BRIEFING

Death and Taxes

Why Inheritance Tax should be replaced with a Capital Receipts Tax

Tony Dolphin

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Summary

- Supporters of taxes on wealth in the UK have weakened their case by defending the current Inheritance Tax regime in spite of its deficiencies.
- There is a strong case on the grounds of equality of opportunity for taxing inheritances. Large inheritances give some people an unfair and unearned advantage in life. They increase wealth inequalities and reduce social mobility. Compared to other taxes, a tax on inheritances has limited disincentive effects and it can be progressive.
- But Inheritance Tax as presently formulated is highly unpopular, raises little money and can be avoided by the very wealthy. It is also not a tax on inheritances, but a tax on estates. It could be reformed, but a better option would be to abolish it and replace it with a Capital Receipts Tax.
- A Capital Receipts Tax would be a fairer means of increasing equality of opportunity. The UK should introduce a progressive tax on lifetime gifts above a certain threshold. The precise formulation of the tax would require careful analysis and discussion but a system that only taxed gifts above £150,000 could raise £1 billion more revenue than Inheritance Tax now does.

Introduction

Benjamin Franklin famously wrote: '… in this world nothing is certain but death and taxes'. Inheritance Tax – the tax paid in the UK on the estate of a person who has died – would appear to illustrate his point perfectly, but in our current world nothing is so simple.

A whole industry has grown up seeking to demonstrate that Inheritance Tax is by no means 'certain' and to show people, in return for a hefty fee, how to minimise their potential Inheritance Tax liabilities. As a result of this industry's efforts, and the Labour government's decision in October 2007 to allow the transfer of the Inheritance Tax nil rate band between partners in married couples and civil partnerships, less than three per cent of estates will pay Inheritance Tax in 2010–11. If the Conservative Party ever implements its proposal to increase the threshold above which Inheritance Tax is paid to £1,000,000, less than 0.5 per cent of estates would pay the tax and revenues would drop to less than £1 billion. Soon after, it's possible that Inheritance Tax would be abolished on account of its reduced revenue.

As part of the Mirrlees Review of the UK's tax system, Robin Boadway et al looked at the taxation of wealth and wealth transfers. They concluded: 'It is clear that the current system for taxing wealth in the UK cannot be sustained and is justly unpopular' (Boadway et al 2010: 810). If they are right, Inheritance Tax is unlikely to be retained in its present form for very much longer. Now is the time, therefore, to ask whether it should be reformed or abolished altogether, and if it is abolished, to ask whether it should be replaced by a different form of taxation.

The theoretical case for inheritance tax in some form

Four broad principles have to be taken into account when considering the transfer of wealth between generations and the rationale for an inheritance tax (Beckert 2008):

1. Family
2. Equality of opportunity
3. Social justice
4. Community

The family principle suggests assets belong not to an individual but to family units. It follows that family members should be free to transfer legal ownership between themselves at any time, in life and upon death. Consequently, there is no case for an inheritance tax, or a tax on lifetime transfers (except perhaps for gifts to non-family members). This principle underlies arguments in favour of allowing family businesses and family homes to be passed through the generations without incurring taxation. The counter-argument is that unearned wealth, as well as giving some people an unfair advantage in life, reduces their incentive to work, innovate, start up businesses and add to economic wellbeing.

The equality of opportunity principle suggests inequalities in society can only be justified by a person's own achievements. Because wealth confers advantages over and above the income that it generates, inheriting a large sum of money gives someone an undeserved head start (Meade 1978). Rajiv Prabhakar et al (2008: 12–14) review the literature on inheritance and wealth and conclude that, although economists are far from being in total agreement, inheritances do increase wealth inequality. As a result, some people have greater opportunities to access education, invest in new business or purchase property. At its most extreme, this principle could be used to justify a 100 per cent inheritance tax, with no threshold. All the assets of one generation would be equally divided among the next generation.

There are two strands to the social justice principle. First, if income is taxed, then transfers of wealth should be too. Otherwise, a person who receives a sum of money as a gift is treated more favourably than someone who works for the same amount in the form of income.[1] The second strand suggests that the assets of estates can be used to help correct inequalities in wealth (or more general inequalities in society). It follows from both these principles that there should be an inheritance tax.

The community principle suggests people are part of a broad community, which helps them to generate their wealth and to which they have obligations, even upon death. It rejects inheritance within the family and redistribution by the state in favour of the voluntary sharing of assets, for example through the establishment of foundations. It is a sentiment with stronger support in the United States than in Europe.

These principles need not be taken in isolation. An inheritance tax that includes a threshold and a tax rate below 100 per cent, like the present UK system, could be justified because it balances the family principle – accepting that people do desire to pass on some assets to their families – and the equality of opportunity principle, by placing a limit on the advantages that parents can provide for their children (Prabhakar et al 2008: 28).

