) is left to charities, the Inheritance Tax rate for the whole estate is lowered from 40 to

27 HMRC, *Estimated costs of principal tax reliefs*, January 2018

28 Disclosure: Resolution Foundation is a registered charity; and the author is on the advisory group for the NVCO's Charity Tax Commission.

36 per cent. This policy was introduced in 2012 and estimated to cost £170 million a year by 2015-16.[29] In the interests of simplicity there might be a case for ending this tax break, but doing so could be expected to reduce charitable giving.

Less significantly (for most) there are also conditional Inheritance Tax exemptions for assets that are considered part of the UK's national heritage – but we do not explore these here.

By excluding most lifetime gifts, Inheritance Tax is fundamentally avoidable

Alongside business and agricultural reliefs, the most important way in which Inheritance Tax is 'easy to avoid' is that it allows the ability to give before death tax-free, applying as it does only to gifts made at or near death. This feature also drives the use of complex mechanisms such as trusts and family investment companies. And it is a facility that is far easier for those with assets that are substantial and liquid, and who are well-advised and healthy.

Given this obvious potential for avoidance, estate duties have (as Box 1 outlined) tended to grow to encompass some lifetime gifts – now covering the seven years before death. As Table 1 shows, gifts made beyond this period are not taxed, and those between three and seven years face lower tax rates (if the value of the estate plus gifts ends up being over the nil-rate thresholds).

Table 1: Lifetime gifts are usually taxed at lower rates than bequests, if not zero

Time between gift and death	Potential tax rate
7 years or more	0%
6-7 years	8%
5-6 years	16%
4-5 years	24%
3-4 years	32%
Under 3 years	40%

Inheritance Tax could therefore be made harder to avoid by simply expanding the seven-year rule (e.g. to 10 or 15 years) and/or changing the tapered tax rates set out in Table 1. Indeed, as life expectancies have grown significantly since these provisions were first created (most recently in 1969), it could be argued that the years rules should have grown too.

Any form of year rule is not ideal, however. For the givers and receivers, it creates a lot of uncertainty about tax treatment – with gifts being 'potentially exempt' or potentially taxed at 40 per cent. It creates great distortions on people's financial decision making. And for the Exchequer, the continuation of *any* rule still allows the wealthiest to give early and favours those who are best able to do that while taxing those less able to do

29 HM Treasury, Budget 2011 policy costings, March 2011

so. Extending the period would also make administration harder still, as gifts need to be accounted for retrospectively – many years after the fact. And any continued link to death – rather than simply capturing all wealth transfers equally, regardless of when they are made – will not address that aspect of Inheritance Tax's unpopularity.

Note that even in the low-tax US (as explored in Box 3) *all* lifetime gifts are taxed – above some very generous limits – irrespective of when the giver dies.

Box 3: The US's estate tax and gift tax

The US has an 'estate tax' with a very generous tax-free amount of $11.2 million in 2018 (more than double what it was the year before, as part of the 2017 tax cuts). As in the UK, this allowance passes to a person's spouse if unused – effectively doubling the threshold for many – and transfers to spouses are exempt. For the tiny minority who pay, the marginal rate is 40 per cent.[1] (Additional taxes exist in some states.)

1 A progressive rate schedule exists ranging from 18 per cent to 40 per cent, but the way the tax operates means that it is equivalent to 40 per cent above the exclusion amount.

However, to prevent this from being entirely circumvented through early giving (unlike in the UK), a related 'gift tax' applies to lifetime gifts – paid by the donor. The above tax-free amount and tax rate applies to these gifts too. In addition, there is an annual exclusion of $15,000 per recipient.

Within the seven-year rule, there are a number of further allowances for relatively small gifts. Gifts of £250 per recipient are exempt. And each donor also has a £3,000 a year annual exemption. On top of this, gifts specifically for weddings and civil ceremonies are exempt up to £5,000 per child (less for others). And 'normal gifts out of income' (as opposed to those that reduce your existing wealth) can also be exempt. This complicated tax break for gifts that do not reduce the giver's standard of living – while ostensibly intended to help with "Christmas or birthday presents"[30] – seems particularly generous to the very wealthy.

For example, someone with a high enough income could give their children £20,000 a year in the years leading up to his/her death but still pay no Inheritance Tax on it, whereas a lump sum not 'out of income' would be liable. There is a lot to be said for sweeping away some or all of these complex and prescriptive rules and having a simpler annual gifts exemption (see Section 4).

It is clear, however, that small changes to the existing Inheritance Tax system cannot fundamentally remove the scope for avoidance; and nor can they address its image problems as a tax related to giving and to death. Bolder reform is needed, with Inheritance Tax abolished and replaced.

30 https://www.gov.uk/inheritance-tax/gifts

Section 4

Replacing Inheritance Tax with a Lifetime Receipts Tax

Given the problems with Inheritance Tax discussed in Section 2 and Section 3, the best option – explored here – is to replace Inheritance Tax with a tax that is levied on the recipient rather than the estate and that captures all lifetime gifts as well as bequests. This section explores how a 'Lifetime Receipts Tax' might work, with a lifetime allowance for inheritances and gifts and a progressive rate schedule above this. The UK's closest neighbours – Ireland and France – both offer experience about how this can be done. Using the Wealth and Assets Survey this section then models how much revenue various options would raise compared to Inheritance Tax. We also look at how to limit existing reliefs to ensure a new system is simpler and harder to avoid than Inheritance Tax.

Our recommended system would address the criticisms levelled against Inheritance Tax, with its explicit link to death broken, lower marginal rates and fewer opportunities for avoidance, while also raising more revenue.

A new Lifetime Receipts Tax should replace Inheritance Tax

To address the many perceptual and practical problems with inheritance taxation, outlined in Section 2 and Section 3, it needs to tax recipients rather than donors, have lower rates and close off opportunities for avoidance. Tackling avoidance – and providing fairness between beneficiaries receiving gifts at different times – means covering all lifetime receipts: both inheritances and gifts. Here we refer to such a replacement to Inheritance Tax as a Lifetime Receipts Tax (LRT).

