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SWEET & MAXWELL

Capital Taxes—Time for a Fresh Look?

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Abstract

The two main taxes on transfers of wealth are capital gains tax (CGT) and inheritance tax (IHT). There is no logical reason why as a matter of policy transfers of wealth on death should pass free of CGT but subject to IHT while lifetime gifts should pass free of IHT but subject to CGT. IHT is unpopular despite raising relatively little money: it is perceived as double taxation and targeted at those whose main wealth is tied up in their family homes rather than at the seriously wealthy who can afford to make lifetime gifts. There is very little published information on how much wealth is handed on tax free during a person's lifetime. This stark contrast between the regime for lifetime gifts versus transfers on death is not followed in most other countries and the fact that lifetime gifts of cash do not have to be reported makes it difficult to frame sensible policies on how to tax transfers of wealth. IHT contains many anomalies and loopholes particularly in the areas of business property. It is complex as illustrated by the recent proposals on the residence nil rate band. It seems difficult to reform such a complex tax: there are many vested interests. It may be better to adopt a different model: abolish IHT but impose CGT on all gifts—whether made during the donor's lifetime or on death. This would ensure a more consistent regime. It would be necessary to limit the main residence relief possibly to total gains of £500,000 over an individual's lifetime and change the CGT regime in relatively minor ways for trusts, emigrants and foreign doms. This change would result in winners and losers with different distributional effects. If the ability to arbitrage between the CGT and IHT regimes was removed along with certain loopholes, overall revenue might increase. The alternative is to reform IHT. Less radical options could include extending the period necessary to survive lifetime gifts from 7 to 10 or 15 years or reforming business property relief. A more radical option is to introduce a donee based system similar to that found in Ireland under which the rate of tax would be dictated by the level of lifetime inheritances by the donee. The more the donee has inherited the higher the rate of tax.

In his Summer 2015 Budget,[1] the Chancellor announced that from April 2017 there would be major changes to the taxation of foreign domiciliaries and the introduction of a residence nil rate band (RNRB) on death to reduce the burden of IHT. In the light of these proposals, it may be timely to examine more critically how capital taxes operate in the UK and whether there is scope for improvement.

Background

The two main capital taxes imposed in the UK are CGT, which is generally charged on the increase in value of an asset between its acquisition and disposal, and IHT which is charged on death or on certain transfers into and out of trusts. There is no wealth tax. Annual tax on enveloped

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[1] HM Treasury, *Summer Budget 2015* (HC 264) (July 2015), available at: *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/443232/50325_Summer_Budget_15_Web_Accessible.pdf* [Accessed November 4, 2015].

dwellings (ATED) is a form of wealth tax on residential property but limited to property worth over £500,000[2] which is owned in companies or "enveloped."

In the case of individuals, gains are no longer indexed. CGT can be chargeable on gifts but there is a tax free step up on death. The first £11,100 of gains realised each year are exempt per individual (so couples between them can realise tax free gains of £22,200 each year) and, of course, any gains made on an individual's main house are also exempt. Gains fall into the basic rate income tax bracket counting capital gains as the top slice of income and taxed at 18 per cent while gains above the higher rate threshold are taxed at 28 per cent. Entrepreneurs' relief is an important and expensive relief for the Government taxing the first £10 million of gains realised on (broadly) disposals of trading businesses at only 10 per cent. CGT is expected to raise £5.9 billion in 2015–16.

IHT operates in a different way. Unlike CGT which charges the gain on a disposal, IHT is charged on the loss to a person's estate which may be very different from the value of the gifted asset. For example, a shareholder owning 51 per cent may give away 2 per cent. The gain may be minimal because a 2 per cent shareholding is worth very little. But the IHT transfer of value is likely to be significant as the donor has lost a controlling interest.