The reasons people choose to pass on assets when they die also affect the appropriate taxation of those assets. Helmuth Cremer argues that only if the bequest motive is pure altruism can a zero rate of inheritance tax be justified, while at the other extreme a 100 per cent tax should be imposed if bequests are purely accidental, that is when people die before using up all their precautionary savings (Cremer 2010: 817). In the real world, though, most bequests are made for a mix of paternalistic motives – because people receive some utility from passing on something to the next generation – and as part of a deal, whereby they receive attention and care in their old age in return for handing over their assets on their death. Cremer argues that if these motives dominate then a non-zero rate of inheritance tax is justified, but finds it difficult to say from theory what the appropriate rate or threshold should be (ibid 820).

Inheritance tax also has to be seen in the context of the rest of the tax system. Thus, it is misleading to criticise an inheritance tax as discouraging savings because, by the same logic, so does taxing interest income and capital gains, while income tax discourages work and duties discourage spending. The government needs to raise a certain level of revenues and if it does so from a range of sources then its effect on economic incentives is spread around.[2] In theory at least, an inheritance tax may cause people to work harder and accumulate more pre-tax assets so as to achieve their desired post-tax level of bequests.

Inheritance Tax in the UK

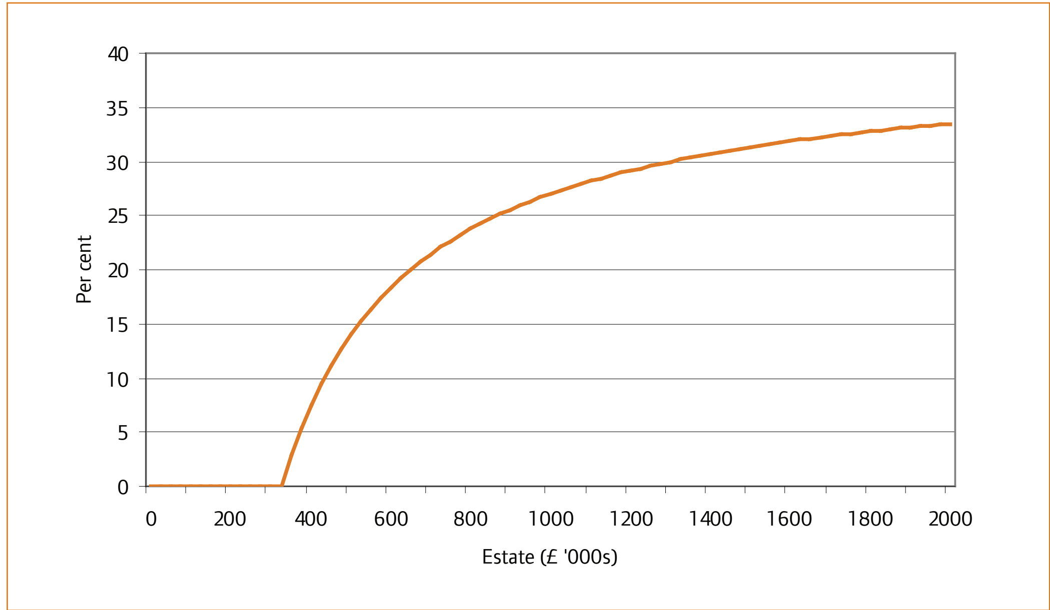
Inheritance Tax in the UK is paid on the estate of a person who has died and, far less often, on gifts and trusts made during the last seven years of that person's life.[3] Tax is paid at a rate of 40 per cent of the value of the estate above the Inheritance Tax threshold, which in 2010–11 stands at £325,000. Because tax is paid only on the value of the estate above the threshold, the average, or effective, tax rate is always less than 40 per cent. An estate of £1 million, for example, will pay £270,000, an effective tax rate of 27 per cent.

1 Arguably, if the tax system is not to be neutral between these two events, it should encourage work over unearned income, not the reverse.

2 Of course, on some cases, such as duties on cigarettes, the government might be trying to incentivise a certain behaviour – less smoking.