Taxing the beneficiary of wealth transfers rather than the donor would address the criticisms of Inheritance Tax (whether fair or not) that it is 'double taxation', that is a tax on giving and that it is a tax on the elderly and infirm. Given that inheritance taxes are best seen conceptually as taxes on the income of the recipient – just as other income is taxed – it makes sense that the tax should actually be on this basis too. And, as explored further below, provided the tax has a progressive design, taxing beneficiaries also has practical benefits in encouraging bequests to be widely shared.

i Policy recommendation

Abolish Inheritance Tax and replace it with a Lifetime Receipts Tax, paid by the beneficiary

Recipient-based taxation is not a new idea. As set out in Box 4, Ireland has a Capital Acquisitions Tax that would be a good model, and Box 5 explores France's succession tax. Such a policy was also recommended by the Mirrlees review of the UK's tax system, which concluded that "a movement towards a tax on lifetime receipts would be more defensible than the current system, both on grounds of fairness and on grounds of economic efficiency".[31]

Box 4: Ireland's Capital Acquisitions Tax

Ireland's Capital Acquisitions Tax, introduced in 1976, is paid by recipients. Both inheritances and gifts are taxed at 33 per cent, but each person essentially gets three lifetime allowances for transfers from different kinds of relations. One threshold, at €310,000 (£275,000), is for receipts from one's parents; one, at €32,500, is for those from other close relations; and another, at €16,250, is for all other receipts. These thresholds currently apply to all transfers made since 1991. As in the UK, transfers between spouses are exempt.

In addition, the first €3,000 of gifts from any benefactor is exempt each year (this does not apply to inheritances). There are also business and agricultural reliefs, with values potentially marked down by 90 per cent before tax is calculated. Farmers only qualify if their assets comprise at least 80 per cent agricultural property, and agricultural property must continue to be held for at least six years after the inheritance or else the relief is clawed back.

A generous tax-free allowance would limit the number of people affected by a Lifetime Receipts Tax

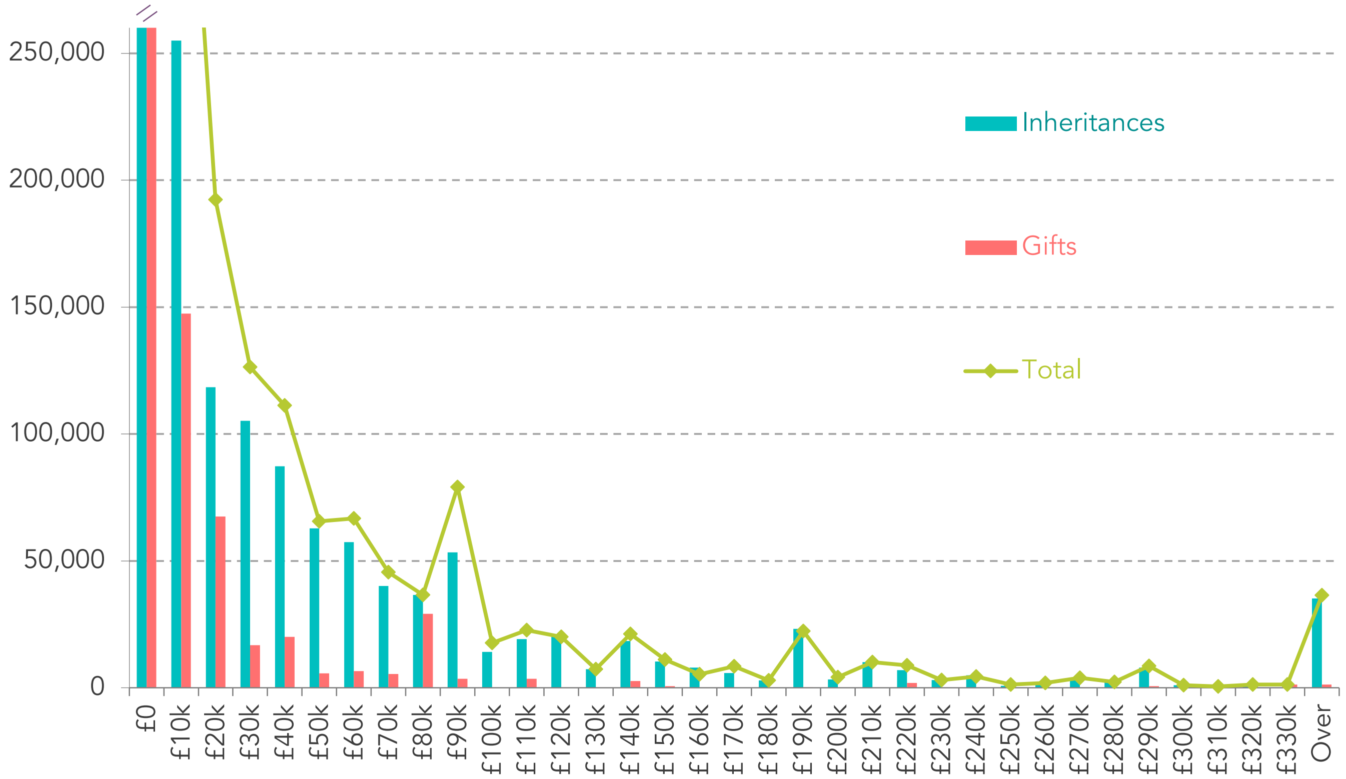
As with many taxes, an LRT could be designed in many different ways – with any tax rates and tax thresholds desired. As in the current Inheritance Tax system an important decision is how large the initial tax-free band (if any) should be. One key difference is that in a LRT system the allowance would be per recipient rather than per estate.