IHT is charged at a flat rate of 40 per cent on transfers of wealth in excess of £325,000 on death or within seven years prior to death. The threshold of £325,000 (the nil rate band) has been frozen in cash terms since 2009–10 but is now transferable between spouses/civil partners. If 10 per cent of the estate is given to charity then broadly the rate on the remaining estate reduces to 36 per cent. IHT was levied on 26,000 estates in 2014–15, representing around 4.5 per cent of all deaths.[3] The prevalence of many exemptions (in particular spouse exemption, business property relief and agricultural property relief) means that in the majority of cases no tax is payable on death. The number of estates liable for IHT is forecast to rise from 4.5 per cent of deaths in 2013–14 to 9.9 per cent in 2018–19,[4] and revenue is forecast to rise to 0.27 per cent of national income in 2018–19 which will be its highest level since 1973. Unlike estate duty, IHT provides complete exemption from tax on transfers between spouses. This is one of the major reasons why it raises relatively little revenue—only £3.4 billion in 2014–15. Another important factor is that lifetime gifts to individuals made more than seven years before death are entirely free of IHT provided the donor retains no benefit in the asset given away. The reservation of benefit rules that prevent a donor retaining a benefit in a gifted asset mean that someone cannot give away their family home and live there rent free as the house is still subject to IHT on the donor's death.[5]

IHT has been relatively stable compared with CGT as there has been no major change since 1986. John Major increased the exemption for business property and agricultural property from 50 per cent to 100 per cent in 1992 but Labour did little to change the tax apart from introducing a transferable nil rate band between spouses/civil partners. By contrast, the CGT regime has

[2] From April 2016. Note that ATED is not payable if certain reliefs apply. The most common is letting the property to an unconnected party.

[3] Source: HMRC, *Statistics at HMRC*, available at: *https://www.gov.uk/government/organisations/hm-revenue-customs/about/statistics#schedule-of-updates* [Accessed November 4, 2015].

[4] Although this will fall with the introduction of the residence nil rate band.

[5] In fact the reservation of benefit rules are penal: there is no possibility of spouse exemption; main residence relief is lost; if the donee dies the property is taxed on his death.

been subject to major restructuring and rate changes at least once every 10 years. For example the Finance Act 1998 introduced taper relief and abolished retirement relief. The Finance Act 2008 abolished taper relief and introduced entrepreneurs' relief.

Problems in changing IHT

IHT is not a popular tax despite the fact that so few estates are actually liable to pay it. A 2001 study found that around half the population believe the tax should be abolished.[6] The average taxpaying estate is worth £875,000 made up of £190,000 worth of cash, £253,000 of shares and bonds and £329,000 of residential property.

The unpopularity of IHT may arise not out of a principled objection to taxing inherited wealth but from its perceived inequities. It tends to fall disproportionately on those whose wealth is tied up in their main house who are therefore unable to circumvent the tax. The 30,000 home loan schemes allegedly carried out in the 1990s to early 2000s by "Middle England" demonstrated the high level of resistance to paying IHT on the family home. It is seen as a tax that targets only the averagely well off rather than the very wealthy who can afford to make gifts more than seven years prior to their death.

IHT is criticised as double taxation: a tax on assets that have already borne CGT and income tax although of course in many cases IHT is being levied on the family home where all the gains have been free of CGT. Double taxation often arises in the UK (we pay value added tax out of taxed income) but seems a particular bone of contention in the context of IHT.

The exemption for lifetime gifts if the donor survives seven years is striking and it is not entirely clear how this can be justified on policy grounds. Few other countries, including the US, differentiate so starkly between death and lifetime transfers.

It is unlikely that increasing the rate, which is currently at 40 per cent (a high rate anyway), or reducing the nil rate band (currently £325,000) would be politically acceptable. In fact, it would probably increase the incentive for people to avoid the tax by transferring assets more than seven years prior to death. It might be possible to reduce the reliefs for business assets and agricultural land which have a combined cost of over £700 million per year and dubious validity for the reasons set out below. Restricting the spouse exemption is unlikely to be acceptable. Taxing lifetime gifts (for example, by lengthening the seven year window before death during which lifetime transfers are taxable) is another option. In 2007, the Liberal Democrats proposed that only transfers made more than 15 years before death should be exempt. It is very difficult to know how much this would raise since there is little or no data on gifts occurring more than seven years before death.