3 Taxes on gifts and trusts amount to only 2 per cent of Inheritance Tax revenues.

Figure 1:
Inheritance Tax: effective tax rate, 2010–11

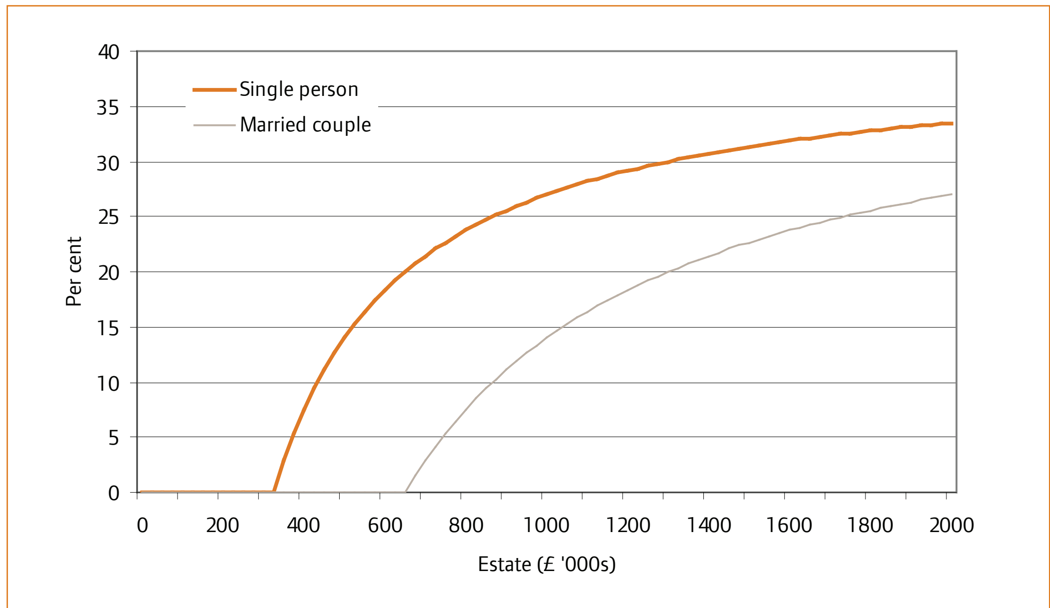


Source: HMRC 2010a

Inheritance Tax is, therefore, progressive, in the sense that the larger the estate, the higher the effective rate that is paid.

Inheritance Tax is not paid on any assets left to a spouse or a registered civil partner.[4] Furthermore, since October 2007 when the first spouse dies his or her unused Inheritance Tax nil rate band can be transferred to the second spouse. The threshold of married couples is, in effect, doubled. So, for example, if the first spouse dies and leaves an estate of £500,000 to the second spouse, no tax will be paid. The first spouse's Inheritance Tax nil rate band has not been used and can, therefore, be transferred to the second spouse. If subsequently the second spouse dies leaving an estate of £1 million, a threshold of £650,000 (twice £325,000) will be applied. Tax will, therefore, only be payable on £350,000 and will amount to £140,000 (an effective rate of 14 per cent). This will apply in the vast majority of cases. In 2008, 86 per cent of those who died aged 65 and over in the UK were either married or widowed.

Figure 2:
Inheritance Tax: effective tax rate for single and married people, 2010–11



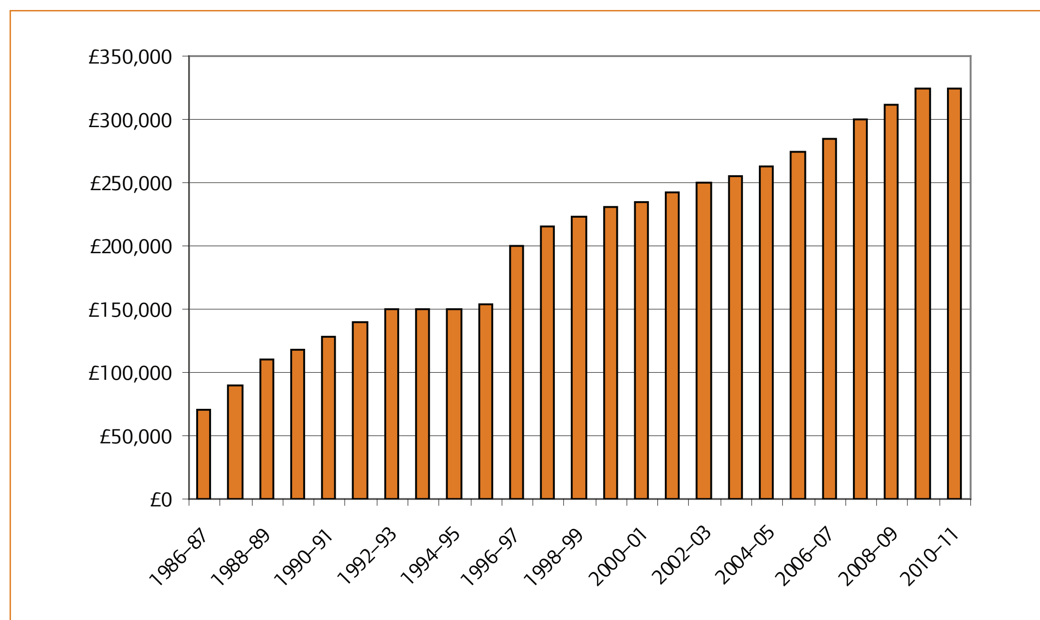
Source: HMRC 2010a

4 In the rest of this paper, a reference to a spouse (or married couple) should be taken to also include a civil partner (or civil partnership).