For comparison with potential allowance sizes, Figure 7 shows the actual distribution of gifts and inheritances received in 2014-16 (according to *Wealth and Assets Survey* responses). Of those who received an inheritance, 50 per cent received £10,000 or less and only 10 per cent received over £100,000. For other gifts typical values are even lower, with only 2 per cent having received a gift worth over £50,000.

31 J Mirrlees et al., *Tax by design*, Institute for Fiscal Studies, September 2011

Figure 7: **Of those receiving inheritances or gifts, relatively few receive over £100,000 in a year**

Number of people receiving inheritance and gifts of different sizes in 2014-16 (annualised), by lower bound of band



Note: The number of people who received an inheritance between £1 and £10,000 was around 1 million, and the number receiving a gift in that range was around 2 million. These values go beyond the Y axis shown. We adjust WAS data on net receipts to try and approximate pre-Inheritance-Tax figures

Source: ONS, *Wealth and Assets Survey*, Wave 5 (2014-2016), GB

As now, a LRT should include a small annual gifts allowance. For example, the first £3,000 of gifts each year from one donor to one donee could be exempt – matching the current exemption for gifts in the seven years before death. Only the value above this would count towards the LRT.

Then there would be a 'Lifetime Receipts Tax Allowance' (LRT Allowance). This could rise with CPI inflation each year like most tax thresholds,[32] though this is not essential.[33] Given that a LRT could now not realistically be implemented until 2020-21 at the earliest, we specify tax thresholds in this paper as might be appropriate in that year – bearing in mind likely increases in asset values before then. We suggest that £125,000 would be a reasonable size for a LRT allowance in 2020-21. This would exclude the large majority of inheritances and gifts. And it would mean that a house of average value – projected to be around £240,000 in 2020-21[34] – could be inherited by two people without any tax being paid.

32 While it may at first seem paradoxical for a lifetime allowance to change each year, such a system is quite possible in practice. Changes in the allowance would simply be added (or subtracted) from people's remaining individual allowance

33 Note that a £100 threshold for estate duty persisted from 1896 to 1946 without being uprated. A Atkinson, *Wealth and Inheritance in Britain from 1896 to the Present*, LSE, November 2013

34 Using ONS, *UK House Price Index: February 2018*, April 2018 and OBR, *Economic and Fiscal Outlook*, March 2018

Policy recommendation

Give each person a Lifetime Receipts Tax Allowance of £125,000 (indexed to inflation) and exclude gifts of £3,000 or less (per donor per year)

In many countries, including Ireland (Box 4) and France (Box 5), taxpayers have multiple allowances depending on their relationship to the donor. However, it is not clear why someone receiving money from a childless aunt should be taxed more than someone receiving the same sum from a grandparent, for example. One of the criticisms of the new residential nil-rate band is that it is only available where assets are left to direct descendants. Indeed, one of the related advantages of a LRT is that it does not discriminate against those with only a single parent as Inheritance Tax does (as those who've had two parents can benefit from two nil-rate bands).

Box 5: France's droits de succession

As shown in Figure 2, France raises a relatively high proportion of public revenue from inheritance taxation. Like Ireland (Box 4), it taxes recipients rather than donors and lifetime gifts are included. There is a tax-free allowance for each donor-recipient pair, but these allowances regenerate every 15 years (rather than having a single lifetime allowance). Gifts – but not inheritances – between spouses are also taxed above a high allowance.

The tax-free allowance depends on the relationship between recipient and donor, and so do the tax rates. For parents, children and grandchildren, the allowance is €100,000 (around £87,000), followed by tax rates progressing from 5 per cent to 45 per cent above €1,905,677 (around £1.65 million), as shown in Table 2.

Table 2: Standard French tax bands for transfers between parents, children or grandchildren

Start of band (€)	End of band (€)	Tax rate
0	100,000	Tax-free
100,000	108,072	5%
108,072	112,109	10%
112,109	115,932	15%
115,932	652,324	20%
652,324	1,002,838	30%
1,002,838	1,905,677	40%
1,905,677		45%

Source: https://www.service-public.fr/particuliers/vosdroits/F14198

For those who are unrelated, the tax rate is a flat 60 per cent above a very small allowance. French law also places restrictions on how estates are divided up – unlike in the UK. Some business and agricultural holdings can receive a reduction of up to 75 per cent but with conditions on length of ownership both before and after receiving the tax break. Farmers only qualify if their assets comprise at least 80 per cent agricultural property.[1]

1 E Chamberlain, *A review of agricultural property relief and business property relief*, British Tax Review, 2016

Importantly, an LRT Allowance would itself affect the incentives for *how* people choose to give. At present, Inheritance Tax – levied as it is on estates – is essentially blind to who receives the inheritances. Whether you leave £1 million to a single individual with high income and high existing wealth or whether you leave £10,000 each to 100 penniless people is irrelevant for Inheritance Tax (with the exception of charitable giving).

With a per-individual allowance, however, an estate concerned about how much tax their recipients would collectively pay might decide to reduce that tax by spreading the wealth across more people (and therefore more allowances). Although this behaviour would reduce revenue for the government, on the other hand it is a welcome and inevitable effect of a progressive tax in which a recipient's inheritance is taxed somewhat more heavily if they have already inherited a lot. In practice, one common way of reducing LRT payable would likely be for parents to leave their estate not just to their child but to their child's spouse: thus benefiting from two LRT allowances. This is a feature of the tax rather than a bug. However, it should be noted that if the child's spouse later received an inheritance from their own parents, they would already have used up some or all of their allowance and so pay more tax. In this way, the long-term effects on government revenues of people splitting up estates are subtler than they may at first seem. To best reduce tax paid, people would target bequests not just on people who had not received inherited wealth previously but on those who were unlikely to do so in future. This would be a desirable outcome in securing a broader distribution of inheritances.

Progressive rates would be fair and further encourage bequests to go to those without substantial wealth

This incentive would be even stronger with a progressive rate structure. As noted in Box 1, it is only for the past 30 years that the UK's inheritance tax has been a flat rate. In France (Box 5), rates progress from 5 per cent up to 45 per cent for transfers from parents, and up to 60 per cent for some others.