Overall there is no political consensus about what to do about IHT which makes instituting change even more difficult as people unhappy with any new regime can wait for a change in government before transferring wealth. It is notable that while countries tend to adopt a fairly consistent pattern in the way in which they tax income, the way in which wealth is taxed varies considerably. Some countries adopt a system where the rate of tax varies depending on the relationship of the donee to the donor. These countries often also have forced heirship provisions

[6] A. Hedges and C. Bromley, *Public Attitude Towards Taxation, research conducted for the Fabian Commission on Taxation and Citizenship* (London: Fabian Society, 2001).

or a matrimonial property regime, concepts unknown under English law. Some federal jurisdictions, notably Canada and Australia, have CGT rather than IHT on death. Others such as Ireland operate a donee based capital acquisitions tax whereby the more the donee inherits the higher the rate of tax.

As the Mirrlees Review[7] pointed out, the method of taxing wealth in the UK has not been reviewed for many years. Instead change proceeds on a piecemeal basis with different policies operating in conflict with each other. So for example high value residential property purchased by foreign domiciliaries, particularly non-residents, has typically been enveloped in foreign incorporated vehicles as this is an easy way to avoid IHT on UK property. The Government introduced ATED in 2013 which was an annual tax charge on such properties to encourage de-enveloping. From April 2017 the IHT exemption for foreign domiciliaries and trusts owning UK property through a foreign company will be removed and this further encourages de-enveloping. However, non-residents CGT was introduced in April 2015 to impose CGT on non-resident individuals, trusts and companies disposing of any residential property of any value. The way to avoid this charge is to sell the shares in the company (and then the purchaser avoids Stamp Duty Land Tax). This encourages enveloping. Hence we have conflicting results arising out of different policies.

Anomalies in the IHT system

Certainly the current IHT regime can produce some very arbitrary results. Consider the following:

Example 1

1. Andrew, a widower, is the sole owner of a family trading company worth £20 million. The shares show a gain of £20 million. He decides to retire and sells the business paying CGT after entrepreneurs' relief at 10 per cent on the first £10 million of gain and 28 per cent on the balance = £3.8 million tax. The net sale proceeds are therefore £16.2 million. He dies later before having made any lifetime gifts. 40 per cent IHT of £6.48 million is payable on death on the net sale proceeds. His children inherit £9.72 million.
2. Consider the position if Andrew decides to continue trading until death. He enters into an option such that immediately after he has died, the purchaser can exercise the option and acquire the shares. On death, there is no IHT due to 100 per cent business property relief. Nor is there CGT as the shares are rebased to market value on death. His children take away £20 million. Note that his children do not have to retain the shares for any period of time after his death.
3. Consider the position if Andrew had sold his main house for £20 million some time ago, moved into a nursing home, and decided to reinvest the proceeds in AIM (formerly the Alternative Investment Market) listed trading shares. After two years he dies. The sale proceeds are free from tax. His children inherit £20 million.

[7] *Reforming the Tax System for the 21st Century: The Mirrlees Review* (IFS, *Dimensions of Tax Design* (Oxford: OUP, 2010) and IFS, *Tax by Design* (Oxford: OUP, 2011)) (the Mirrlees Review).

4. He decides to sell his company to a rival unlisted trading company and is offered cash, shares or loan notes. He decides to take preference shares. These have a fixed right to dividends and a guaranteed capital value. On his death, the preference shares qualify for full business property relief and he will be in the same position as in point 2 above.
5. Andrew is a partner in a trading partnership. He has a small capital share and a large loan. Just before death his loan is capitalised. Full business property relief is obtained on the loan.

Other countries do offer some relief for businesses on death, including Ireland and Germany. However, generally the business must be retained for a minimum length of time after death to qualify for the exemption, on the basis that the purpose of the relief is to preserve family businesses and secure continuity. The policy objective is presumably similar for the UK and yet there is no rule requiring a minimum period of ownership by the heirs after death. It is accepted that such a rule may be distortionary as no doubt even if the heirs proved unable to run the business they would keep it for the minimum period for tax reasons. Equally it is not clear why being required to hold the business until death is necessarily any better.

