Inheritance Tax abolition or reform?

Synopsis: Saturday's Financial Times headlined rumours that the Conservatives were flirting with the abolition or phasing out of inheritance tax. Four days later, the Institute for Fiscal Studies set out the case for reform.

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Inheritance tax (IHT) is a hot button topic that regularly prompts press campaigns for its abolition, the latest being from the Daily Telegraph. IHT is frequently branded as the UK's most disliked tax, with the latest YouGov survey showing that 50% of respondents think it 'unfair' or 'very unfair', against 19% who took the opposite positions.

As the Office of Tax Simplification (OTS) demonstrated in its first report reviewing IHT, there is a perception that the tax has a much greater impact than is actually the case. Even 26% of those who responded to an OTS public call for evidence – a self-selecting group who ought to have had some knowledge of the tax – believed that 20% or more of people paid IHT. The latest HMRC figure (for 2020/21) is 3.73%.

A new report on IHT from the Institute for Fiscal Studies (IFS) does not answer the impossible question which Paul Johnson, the IFS's Director, recently posed in a Times' article: what is the question to which abolishing inheritance tax is any sort of plausible answer?

However, the report does make a range of points about the operation of the tax and its potential reform...

1. **Inherited wealth is growing compared with earned incomes and will have a growing impact on inequalities by parental background.** Inheritances will remain small for those with the least wealthy fifth of parents, but for those with the wealthiest fifth of parents they are set to rise from averaging 17% of lifetime income for those born in the 1960s, to averaging 30% of lifetime income for those born in the 1980s.

2. **The share of deaths resulting in IHT is small, at around 4% in 2020/21 (and about 5.5% now), but a larger and growing proportion are potentially affected by the tax.** The proportion of deaths resulting in IHT is projected to grow to over 7% by 2032/33. However, inter-spouse/civil partner exemptions means that the number of people affected by IHT is larger. By 2032/33, one in eight people are projected to face IHT either on their death or their spouse/civil partner's death.

3. **IHT revenues are small, at £7 billion (or 0.3% of GDP) a year**. The 2032/33 projection is just over £15 billion in today's prices (0.5% of GDP), driven by increasing levels of wealth held by subsequent generations of retirees.

4. **The current cost of IHT abolition would be £7bn**. 47% of that benefit would go to those with estates of £2.1m more at death. That group, which represents the

top 1% of estates, would benefit from an average tax cut of around £1.1m. The 90%ish of estates outside the IHT net would not be directly affected by such a reform. Those highly skewed figures underline the political risk for Mr Sunak in IHT abolition.

5. **IHT Reliefs for agricultural and business assets and DC pension pots create opportunities to avoid the tax and distort economic decisions.** The residence nil-rate band, which gives special treatment to property passed to direct descendants, raises similar types of problems and is of greater benefit to those in London and the South. IHT would be a cleaner, more coherent tax if there was no special treatment for certain types of asset.

Abolishing reliefs for agriculture, businesses and DC pension pots could raise up to around £1.5bn a year – 20% more IHT revenue. Combining these changes would reduce the scope for substituting one avoidance channel for another. 80% of the tax revenue from business relief reform could be captured just by capping the relief at £500,000 per person instead of outright abolition. Most business wealth is concentrated among those with high wealth, so the fiscal cost of a £0.5m threshold would be low. Around 90% of business wealth bequeathed is given as part of an estate worth over £2m.

The IFS makes no comment on defined benefit (DB) pensions – its stance presumably reflects the general absence of meaningful death benefits beyond survivor's pensions once retirement has been reached.

6. **Scrapping the residence nil-rate band and extending the nil-rate band (NRB) would make the system fairer.** A single £0.5m NRB would cost around £0.7bn a year and hold the proportion of deaths resulting in inheritance tax down at around 4%.

7. **Combining simple reforms could lead to a better IHT structure**. A package that capped agricultural and business reliefs, brought DC pension pots within the scope of IHT and abolished the residence NRB could fund an increase in the nil-rate band to around £525,000 on a revenue neutral basis. Alternatively, the inheritance tax rate could be cut from 40% to around 25%.

8. **Maintaining the share of deaths resulting in IHT at its long run 4% level requires the current NRB to be £380,000**. It would cost about £0.9bn a year for such a 17% increase in the NRB – well below the 53% CPI increase from April 2009, when the NRB reached its current £325,000. The cost of limiting the scope of the inheritance tax system to a 4% share would grow over time, reaching £2.7bn by 2032/33.

9. **Other changes to taxation at death could improve efficiency and fairness, as well as raise revenue.** Levying capital gains tax at the point of death would produce around £1.6bn a year. Levying income tax on *all* withdrawals from inherited pension pots would also raise further revenue.

10. **IHT has only a small impact on the distribution of inheritances received and intergenerational wealth mobility.** The wealthiest fifth of donors will

bequeath an average of around £380,000 per child and pay inheritance tax of around 10% of this amount. The least wealthy fifth of parents will leave less than £2,000 per child.

By the time inheritances are received, wealth inequality is already substantial. Inheritances are most often received when people are in their late 50s or early 60s. Around the ages of 50–54, children of the wealthiest fifth of parents have an average of £830,000 in wealth, while children of the least wealthy fifth have on average £180,000.

Comment

The IFS report is a useful exercise in showing how IHT can be reshaped by removing the reliefs which have accumulated over time. However, the proposals outlined above are a long way from some of the more radical ideas that have appeared in recent years, such as applying income tax to beneficiaries' (not donors) receipts above a cumulative lifetime threshold.

The main political parties, particularly the Conservatives, cannot afford to ignore this (or any other) IFS report. The IFS is the media's go-to think tank for tax matters – think how much Paul Johnson dominates the airwaves at Budget time. The parties' strategists and spin doctors would all be aware of the need to have responses ready when a journalist raises questions based on IFS material. That is particularly pertinent for Mr Sunak et al in the context nearly half of the benefits of IHT abolition going to those with estates over £2.1m.

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