Indeed, a simple and progressive way to tax a person's receipts of inheritances and gifts (in theory) would be to use the Income Tax system itself.[35] That is, beyond a lifetime allowance – as above – inheritances and gifts would be treated exactly like any other taxable income. If, for example, you inherited £300,000, this would be added to your taxable income and taxed at a mix of zero, 20, 40 and 45 per cent, depending on your income. Or, to be treated equally with earnings, National Insurance would also be paid (an additional 12 per cent for basic rate payers and 2 per cent at higher incomes).

In practice, a complete merger of receipts taxation with Income Tax would be very punitive compared to the current system, with the 45 (or 47) per cent rate in practice applying to most of the value of large inheritances. The potential for high marginal rates would also leave one of the main criticisms of Inheritance Tax in place. And its administration would likely be complex. (One option would be to let people average their inheritance over several years for tax purposes – as some artists can with their income – but again this would be complex).[36]

35 A Atkinson, *Inequality – What can be done?*, Harvard University Press, 2015

36 See https://www.gov.uk/government/publications/averaging-for-creators-of-literary-or-artistic-works-hs234-self-assessment-helpsheet/hs234-averaging-for-creators-of-literary-or-artistic-works-2015

Instead, the LRT should have its own rate schedule with bespoke tax thresholds. And, as the modelling below shows, these rates could be much lower than Inheritance Tax's single 40 per cent rate.

A Lifetime Receipts Tax could raise substantially more revenue even with a much lower starting rate than Inheritance Tax

Using the *Wealth and Assets Survey* (see Annex for more details) we are able to model the revenue impacts of different recipient-based taxes. These should be compared to the £5.9 billion expected to be raised by Inheritance Tax in 2020-21. Here we look at the revenue raised in Year 1, where everyone starts with a full LRT Allowance. In keeping with our assumption that such systems would lead to inheritances being spread wider than at present, we model this (simplistically). So for every three people currently set to receive an inheritance, we assume that one more would benefit – with the average inheritance being lower as a result. With 2 million people having some inheritance in 2015-16, this assumption implies that 680,000 additional people would have received something.

Table 3 presents seven illustrative forms of receipts tax. For example, the "Flat 40p rate" system parallels the existing Inheritance Tax system – with a single 40 per cent rate and a high LRT Allowance (£500,000) – but is based on recipients. This would raise an estimated £700 million more than Inheritance Tax. In contrast, the "Flat 10p rate" system shows how low marginal rates can go if the tax threshold is reduced and – in this case – the spousal exemption is also abolished.

Our central scenario features a £125,000 LRT Allowance in 2020-21, a basic rate of 20 per cent, and a top rate of 30 per cent above a threshold of £500,000. This would raise £4.8 billion more than Inheritance Tax is projected to in that year.

Table 3: Revenue from different schemes in Year 1, if introduced in 2020-21

	Lifetime allowance	Tax rates	Revenue (2020-21), £bn	Extra revenue, £bn
Current system			5.9	
Recipient-based taxes				
Flat 40p rate	£500k	40% above that	6.6	0.7
Flat 15p rate	£125k	15% above that	6.9	1.1
Flat 10p rate	£125k	10% above that, with no reliefs or spousal exemption	6.2	0.3
Our recommendation	£125k	20% up to £500k; 30% above that	10.7	4.8
10x income tax thresholds	£125k	20% up to £500k; 40% up to £1.5m; 45% above that	13.5	7.7
Income Tax	Any unused personal allowance. Income Tax rates		15.0	9.2
Income Tax and NICs	Any unused personal allowance. Income Tax and NICs rates		16.1	10.2

Notes: Includes a behavioural effect for extra splitting of estates (except in the bottom two scenarios). All include a £3,000 gift allowance.

Source: RF modelling using ONS, *Wealth and Assets Survey*, Wave 5 (2014-2016) and OBR Inheritance Tax forecast

Even more revenue would be raised by simply taxing inheritances and gifts through the Income Tax system, as discussed above, with no lifetime allowance. Such an approach, with marginal tax rates therefore ranging from 20 per cent to 45 per cent, would raise £9.2 billion more than Inheritance Tax. Including National Insurance would raise even more, but the lack of a lifetime tax-free allowance makes these options both politically and administratively difficult.

Our recommended system would do away with Inheritance Tax's 40 per cent rate and replace it with rates of 20 and 30 per cent. In addition to being lower than at present, 30 per cent would be a lower top marginal rate than in most inheritance taxes internationally (including the US, Ireland and France – see boxes 3, 4 and 5). But of the 2 million people receiving some inheritance in 2015-16, only 140,000 would pay any tax and of those only 10,000 would pay the higher rate of 30 per cent. The vast majority of those with any LRT liability would pay the 20 per cent rate – half the current marginal rate.