Moreover the rules are not aligned between CGT and IHT. The arbitrariness of the reliefs encourages complex structures and avoidance. Generally the IHT reliefs are more generous, not least because once available the relief is at 100 per cent and uncapped. At best, entrepreneurs' relief exempts the first £10 million of gains on a disposal of a business and the tax rate is 10 per cent.

Business property relief is not available

> "if the business … consists wholly or mainly of one or more of the following, that is to say, dealing in securities, stocks or shares, land or buildings, or making or holding investments."[8]

"Mainly" is interpreted as more than 50 per cent. The CGT rules operate a substantially test: the business must be substantially trading meaning at least 80 per cent to obtain entrepreneurs' relief. It is in this area where there has been much recent tax litigation as the tax differences can be huge. So if a business is 51 per cent trading and 49 per cent investment then full business property relief is obtained even on the investment assets. If the position is reversed no relief is obtained. How do you determine what is mainly trading or investment and over what period of time do you judge the position? The case law tells us to look at the matter "in the round"[9] when assessing such situations looking at profit, turnover, employee time, and asset value but this test is not always easy. Caravan parks and mobile homes have proved particularly difficult with some cases obtaining relief and others not. The rules are not consistent between CGT and IHT.

[8] Inheritance Tax Act 1984 s.105(3). Note the "mixed business" cases, especially: *Farmer v IRC* (*Farmer*) [1999] STC (SCD) 321; *George and Loochin (Executors of Stedman, Deceased) v IRC* [2003] EWCA Civ 1763; [2004] STC 147; and *Brander v HMRC* [2010] UKUT 300 (TCC); [2010] STC 2666.
[9] *Farmer*, above fn.8, [1999] STC (SCD) 321.

Example 2

Falklands Ltd runs a metal recycling and boat building business in Cornwall. Over time the company has reinvested surplus profits in some let properties. The company now has three businesses—recycling, boats and let properties. Each part is run by a separate member of the family who all work in the business full time. It turns out that some of the land on which the boat building takes place has development potential. The family want to minimise commercial risk so they put a holding company at the top with each business held in a separate subsidiary company. What is the business property relief position?

Overall looked at in the round the business is still mainly trading. So it passes the first hurdle. However, the let properties are held in a separate company. As that company is not mainly trading, no relief will be available on the value attributable to the property investment company.[10] However, if the let properties were spread between the trading subsidiaries or moved up to the holding company level then business property relief would be available *on the whole business including the let properties*. If Falklands Ltd goes into a joint venture with other third parties and owns only 50 per cent or less in a trading company there is no relief on those 50 per cent companies even though they are trading. They are not 51 per cent subsidiaries so Falklands Ltd is treated as owning an investment asset.

Suppose the development land is moved outside the company so that it is owned by the shareholders personally and then leased back to the company for its trading purposes? In these circumstances there is no relief unless the owner of the land controls the company and even then relief is restricted to 50 per cent.

Matters get even more bizarre if one starts introducing trusts:

Example 3

Judith settles property qualifying for 100 per cent business property relief in 2010. In 2019 the business is sold and all the cash is distributed amongst the beneficiaries just before the 10 year anniversary. An exit charge arises (maximum 6 per cent and in this case slightly less). If the trustees had waited until after 2020 before selling the business then there would have been no 10 year anniversary charge and no tax charge on any distribution of the sale proceeds for the next 9.9 years. Business property relief acts as a protecting veil.[11]

By 2020 the Chancellor will be able to claim a married couple with £1 million of assets pays no IHT due to the RNRB. Of course it is not that simple: the couple will have had to have owned a residence at some point since July 2015 worth £350,000 even if they sell it before death. If they gave it away or sold it before July 2015 and moved into a nursing home, they will not get any additional RNRB unless they acquire a new one and live there for a month! For the first time the rate of tax will be different depending on the relationship between the deceased and those who inherit. If the house or its equivalent value is left outright to direct descendants then relief is available; if it is left to a brother then it is not. To obtain the RNRB relief the testator's estate must not exceed £2 million. The fact that he may have given away a sum immediately

[10] Inheritance Tax Act 1984 s.111.