Inheritance Tax was introduced by the Conservative government in 1986 to replace capital transfer tax, which had in turn replaced estate duty in 1975. The standard (and only) rate of Inheritance Tax has been 40 per cent since 1988–89. In 1986–87 there were seven rates (ranging from 30 to 60 per cent in increments of five percentage points) and in 1987–88 there were four rates (30, 40, 50 and 60 per cent).[5]

When Inheritance Tax was introduced in 1986, the threshold was £71,000. It has been increased in most years since, although it was frozen at £150,000 from 1992–93 to 1994–95 and has again been frozen in 2010–11. There was a particularly large increase in the threshold, from £154,000 to £200,000, in 1996–97. The threshold is now £325,000, four and a half times larger that it was when the tax was introduced.

Figure 3: Inheritance Tax: threshold



Source: HMRC 2010b

After allowing for price inflation, the threshold has doubled since 1986. However, a comparison with retail price inflation is somewhat meaningless, as Inheritance Tax is paid on assets, most of which are not consumer goods. In 2007–08, around 40 per cent of the assets of those estates that might be liable to pay Inheritance Tax were in the form of residential buildings, 20 per cent were in securities, another 20 per cent in cash and the rest were in other assets such as insurance policies, land and physical goods (HMRC 2010c). For this reason, it has been suggested that the Inheritance Tax threshold should be increased in line with house price movements. In fact, the threshold has kept up with house prices since 1986–87: after allowing for house price inflation, the threshold has increased by 12 per cent since 1986.[6]

The change to Inheritance Tax for married couples and civil partnerships, introduced in October 2007, had a significant effect on the number of estates paying Inheritance Tax and on receipts from the tax. HM Revenue and Customs figures show that 34,000 estates paid the tax in 2006–07, falling to 15,000 in 2009–10 (HMRC 2010d). They also show that receipts fell from £3.6 billion in 2006–07 to £2.4 billion in 2009–10 (HMRC 2010e).[7] These falls are largely due to the transferability of the nil rate threshold, although lower house prices (which peaked in the third quarter of 2007 and were still 12 per cent below their highs in the first quarter of 2010) will also have played a part in reducing the taxable value of estates.

5 See the Appendix for details of Inheritance Tax thresholds and rates.

6 The relationship between Inheritance Tax and the family home is discussed in more detail in a later section.

7 Receipts in the first four months of 2010-11 were £954 million, compared to £752 million in the same four months of 2009-10, suggesting full-year receipts could be close to £3 billion.

Table 1:
Inheritance Tax

	Number of estates paying Inheritance Tax ('000s)	Inheritance Tax receipts (£ billion)
2001–02	23	2,383
2002–03	27	2,375
2003–04	31	2,521
2004–05	32	2,941
2005–06	33	3,276
2006–07	34	3,563
2007–08	25	3,824
2008–09	16	2,851
2009–10	15	2,396

Source: HMRC 2010d, HMRC 2010e

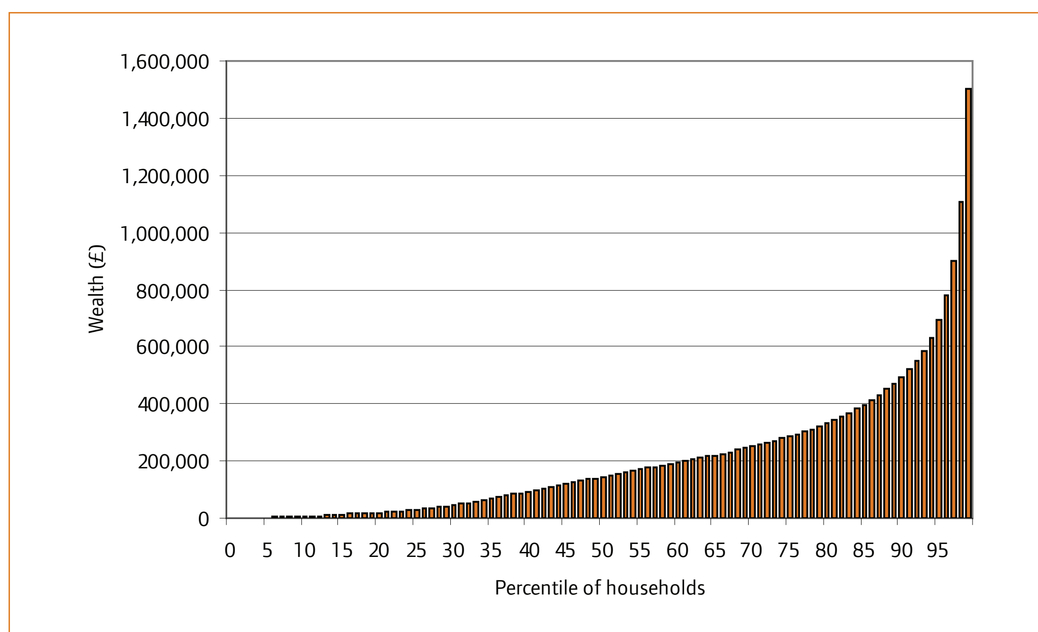
The result is that the proportion of estates paying Inheritance Tax, which was six per cent in 2006–07, fell to four per cent in 2007–08 (when the transferability of thresholds was introduced mid-year) and to just 2.5 per cent in 2009–10.