i Policy recommendation

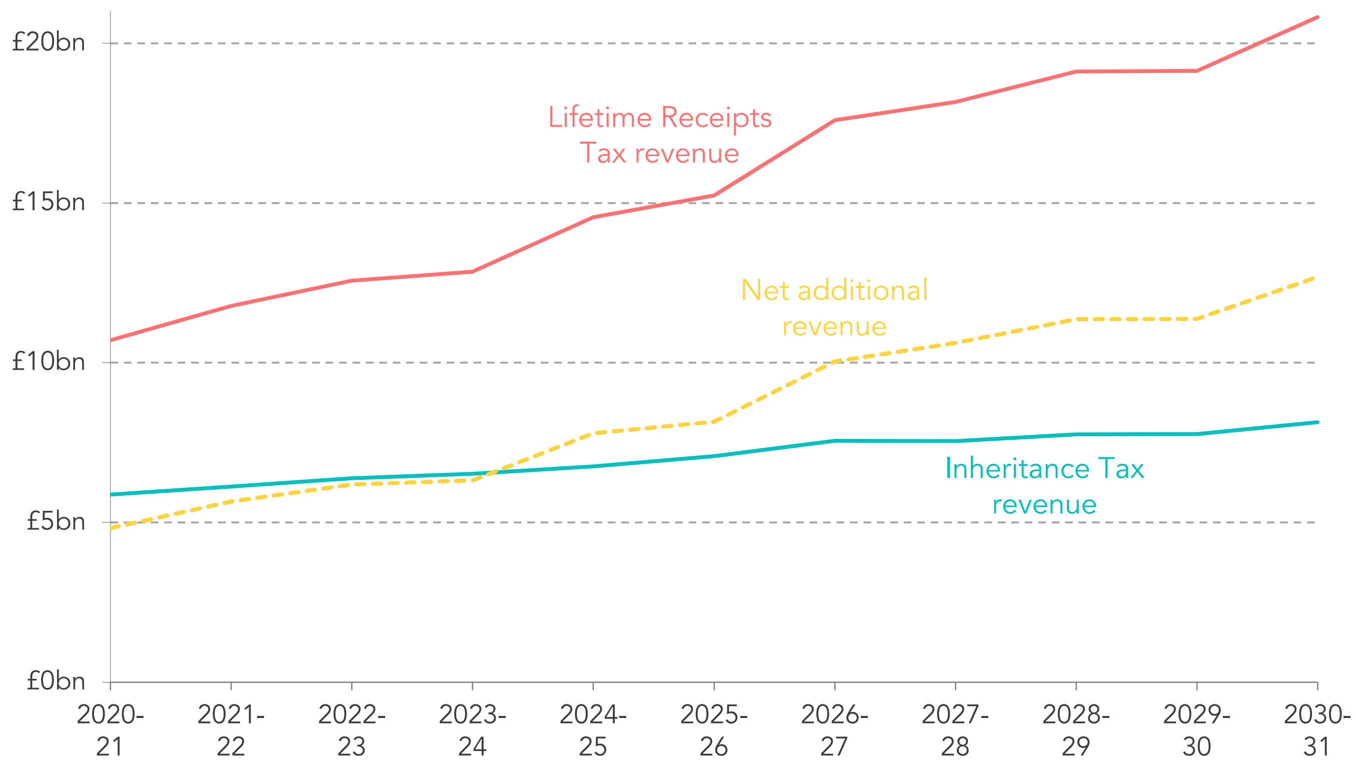
Beyond the Lifetime Receipts Tax Allowance, apply a progressive rate schedule with a basic rate of 20 per cent and a higher rate of 30 per cent above £500,000

The costings in Table 3 are for 2020-21 (assuming that is the year of introduction). However, tax revenues for a LRT could be expected to rise substantially over time beyond the first year for two reasons. First, as set out in Section 2 inheritances are set to grow in importance (both in terms of number and size) as large, wealthy cohorts pass through retirement. Second, a LRT is most generous in its first year when people's LRT Allowance and other thresholds have yet to be reduced by past inheritances. As the years progress, a number of people will have had multiple inheritances and so may be taxed on their new inheritance.

Figure 8 models this increase over the 2020s. LRT receipts grow from £11 billion in 2020-21 to £21 billion in 2030-31. Inheritance Tax receipts are set to grow, but not so significantly. As such, the difference between the two increases from £5 billion in 2020-21 to £13 billion by 2030-31.

Figure 8: **A Lifetime Receipts Tax introduced in 2020-21 could raise £5 billion more than Inheritance Tax in that year, rising substantially over the 2020s**

£ billion, nominal



Notes: See Annex for methodology

Source: RF analysis, and OBR Inheritance Tax projections up to 2022-23

Clearly, a receipts tax that keeps up the growth of inheritances rather than falling behind like Inheritance Tax has is possible; as is a tax with lower rates than at present and that includes lifetime gifts to curtail avoidance. Of course, others may want a LRT system that differs from that modelled above, depending on their priorities. Some may want to raise less revenue but with a higher threshold or (even) lower tax rates, while others might want more revenue with higher rates – closer to parity with how we tax earned income. Both are quite possible within the framework of a LRT.

This would be a big change for HMRC, but there are no insurmountable obstacles

We turn now to some of the important details of a LRT – though this paper is not an attempt to address every question that would be covered in the long consultative and legislative process that such change would require.

One advantage of Inheritance Tax (versus its many disadvantages) is that it is levied at a point in time when it is administratively easy to do so, and where the tax comes out of the estate before people receive their bequests. A Lifetime Receipts Income Tax should try to retain these advantages. For example, tax should ideally be paid when the assets are transferred rather than having people inherit assets tax-free and then try to sort out their tax treatment later.

This would inevitably require some new structures in the inheritance process (while removing others). HMRC would maintain a database recording each individual's (taxable) gifts and inheritances so far. When an estate is being administered, HMRC would look up the total previous lifetime receipts for each recipient and work out how much tax they should therefore pay on the inheritance. As now, HMRC could have assets liquidated from an inheritor's share if tax is due. And, as now, inheritors could in some cases pay in delayed instalments for up to 10 years, with interest (or take out a temporary loan or mortgage).[37]

Recipients would have a duty to declare taxable lifetime gifts. To facilitate this, questions about gifts would be added to the self-assessment process, and those who do not use self-assessment would be expected to proactively declare any large gifts (above £3,000). Some existing structures would facilitate this process. In the case of help from the 'bank of mum and dad' when purchasing a home, the source of funds already has to be checked under anti-money-laundering rules. This information could be passed to HMRC at the same time.

None of this is revolutionary in terms of administration, but it would increase the volume of work (simply because there are more recipients than there are estates). HMRC is known to be overstretched in many regards (including probate and trusts) and this would need ameliorating if such a reform were to be implemented.

This paper does not attempt to present a complete blueprint of an LRT. But reform would raise a number of policy questions that deserve a quick exploration.