[11] This is because the exit charge is no longer calculated by reference to the value of property, as it is on distribution in the first 10 years, but by reference to the rate of tax charged at the 10 year anniversary which in this case is 0%.

before death that is just sufficient to bring him below £2 million will preserve the relief even if he dies within seven years. But woe betide him if he owns more than £2 million until his death. Then the residence nil rate band will disappear after £2.2 million.

One must question whether these sorts of reliefs, loopholes and anomalies are justifiable. The trouble is that strong vested interests make almost any sort of reform difficult. Is it worth trying to preserve IHT at all? Given the unpopularity of IHT and yet its relative ineffectiveness, is there an alternative?

CGT on death

At present, CGT is forgiven at death. There is a tax free step up on the assets comprised in the deceased's estate. This cost the Exchequer an estimated £490 million in 2012–13. But that figure does not take account of the cost of allowing hold over relief on lifetime gifts and transfers out of trusts.

This forgiveness of CGT at death is meant to reflect the fact that IHT is paid. The argument is that one should not impose 28 per cent CGT on the gain in addition to 40 per cent IHT. But in principle, there is no particular reason why CGT should be forgiven at death. Imposing CGT on death would merely make the double taxation more explicit. But if CGT is meant to tax gains and IHT to charge transfers of inherited wealth it is difficult to see why one is excluded on death. Moreover the same system does not operate on lifetime gifts. For example, assets transferred in a lifetime which show a gain are often subject to CGT. Why should some lifetime gifts be subject to CGT and not IHT and gifts on death be subject to IHT and not CGT? In fact if the person dies within seven years the gift can attract both IHT and CGT with very limited relief for double taxation. In other cases there is no IHT or CGT even on lifetime gifts.[12] None of this has any coherence in terms of policy objectives.

Forgiveness of CGT at death results in odd behaviour. It encourages people to hold on to assets that have risen in value even if in the absence of tax considerations it would be preferable to sell them, particularly where the assets are business property or spouse exemption is available and will therefore not be subject to IHT anyway. The surviving spouse can then give assets away free of CGT (due to the death uplift) and also avoid IHT if s/he survives seven years.

The ending of forgiveness of CGT at death need not mean that CGT would be immediately payable. Death could be a non-event. The system could be designed so that CGT is only payable on an actual sale of the asset with the base cost deemed to be the original purchase price rather than market value on death. In other words, it would be similar to transfers of assets between spouses. Eventually CGT would be payable on the sale. IHT would operate as at present.

An alternative is to abolish IHT and instead have a deemed CGT disposal on death. There would be no tax free step up. Instead the executors would pay tax on the gain. As valuations are obtained anyway for IHT purposes on death there would be no material difference. As is presently the case for IHT, CGT on illiquid assets such as land and unquoted businesses could be paid in instalments. The current CGT rules could continue to operate largely as they do at present except that hold over relief on transfers out of trusts and on lifetime gifts to anyone other than a spouse would be abolished—consistent with the objective to tax the gains realised on transfers of wealth.

[12] e.g. gifts of farmland even if it has development value.

There would be a "no gain no loss" position on transfers between spouses on death as in their lifetime so no immediate tax is due until the transferee spouse sells. (This would raise more money than the current position where gains are wiped out on death and there is a complete IHT exemption so the surviving spouse can then sell or gift the assets free of any tax.) Entrepreneurs' relief would operate on disposals of business on death but would effectively be capped at £10 million with a 10 per cent rate rather than exemption. Entrepreneurs' relief is more tightly targeted than business property relief and this would remove some of the anomalies illustrated in Example 2 whereby investment assets can qualify for business property relief simply by being moved into a business that is mainly trading.