Inheritance Tax and wealth

An assessment of the likely incidence of Inheritance Tax can be deduced from the latest data on household wealth. The National Equality Panel (NEP), which published its report in January 2010, was able to access data from the new Wealth and Assets Survey covering the period from June 2006 to June 2008. It found that median household wealth in the UK during this period was £145,400 (NEP 2010: 58).[8]

The NEP also set out the full distribution of wealth in the UK in 2006–2008. In all, 21 per cent of households had wealth above the current Inheritance Tax threshold of £325,000 but just six per cent had wealth above the married couple 'double threshold' of £650,000. Since these wealth data, for the most part, predate the falls in asset values caused by the financial collapse and recession, current wealth data (that is, for 2010–11) would show slightly lower percentages still. The current average house price in the UK is, for example, five per cent lower than in 2006–08 and the equity market is about 10 per cent lower in value than it was in that period (although the value of equity holdings will have fallen by less if dividends have been reinvested).

Figure 4:
Net non-pension wealth in the UK, 2006–08



Source: NEP 2010: 58

8 The NEP used several definitions of wealth. This one includes financial and physical wealth, including household goods and houses but excluding pension rights, and is the best definition when considering potential Inheritance Tax liabilities.

These estimates are based on the complete distribution of wealth across all households in the UK, including those where the 'household reference person' (HRP) is as young as 16 and so unlikely to have accumulated much wealth (and also unlikely to die). The wealth of households where the household reference person is older is higher than the average.

Table 2: Financial, physical and property wealth, 2006–2008, £

Age of HRP	Median	70th percentile	90th percentile
16–24	11,678	23,430	70,750
25–34	48,200	96,500	198,843
35–44	120,014	205,600	399,650
45–54	184,246	284,185	554,150
55–64	243,255	373,474	666,900
65–74	213,220	313,712	584,807
75–84	182,700	275,017	507,224
85+	156,300	238,506	443,707

Source: NEP (2010) Wealth tables at http://www.equalities.gov.uk/docs/200608_Wealth_tables.xls

Households begin to consume some of their wealth once they stop working, so wealth tends to decline with age during retirement. In 2006–2008, the median wealth of a household with a HRP aged 85 or over was only 64 per cent of the median wealth of a household with a HRP aged 55–64. In part, this might reflect the higher living standards and greater home ownership rate of the younger group. But it also shows the effect of the consumption of wealth in retirement. Among households where the household reference person is aged 65 or over (those most likely to die[9] and leave an estate that might have to pay Inheritance Tax), less than 30 per cent have wealth exceeding the Inheritance Tax threshold and less than 10 per cent have wealth above the 'double threshold'.

Based on the age distribution of wealth in Table 2 and the age distribution and marital status of those who died in 2008, less than 10 per cent of estates in the UK hold sufficient assets to be liable to pay Inheritance Tax under the current system. In fact, less than three per cent of estates actually pay it.

If the Inheritance Tax threshold is frozen at its current level for four years and wealth increases at an average rate of eight per cent per annum over the same period, less than five per cent of estates will be paying Inheritance Tax in 2014–15. Inheritance Tax in its current form is not a tax on the middle-classes. It is a tax that falls only on the wealthiest households in the UK.

Inheritance Tax and the family home

Houses are the most valuable item in most estates. In 2007–08, residential property accounted for around half of all assets in estates, with one-quarter being accounted for by cash and the rest by equities, bonds, insurance policies and other assets. However, houses were less important in those estates that might be liable for Inheritance Tax: in those that were valued at more than £300,000, and particularly in the largest estates.