- **Tax evasion**: Taxing lifetime gifts is inevitably more prone to (illegal) tax evasion than taxing inheritances. Transfers can be made between people without ever reporting them (especially in cash). However, HMRC is certainly not powerless. They can already access banks' data, for example, to check for undeclared savings income, and a similar process could flag up large undeclared gifts. Enforcement can happen at any later time, with significant penalties for evasion. Although most people want to comply with the law, it is important that evasion be minimised given Inheritance Tax's perception (for other reasons) as being voluntary.

- **Non-cash gifts**: Gifts such as cars from parents would be taxable – though in most cases for young people these would come within the LRT Allowance rather than being taxed.

- **Raising children**: The costs of raising children should clearly not be part of a LRT, and this includes the costs of supporting their education. Private school fees or university fees would not count as gifts.

37 https://www.gov.uk/paying-inheritance-tax/yearly-instalments

- **Use of property and interest-free loans**: As in Ireland, the free use of an entire property and the benefit conferred by large interest-free loans would both be taxable.[38]
- **Recycled money**: in cases where money is given to someone and then returned, provision can be made to ensure this is not taxed twice. One example – with special treatment in Ireland – is where parents give money to a child who then predeceases them with the parents inheriting the money they had given.
- **Charities**: As now, and in keeping with charities' general tax treatment, gifts and bequests to charities would not be taxed. However, the small tax bonus for estates where 10 per cent of the net value has been left to charities (mentioned in Section 3) would no longer exist due to the switch away from an estate-based system.
- **Residence and tax status**: Inheritance Tax applies to UK assets and to UK doms (with the recipients being irrelevant). One solution for LRT – in line with Ireland and France[39] – would be to apply it where either the donor or the recipient is UK domiciled or the assets are UK-based.
- **Trusts**: The current Inheritance Tax system for trusts would need replacing with one that mirrors the LRT for individuals. This would involve abolishing the aspects of the system that relate to the seven-year rule; approximating the tax levels paid by individuals; and moving to a beneficiary-focused rather than estate-focused approach. The difficulty of doing this should not be underestimated, but the existing system is itself complex and imperfect.
- **Transition**: Moving from one system to the other would not present too many transitional problems. Deaths up to, say, 31 December 2019 could be treated under Inheritance Tax, while those from 1 January 2020 would be covered by the new tax – as would any new gifts. One complication is how existing Potentially Exempt Transfers – those gifts made less than seven years before the start of the new system – would be treated. By default, these gifts would not be included in the new tax (as it would not apply retrospectively)[40] but also would not be caught through Inheritance Tax in the way they might have been (because it would be abolished). To avoid some people benefiting from this gap between the two tax systems, HMRC may have to introduce a temporary backstop for valuable estates that have recently given significant lifetime gifts.

In introducing a new inheritance tax system, the government should also look at making the tax practically easier to pay (though note that a consultation on tax simplification is already underway)[41]. In particular, for those who receive illiquid assets such as residential property, it can be difficult to pay tax before actually receiving the asset. Government could consider expanding the scope of the yearly instalment option (currently only available to those who decide to live in the property) so that inheritors

38 https://www.revenue.ie/en/gains-gifts-and-inheritance/valuation-date-and-the-value-of-certain-benefits/free-use-of-property-and-interest-free-loans.aspx

39 EY, *Worldwide Estate and Inheritance Tax Guide 2017*

40 There may be a case for some anti-forestalling provision however, such as applying the Lifetime Receipts Tax immediately from the point of announcement – to prevent a rush of gifts before the new tax comes in.

41 Office of Tax Simplification, *Inheritance Tax Review Call for evidence and Survey*, April 2018

have time to sell or mortgage the property. Or the government could even take a share of the equity (as it does in the Help to Buy scheme). Note however that the majority of those who receive property sell it, and only 12 per cent live in it as their main home.[42]

The system can also be simplified and broadened in other ways by cutting down on the reliefs that help make Inheritance Tax so porous for the well-advised.

Business Property Relief and Agricultural Relief should be curtailed

Replacing Inheritance Tax with a LRT would not itself answer the question of what should be done with Business Property Relief and Agricultural Relief. As set out in Section 3, an important part of reform should be to curtail the generosity of these reliefs to help restore confidence in the inheritance taxation system and allow lower rates.

One option, of course, would be to scrap the reliefs entirely. Another would be to return to providing only partial (e.g. 50 per cent), rather than 100 per cent, relief. To focus support on trading companies, a further option would be to reduce (from 49 per cent) the proportion of the business's value that can be in the form of restricted investment assets (e.g. to 20 per cent),[43] or apply relief only to trading assets.

But to make inheritance taxation less 'leaky' while maintaining the publicly supported goal of helping genuine small family-owned businesses and farms, a number of changes should be made to better target these reliefs.[44] Changes like these could be made to either Inheritance Tax or a LRT.

i Policy recommendation

Restrict Business Property Relief and Agricultural Relief (including within trusts) to small family businesses by:

- Introducing a cap (e.g. £5 million) for the value that can receive relief
- Increasing the minimum ownership period from two years (e.g. to five), and introducing a period after receipt in which tax relief can be clawed back if the inherited assets are sold on
- Introducing a 'farmer' test for Agricultural Relief, as in Ireland and France, whereby the overall assets of the beneficiary (including the inheritance) must comprise at least 80 per cent agricultural property; and a 'family business' test for Business Property Relief whereby the beneficiary must receive at least 25 per cent of the business and the donor must have had a demonstrable working relationship with the company

42 RF analysis of WAS, Wave 5, 2014-16

43 This would bring Business Relief into line with CGT relief rules. The Office of Tax Simplification has noted that the current inconsistency between tests can lead to misunderstanding. OTS, *Business Lifecycle Report: Simplifying the taxation of key events in the life of a business*, April 2018

44 See also E Chamberlain, *A review of agricultural property relief and business property relief*, British Tax Review, 2016 which discusses some of these options in more detail

Such changes could be expected to save a substantial portion of the £1.2 billion a year currently spent through these reliefs. Any extra revenue from this is not included in our modelling above but would allow the LRT system to have higher thresholds or (even) lower rates; or the money could be used in other ways – perhaps including alternative ways to help entrepreneurs and farmers.