Consequences of a CGT charge on death/technical issues

Under this route there would be different winners and losers. People who inherit £10 million of cash on a death pay no tax under this system as opposed to £4 million under the current system.[13] It might be argued that the disponer would have paid CGT during his lifetime on a sale of the asset for £10 million and therefore the wealth does not need to be taxed again, that is, double taxation truly is avoided.

Businesses would be subject to a £10 million cap and tighter restrictions than at present. Inheriting spouses would still have to worry about CGT on a later disposal after death. Main residence relief would also have to be addressed. People's main residences are currently entirely exempt from CGT, reducing CGT liabilities by around £9.9 billion. If CGT rather than IHT was introduced on death, this would exempt a major asset. Possibly the main residence exemption on death *and* lifetime transfers would have to be limited to up to a £500,000 gain over the lifetime of an individual.[14] This would exempt most "ordinary" houses while catching gains realised at the higher levels.

A number of technical issues need to be considered. An individual holding assets showing large unrealised gains may choose to emigrate just before death to avoid CGT as non-residents do not generally pay UK CGT.[15] At present, four complete tax years are required to lose IHT deemed domicile for someone born here who emigrates and in practice much longer is usually needed as the emigrant must show that he does not intend to live in the UK again and has settled in a particular territory permanently. Under the new regime, from April 2017 the minimum period required to lose UK domicile will increase to six years. It should not be easier to avoid CGT than IHT. This problem could be addressed by providing that in the event people die within, say, six years of leaving, CGT is imposed at the full rate and thereafter it is levied for the next four years on a sliding scale.[16]

[13] 40% of £10 million ignoring any nil rate band.
[14] Principal Private Residence Relief operates on the basis of a couple who are married or in a civil partnership but as soon as it is capped limiting it to a couple rather than individuals would cause problems if the couple divorced having made sales. Who takes the unused part of the £500,000 allowance, etc?
[15] With some exceptions, e.g. non-residents CGT on property; CGT on UK land used in a trade, etc.
[16] On the basis that this is equivalent to the difficulties in losing a domicile of origin and thereby avoiding IHT. This is not far off the five years non-residence required anyway at the moment for those leaving the UK and then returning. To those who say how would one collect CGT on someone who has emigrated the same point could be made about IHT payable by non-residents. Secondary liability is usually imposed on those who inherit and if they are in the UK they will therefore need to pay the tax.

How would the regime operate in relation to foreign domiciliaries? Where they have been resident already for more than 15 years, then from April 2017 they will (under the current regime) no longer qualify for the remittance basis on gains realised on foreign situs assets. Therefore if CGT arises on death the foreign dom who is now deemed domiciled here will have to pay 28 per cent CGT on worldwide assets. This might be seen as more palatable than a 40 per cent IHT charge to which at present they are subject anyway if they are here for more than 16 years.[17]

Foreign domiciliaries who have just arrived in the UK and have not yet become deemed domiciled would not be subject to CGT on foreign assets if they died before the 16th year of UK residence.[18] There would still be a deemed disposal but the gain would not be chargeable. If they sold the foreign asset during their lifetime the gain would still not be chargeable but could not be remitted—the position would be just the same as at present.

Trusts inevitably raise more complex issues. Trusts do not die so there is no occasion for a disposal. Without special rules assets could be retained by a family within a trust structure with no tax charge on death. Where trusts had been set up by UK domiciled settlors, one could provide that there was a deemed disposal of all trust assets on the settlor's death, irrespective of whether he was a beneficiary or not. However, it would be rather arbitrary to impose a CGT charge on the death of the settlor even if he was excluded from the trust.

At present, most trusts set up by UK dom settlors pay IHT every 10 years at up to 6 per cent or on the death of the beneficiary with a qualifying interest in possession.[19] This is a dry tax charge as it does not depend on a disposal of the assets but is simply a snap shot of the assets at the 10 year anniversary. Obviously trusts would be subject to CGT on sales just as at present. They could also be subject to tax on gains realised from appointments of assets out to beneficiaries (currently largely avoided by virtue of hold over relief).