Table 3: Assets by estate value in 2007–08 (per cent)

	Estate value (£ '000)					
	Up to 300	300 to 500	500 to 1,000	1,000 to 2,000	Over 2,000	All estates
Securities	5.0	11.1	19.2	28.8	33.5	13.2
Cash	27.4	24.1	21.9	16.4	11.4	23.4
Insurance policies	3.9	4.6	3.7	4.1	1.5	3.8
Residential property	58.4	54.0	43.3	33.9	24.0	49.8
Other land and buildings	0.8	2.0	5.4	9.4	12.1	3.6
Loans and other assets	4.5	4.3	6.6	7.3	17.5	6.3
Total gross capital value	100.0	100.0	100.0	100.0	100.0	100.0

Source: HMRC 2010c

9 83 per cent of the people who died in England and Wales in 2008 were aged 65 or over; 67 per cent were aged 75 and over, and 36 per cent 85 and over (Office for National Statistics 2009: 5–8).

Although some estates include second homes and houses bought to let, the vast majority of the housing assets in estates will be primary residences. Hence, one of the main complaints about Inheritance Tax is that it prevents people passing on the 'family home' to their children. Deliberative workshops have revealed 'passionate complaints about [Inheritance Tax] "forcing" the sale of the family home' (Maxwell 2004: 29).

The obvious objection to these complaints is that the vast majority of people do not move into their parents' home when their second parent dies. Typically, they already have a home of their own, or they may live and work in another part of the country. But, even in the case where one or more children wishes to move into the 'family home', the Inheritance Tax rules go a long way to allow them to do so. In particular, inheritors are allowed to pay Inheritance Tax liabilities over a 10-year period if the value of an estate is tied up in a house (or when the house is sold if that occurs sooner). This allows them plenty of time to find other means of meeting the tax liability without having to sell the house.

Furthermore, HMRC data suggest that few estates paying Inheritance Tax in 2007–08 would have had to sell the family home to meet the tax bill, if the inheritors were prepared to sell other assets instead. From data on the number of estates paying Inheritance Tax and the amount paid, it is possible to derive the average tax payment, and thus the average value of the estate in various value bands.

Table 4: Estates paying Inheritance Tax, 2007–08

Range of net estate	Total Inheritance Tax take (£ million)	Estates taxed	Average Inheritance Tax (£)	Average estate value (£)
£300,000 to £500,000	352	12,670	27,782	369,455
£500,000 to £1,000,000	926	7,948	116,507	591,268
£1,000,000 to £2,000,000	849	2,683	316,437	1,091,092
Over £2,000,000	945	989	955,511	2,688,777

Source: HMRC 2010f

From data on the number of residential buildings and their value in estates it is also possible to derive the average value of residential property, and thus the value of other assets in the same value bands.[10]

Table 5: All estates, 2007–08

Range of net estate	UK residential buildings			Average value of non-housing assets (£)
	Value (£ million)	Number	Average value (£)	
£300,000 to £500,000	6,741	27,269	247,204	122,252
£500,000 to £1,000,000	4,233	11,954	354,107	237,161
£1,000,000 to £2,000,000	1,799	3,150	571,111	519,981
Over £2,000,000	1,595	1,175	1,357,447	1,331,330

Source: HMRC 2010c

By comparing the final column of Table 5 with the penultimate column of Table 4, it can be seen that the average Inheritance Tax bill is considerably less than the average value of non-housing assets in estates. Thus, for example, the average estate with a value of between £500,000 and £1,000,000 faced an Inheritance Tax bill of £117,000 in 2007–08, but held non-housing assets of more than twice that amount, at £237,000.

10 These data cover all estates, those paying and not paying Inheritance Tax, so it is assumed the average value of houses is the same in both cases. The figures will also include second homes and other houses that are not the 'family home', so the estimate of non-housing assets will be an underestimate of 'non family home assets'.

This does not mean that there were no estates in 2007–08 where the Inheritance Tax liability was larger than the value of non-housing assets (that could only be shown with the complete distribution of tax liabilities and housing values). But the magnitude of the gap between the average value of non-housing assets and the average Inheritance Tax bill suggests the number of estates that were in the position of having to sell the family home to meet an Inheritance Tax bill was very small. What is more, the transferability of the Inheritance Tax threshold for married couples was introduced halfway through 2007–08 and so is only partially reflected in these figures. This move will have diminished Inheritance Tax bills and so reduced this problem almost to the point of extinction.

If a problem does remain, it will occur where there are multiple inheritors and one wants to keep the family home but its value is greater than his or her share of the estate. An example could be the case of a widowed man dying and leaving an estate of £1,000,000 to be divided equally between his two daughters, of which £500,000 is represented by the family home and £500,000 by other assets. Assuming that his wife's Inheritance Tax nil rate band was transferred to him when she died, the Inheritance Tax liability of the estate will be £140,000. This leaves £860,000 to be divided equally between the two daughters, £430,000 each. But if one takes the house valued at £500,000, she will 'owe' the other £70,000. If she does not have this amount of money (and cannot borrow it) and the two cannot come to some agreement, the house might have to be sold.