Some pension savings can be passed from generation to generation without any tax ever being paid

One other element of the inheritance tax system that should be tightened is the treatment of private pensions.

When spouses receive a spouse's pension, it is clear that Inheritance Tax or a LRT should not be paid. But – just as their spouse did – they should pay Income Tax on their annuity or drawdown. For both partners, this is because pension contributions tend to be free of income tax (due to relief) so this tax should be paid instead when the pension is received.

For others, receipts should be liable to both the LRT (or Inheritance Tax at present) and Income Tax. Addressing this issue is particularly important as, with the rise of defined contribution pensions and 'pension freedoms', it is now much easier to leave pension pots to people other than a spouse.

Changes made in 2014, however, have made the inheritance of pension pots extremely tax-advantaged for some. For deaths before the age of 75, pension pots can now be inherited tax-free – with neither Inheritance Tax nor Income Tax due (for savings below £1 million). Given that Income Tax relief would have been received on the pension contributions, this means no tax would ever be paid on this income. Despite the tragedy of early deaths, it is appropriate that spouses should pay some tax on this income. While there might be a general case for extra support for widow(er)s, cancelling all income tax is perhaps the most regressive way of doing so – with those on the lowest incomes gaining nothing and those in the higher tax bands benefiting the most.

For deaths above the age of 75, recipients do pay Income Tax as they draw down inherited pension pots. This is appropriate for spouses. But for non-spousal receipts, this doesn't account for the Inheritance Tax that would otherwise be due. For pensioners, therefore, there is an incentive for other assets (that would attract Inheritance Tax) to be spent before drawing down pension pots (which do not).

As previous work for the Intergenerational Commission has shown, decent pension saving is still very far from universal. For those who have done well from the pension market, there is no need for such extra tax planning opportunities. A partial reversal of the 2014 changes – which were together costed at £185 million[45] – would reduce the scope for such planning and preferential tax treatment. For non-spousal receipts of pension wealth this would mean – under an Inheritance Tax replacement – ensuring that both the LRT and Income Tax were applied.

45 HM Treasury, *Autumn Statement 2014: policy costings*, December 2014

Policy recommendation

Remove the tax-free treatment of pension pots inherited on deaths before 75, and for recipients other than spouses levy both the Lifetime Receipts Tax and Income Tax on pensions to give parity with other assets

Capital Gains Tax should not be forgiven at death

An LRT combined with the additional changes above would make inheritance taxation considerably harder to avoid. But the relationship between it and Capital Gains Tax (CGT) should also be considered.

In a previous report we discussed the current exemption from CGT of main residences.[46] This exemption itself weakens the 'double taxation' argument against Inheritance Tax – as a lot of inherited wealth may never have been taxed.

But another exemption comes in the form of CGT for other assets – such as shares or additional properties – being essentially cancelled at death. To give an example, if someone bought a home to let in 2002 for £100,000 and sold it in 2018 for £200,000, they may have to pay a CGT bill of around £25,000.[47] However, if they were to hold on to the property until death, no tax would be due and their beneficiaries could inherit the £200,000 property tax-free. If the beneficiaries were to sell the property later, CGT would be calculated from the starting point of £200,000 rather than £100,000.

This policy therefore creates a very strong perverse incentive for particular assets to be held until death. As argued in a previous paper, this is a particular concern for residential property given the UK's housing needs, and given the (justified) higher CGT rate for additional residential property compared to other assets.[48]

Of course, in this example, the beneficiaries may have to pay LRT on the £200,000 property. But they would also have to pay that tax if the asset had been sold one day – or one year, or one decade – before death and CGT had therefore been paid too. And they would also pay the LRT on top of another tax if the donor had received income in the form of dividends or salary, rather than capital gains. So the presence of taxation at the time of inheritance is irrelevant to whether CGT should be applicable at death. To forego the CGT is to favour one particular form and timing of income (capital gains not realised before death) over all others. As the Mirrlees review puts it "Whatever kind of wealth transfer tax one does (or does not) want, there is no case for forgiveness of CGT on death."[49] It should also be noted that in many cases at present – particularly due to the business and agricultural reliefs – neither Inheritance Tax or CGT are paid.

46 A Corlett & L Gardiner, *Home affairs: options for reforming property taxation*, Resolution Foundation, March 2018

47 Assuming they pay tax at the higher CGT rate of 28 per cent, but use the annual exemption of £11,700.

48 L Judge & D Tomlinson, *Home improvements: action to address the housing challenges faced by young people*, Resolution Foundation, April 2018

49 J Mirrlees et al., *Tax by design*, Institute for Fiscal Studies, September 2011

Policy recommendation

Scrap forgiveness of Capital Gains Tax upon death, at least for additional residential properties and assets qualifying for Business Property Relief or Agricultural Relief

Were this forgiveness abolished, HMRC could either require CGT to be paid at death or – instead – simply use the value the deceased paid for the asset when it is later sold and CGT calculated (rather than using the value from when the asset was inherited, as now).

The exemption was costed at £600 million in 2011-12, but HMRC has not been able to estimate the cost since.[50] CGT revenue overall has doubled between 2011-12 and 2018-19, however, suggesting that this relief may now be worth £1.2 billion.[51] Note again that these figures all exclude capital gains on primary residences, so changing the policy would only affect those with multiple residences or with substantial shareholdings outside ISAs, and only where the gains exceed the CGT allowance of £11,700. Again we do not use this revenue in our costings but (although ending this exemption would in turn reduce LRT receipts slightly) the significant sum could be used to fund a higher LRT allowance or further lower rates compared to Inheritance Tax (or for many other better uses).

Clearly there is a lot of potential for removing or restricting reliefs surrounding inheritance taxation, and so create a broader, simpler and less distortionary tax. Such a tightening should be an important part of replacing Inheritance Tax with a LRT, creating an equitable and economically efficient inheritance tax system to restore public confidence.