One could impose deemed disposal of the trust assets every 10 years and tax the unrealised gains. On an actual disposal of the trust assets the gain would be calculated from the value taken at the date of the last deemed disposal so that in practice if the asset continually increased in value only the actual gain would be taxed, albeit some of the tax would have been paid at an earlier date on the deemed disposal. It would be better to have a deemed disposal every 10 years rather than annually to reduce the problems of trustees being unable to take a long-term view and retain assets for a reasonable length of time without paying a dry tax charge. As with IHT, the CGT on a deemed disposal could be paid in instalments. Of course there would be anomalies: the charge would be a snap shot based on the gain on the asset at the 10 year anniversary. If the asset was later sold at a lower value that loss could not relieve the tax paid earlier but presumably could be taken into account when calculating gains on later deemed disposals.

Gifts into trusts need consideration. At present gains can be held over on lifetime gifts into trust on the basis that most gifts to trusts involve some payment of IHT if the values are above £325,000 per individual. However, this is not entirely consistent as business assets can at present be settled without any immediate IHT or CGT. It is suggested that hold over relief on lifetime

[17] See Inheritance Tax Act 1984 s.267.
[18] Canada, which has a CGT on death, has a CGT uplift for immigrants, rebasing everything to market value on entry.
[19] Then the rate of tax is the same as if the beneficiary owned the assets outright. A qualifying interest in possession trust means a trust where there is an entitlement to income and (broadly) the trust was (a) created before March 2006 (b) the trust is for a disabled beneficiary or (c) the property is settled on death for the interest in possession beneficiary.

gifts should be abolished. The principle is that gains on transfers of assets by gift or sale and whether in lifetime or on death should be subject to CGT as IHT has been abolished. There would be less incentive to make lifetime gifts simply to avoid IHT. The tax regime would be the same on death as in life.

What about non-resident trusts set up by foreign domiciliaries? At present, such "excluded property" settlements are entirely free of IHT provided they hold no UK assets directly. Such trusts generally pay no CGT so HMRC are receiving little capital taxes revenue. Only when UK resident beneficiaries receive assets is there any possible tax charge. This charge would continue as at present.[20]

The first point in relation to non-resident trusts set up by foreign domiciliaries is to consider the connecting factor. Should tax be based on the residence of the settlor or the situs of assets or both? A deemed disposal charge imposed on all assets held by a non-resident trust set up by a non dom settlor who happens to be UK resident here for a short period is likely to deter rich people from coming here. The trust assets might have increased in value long before the individual beneficiary or settlor ever arrived in the UK and it would be seen as unfair for such pre-entry gains to be subject to CGT. One option instead is to limit the deemed disposal decennial charge to deemed gains made by non-resident trusts set up by foreign doms where the trust owns UK assets directly or UK residential property directly or indirectly and the residence of the foreign dom settlor is irrelevant (as at present).[21] That would more or less follow the current rules on IHT.

The second option is to follow the one adopted in Canada and have a tax free step up for all assets when an individual enters the country. That deals with gains accrued in the period before the individual had any connection with Canada. The same step up could apply to personal and trust assets. The remittance basis would then be abolished for personal assets; trusts where the settlor becomes UK resident would thenceforward be subject to the same CGT rules as for UK doms. Only post entry accrued gains would then be subject to tax and there would be no need to have a special exemption for foreign situs assets. This would be a major change in the treatment of foreign domiciliaries which given the current level of uncertainty following the July announcements is likely to prove unpopular. The first option is safer.

Conclusions

It is very difficult to determine whether abolishing IHT on death and introducing CGT would raise more or less money. Capping the main residence relief, removing a CGT uplift on death (which currently allows surviving spouses to benefit from tax free gains) and abolishing hold over relief on gifts and transfers out of trust may well compensate significantly for the fact that inheritances of cash would no longer be taxed. The policy would arguably have different distributional effects but is more coherent[22]: the clear objective is to tax increases in value whether on lifetime transfers or on death rather than tax certain transfers of wealth and not others. Most