It is wrong, therefore, to believe that Inheritance Tax forces the sale of thousands of family homes every year. This is not the case.

Another myth is that, notwithstanding the falls in 2008 and 2009, house price increases over the last decade or so mean many millions of homes in the UK are now valued at more than the Inheritance Tax threshold and that this will lead to many more estates being liable for Inheritance Tax in the future. Data from the Land Registry for England and Wales (including Scotland would make little difference) show that less than one-fifth of houses are currently valued at more than £300,000 and just 3.5 per cent at more than £600,000. With an effective Inheritance Tax threshold of £650,000, few married couples will pay Inheritance Tax on the basis of the value of their home alone.

Table 6: House sales in England and Wales, December 2009

Price range	Number	Percentage
Less than £300,000	40,391	81.7
£300,000 to £400,000	4,379	8.9
£400,000 to £500,000	2,118	4.3
£500,000 to £600,000	781	1.6
£600,000 to £800,000	942	1.9
£800,000 to £1,000,000	375	0.8
£1,000,000 to £1,500,000	269	0.5
£1,500,000 to £2,000,000	92	0.2
Over £2,000,000	65	0.1

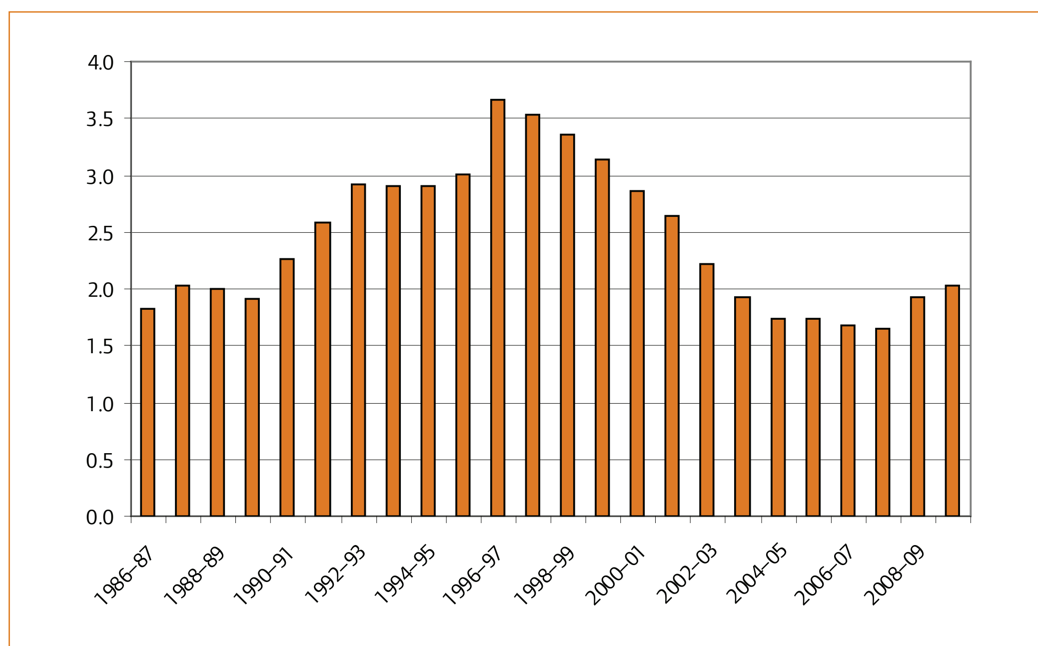
Source: Land Registry 2010: 13

Lastly, the common perception that, since its introduction in 1986, the incidence of Inheritance Tax has increased due to rapid house price inflation is also wrong. The average house price in the UK in 2009–10 was £160,000, 4.1 times higher than the 1986–87 average of £39,000 (Nationwide Building Society 2010), while the Inheritance Tax threshold was 4.6 times higher. Since the introduction of Inheritance Tax, the threshold has more than kept pace with the increase in the value of the main asset left in estates.[11]

This is not quite the whole story. First, the relationship between the threshold and the average price of a house has varied considerably over time. When Inheritance Tax was introduced in 1986–87, the threshold was 1.8 times the average house price. After the large increase in the threshold in 1996–97, the ratio had increased to 3.7 times, but it has subsequently fallen back to 2.0 times as a result of very high house price inflation between 1996 and 2005.