Replacing Inheritance Tax with a LRT would involve a large number of choices and trade-offs. But we believe the options we have suggested here gives a good example of the benefits that could come from reform, with lower rates, less avoidance, and more revenue.

50 HMRC, *Estimated costs of principal tax reliefs*, 2012

51 This does not account for the fact that the number of deaths has also risen over this period relative to population size – which might be expected to have further increased the cost of the relief.

Section 5

Conclusion

The work of the Intergenerational Commission has shown that there are big new challenges facing Britain, from the weak incomes and even weaker wealth of millennials to the health and care needs of older generations. Within families, people have (as ever) responded to these changing needs by helping other generations, from the ‘bank of mum and dad’ to a widening of caring responsibilities.

Most people agree that they want each generation to have a higher quality of life than the last. Certainly we want our own children and grandchildren to have it better than us. So the fast growth of inheritances is entirely natural. But the fairness and efficiency arguments for effectively taxing inheritances are also strong. Inheritance taxation has an important role to play in both contributing revenue and reducing slightly the unequal lottery of birth, but at present it is doing a very bad job of keeping up with the growth of inheritances. We can do better than this by addressing head on the root causes of the current system’s unpopularity – by taxing those lucky enough to receive not those dying; lowering the marginal rate of the tax; and drastically scaling back exemptions that make the tax voluntary for some. A Lifetime Receipts Tax would achieve these objectives.

Replacing the unpopular yet timid Inheritance Tax with a bold new approach would inevitably still be politically difficult. But our approach tackles the key drawbacks of Inheritance Tax and would contribute to meeting the challenges raised by the Intergenerational Commission. Building on this, the final report of the Commission will propose a broad-ranging package of policies for a renewal of Britain’s intergenerational contract.

Annex – Methodology

Modelling inheritance taxation in the Wealth and Assets Survey

To model a replacement to inheritance tax, we primarily use the *Wealth and Assets Survey* (WAS), Wave 5 (2014-16). This survey data (with some in-built imputation) gives people's annual total gifts from friends/family and their total inheritances – which are primarily in the form of property, money and savings. In our modelling of taxes we exclude inheritances from spouses (as these are not – and would not be – taxed) and inheritances in the form of businesses (due to Business Property Relief).

Inheritances in WAS are net of Inheritance Tax. To model a new system, we first adjust these incomes to try and get to the gross figures that might have been inherited in the absence of Inheritance Tax. We do this by assuming that inheritances above £375,000 come from estates that have paid Inheritance Tax and scale up any value above £375,000 by two thirds (the reverse of subtracting 40 per cent). This threshold was chosen to try and match actual Inheritance Tax revenues in 2015-16, and lies between the £325,000 nil-rate band and the £650,000 that can potentially be inherited tax-free from a widow(er). As this calculation is based on the recipients' inheritance rather than the value of the estate this is inevitably only a very rough approximation.

To model the behavioural effect that a Lifetime Receipts Tax might have, in terms of encouraging estates to be split more widely, we reduce all inheritances by 25 per cent but multiply the size of the population receiving inheritances by an equivalent factor. The overall amount inherited therefore remains the same but it is distributed more widely (and therefore our suggested progressive tax system raises less money than if behaviour were unchanged).

New taxes are modelled simply using each person's total inheritances and total gifts (above a £3,000 allowance), along with the relevant tax thresholds and rates. It should be noted, however, that the sample size of those receiving an inheritance is relatively small and the number receiving large inheritances even smaller. Costings should therefore be considered to have a large degree of uncertainty.

WAS covers only Great Britain. For comparison with the UK-wide revenue raised by Inheritance Tax, we slightly scale up the results of our modelling from Great Britain to UK (i.e. to include Northern Ireland) using actual Inheritance Tax receipts by region.[52] And because the income of trusts is not included in the WAS data, we assume no change in trust tax revenue under different systems.

Forecasting future receipts

Our base survey data is from 2014-16. But we are concerned with what the revenue from a new system would be if introduced in future, such as for 2020-21, and how that might subsequently evolve.

Tax thresholds are therefore chosen in 2020-21 and then for modelling purposes deflated back to 2015-16 in line with CPI inflation (which would be a sensible indexing policy). In addition, up to 2022-23, Lifetime Receipts Tax revenue is increased in line

52 HMRC, Table 12.10

with the Office for Budget Responsibility's projection for Inheritance Tax receipts but stripping out the effect of the residence nil-rate band tax cut on those. Beyond 2022-23 (the end of the OBR forecast) we increase receipts in line with the inheritance projection undertaken in previous work for the Intergenerational Commission.[53] This accounts both for the expected size and breadth of bequests in future and demographic effects. The same is applied to Inheritance Tax.

For Lifetime Receipts Tax revenue (but not Inheritance Tax), we must also account for the lifetime nature of the tax in terms of its Lifetime Receipts Tax Allowance and higher thresholds. In the first year of the tax everyone starts with a full allowance, but in subsequent years many people may have used up their allowance already and therefore any new inheritances would be taxed from the first pound.

To model this, we use Wave 1 of the Wealth and Assets Survey (2006-08) which asked respondents about all their historical inheritances. We model a Lifetime Receipts Tax in 2007-08 as if that were the first year of the tax, but then use the historical information to model the effect on revenue of counting previous years against allowances too, from one year up to many decades. The pattern of tax receipts this produces provides some guide to what the future of a Lifetime Receipts Tax would hold. This profile is applied to our Lifetime Receipts Tax projection, boosting revenue by almost 40 per cent in the long run – in isolation from any other effects. Note however that relatively few people receive multiple inheritances over their lives – and this would be even lower if a Lifetime Receipts Tax had the expected behavioural consequences.

53 L Gardiner, *The million dollar be-question: inheritances, gifts, and their implications for generational living standards*, Resolution Foundation, December 2017

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Intergenerational Commission

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