[20] TCGA s.87.
[21] In line with the proposals announced in July 2015.
[22] Although in fact if someone has £20 million of cash realised from an asset, e.g. the sale of a main residence as they downsize, in practice they are very likely to have given away cash to their children during their lifetime anyway and survive seven years. So the distributional effects may well be exaggerated.

people seem to be able to accept they should pay tax on a gain. Abolishing one tax would also get rid of a considerable amount of complexity and administrative duplication. Instead of having two capital taxes with different reliefs and often contradictory rules, there would just be one system to consider. The transitional provisions could be relatively straightforward and the need for forestalling legislation minimal. Even if people accelerate lifetime gifts before any change in order to take advantage of hold over relief the gain still eventually gets taxed.[23]

In Example 1 if CGT operated on death instead of IHT, then the position would be as follows.

Example 1 continued

1. There would be no IHT and no CGT on the cash. Tax would be £3.8 million CGT on the sale. Andrew's children inherit £16.2 million.
2. The same as in 1 above would occur on death. £3.8 million of tax.
3. If the main residence relief was restricted, there would be CGT on the sale of the house. There would also be CGT on any gain on the AIM shares.
4. The same position would occur as in 1 above. £3.8 million on death.
5. No difference between lifetime and death—one is simply looking at the gain on death.

Other options

One option which has been suggested by the IFS[24] is to have a properly functioning tax on lifetime transfers. Thus one way or another, when people transfer wealth above a certain threshold, all such transfers are taxed. It is notable that even the US, generally not regarded as a particularly progressive country, taxes lifetime gifts albeit only above a high threshold of US$5 million.

In 1976 Ireland introduced capital acquisitions tax which is a donee based system albeit with some relief for business assets and a complete spouse exemption. (It is interesting that in 1972 the Conservative Government published a Green Paper[25] suggesting the possibility of an accessions tax in place of estate duty but the change of government in 1974 prevented any chance of that reform occurring.) A donee based system generally looks at the cumulative total of all accessions received in the donee's lifetime or over a certain period and so takes account of all the recipient's inheritances whenever received and from whatever source. Hence an estate left to four children would suffer less tax than an estate left to one assuming the four children had not received any earlier inheritances. It is seen as more redistributive as donors have an incentive to divide their wealth among more people. Sandford[26] argued that

> "it is large inheritances not large estates as such which perpetuate inequality and an accessions tax falls heavily on the person who receives most by way of gifts and legacies."

[23] There would need to be some consideration given to the transfer of heritage assets or assets of pre-eminent importance to ensure these can be handed on but presumably it would be a form of hold over relief on death or a gift linked to a requirement for public access very much as at present.
[24] See IFS, *Green Budget* (February 2013) and the Mirrlees Review, above fn.7, *Tax by Design*.
[25] Green Paper, *Taxation of Capital on Death: a Possible Inheritance Tax in Place of Estate Duty* (HMSO, 1972), Cmnd.4930.
[26] C. Sandford, *An accessions tax* (IFS, 1973).

It is seen as fairer as it reduces the incentive to make lifetime gifts and removes the lottery of the seven year rule. There is no difference in tax rates between those who make lifetime gifts and those who keep their wealth until death. It is also more flexible as it can take account of the particular circumstances of any beneficiary. For example, disabled beneficiaries might be able to inherit more at a lower rate of tax.

There are, however, disadvantages to a donee based system. It requires significant record keeping and administrative hassle as the donee has to keep a lifetime record of inherited wealth. Trusts once again prove problematic. It would also be difficult to introduce without cross party political consensus. At least with CGT on death or on lifetime gifts the tax is captured at the time of disposal. With a capital acquisitions tax a long-term view must be taken. Forestalling would also be more difficult as people would transfer wealth to donees before any changes came into force. It is doubtful whether there is any appetite for this sort of major upheaval in the UK system.

Successive governments have left IHT alone because no one can work out what to do with it. As Kay and King put it, IHT is written with loopholes that favour "the healthy, wealthy and well advised."[27] Perhaps now is the time to abolish it.

[27] J. Kay and M. King, *The British Tax System* (Oxford: OUP, 1990).

Capital gains tax; Inheritance tax; Tax reform