11 It has also outstripped the increase in value of assets held in cash, but not equities and government bonds.

Figure 5:
Ratio of Inheritance Tax threshold to average house price



Source: HMRC 2010b, Nationwide Building Society 2010

Second, the decision in October 2007 to allow the transfer of the unused threshold of the first spouse to the surviving spouse doubles the effective Inheritance Tax threshold for the vast majority of people. For over 80 per cent of estates, therefore, the threshold is now 4.0 times the average house price. The Inheritance Tax threshold is, thus, little different now for single people – in relation to average house prices – than it was when it was introduced in 1986. For married couples it is more generous than it has ever been on this basis.

If the Inheritance Tax threshold is increased in the future, there could be a case for indexing it to house price inflation. However, there is not a good case for exempting a person's primary residence from Inheritance Tax, as has been suggested in some quarters. First, the current level of house prices will cause only a small proportion of estates to be liable to the tax. Second, if primary residences were exempt, the revenues from Inheritance Tax would be so low that it would not be worth persisting with. And third, exempting one asset from Inheritance Tax would distort incentives and so create inefficiencies. Old people would be encouraged to retain their home, knowing that it was exempt from tax, even when it might be better for them to sell.

The problems with Inheritance Tax in its current form

In some respects, therefore, Inheritance Tax is not as bad as the myths suggest, and it has played a progressive role in the UK's tax system. But, particularly since the 2007 reforms, it is far from being an ideal tax – one that is equitable, efficient and simple, and designed to ensure a high rate of compliance.

Boadway et al (2010) argue that Inheritance Tax is inequitable because the very wealthy can give away large chunks of their wealth – in the form of equities, bonds and cash for example – tax-free during their lifetime (as long as they do it more than seven years before their death) without affecting their own standard of living. They can also make use of trust arrangements to reduce their tax liability. These options are not available to the less wealthy because the bulk of their wealth is tied up in their home. It could be argued that the ability of the rich to dispose of their assets also means that Inheritance Tax fails the compliance test too.

The latest data from HM Revenue and Customs appear to confirm that Inheritance Tax can be avoided. Of those estates notified for probate as a result of deaths in 2007–08 (the latest year for which figures are available), there were 3,672 of a value over £1,000,000 that paid Inheritance Tax, but a further 1,816 that did not. So 33 per cent of estates known to be well above the threshold (£300,000 for all estates in the first half of the year and £300,000 for a single or divorced person and up to £600,000 for widows and widowers) were not taxed.

Table 7:
Estates notified for probate, 2007–08

Range of net estate	Number taxed	Number not taxed	Percentage not taxed
£300,000 to £500,000	12,670	20,116	61
£500,000 to £1,000,000	7,948	6,667	46
£1,000,000 to £2,000,000	2,683	1,362	34
Over £2,000,000	989	454	31
Total	**24,290**	**28,599**	**54**
Total over £500,000	11,620	8,433	42
Total over £1,000,000	3,672	1,816	33

Source: HMRC 2010f

Furthermore, HMRC say that, while the number of estates paying tax is almost fully complete, they might have captured only five-sixths of non-taxpaying estates. If so, up to 37 per cent of estates valued at more than £1,000,000 might have avoided paying Inheritance Tax in 2007–08. If loopholes can be exploited to such an extent, then Inheritance Tax is neither fair nor efficient in practice, whatever the theoretical arguments in its favour.

If Inheritance Tax is so far from ideal, it may not be worth persisting with it. Revenues from Inheritance Tax peaked at just under £4 billion in 2007–08 and are expected to fall to £2.2 billion in 2010–11 (HM Treasury 2010a: 100). If the Conservative Party's proposal to increase the threshold to £1,000,000 is implemented, revenues would fall to less than £1 billion.

It is also likely that a fall in revenues would be associated with an increase in the average cost of collection. In 2008–09, it cost 0.99 pence to collect every £1 of Inheritance Tax revenue, compared to 0.62 pence for VAT and 1.24 pence for Income Tax (HMRC 2009), so it is not a relatively expensive tax to collect. But the cost of collecting Inheritance Tax was up from 0.64 pence for every £1 in 2007–08 over a period when revenues fell from £3.8 billion to £2.8 billion. This suggests that the marginal cost of collecting Inheritance Tax is lower than the average cost, and that a further fall in revenues is likely to be accompanied by an increase in the average cost of collection. Faced with such evidence, a future Conservative government that had already increased the threshold to £1,000,000 may decide to abolish Inheritance Tax altogether, particularly if it could find the lost £1 billion of revenues in another way that was less unpopular than Inheritance Tax.

Public attitudes to Inheritance Tax

Opinion polls suggest Inheritance Tax is one of the most unpopular taxes in the UK. A MORI poll[12] in 2004 asked whether taxing a person's estate was fair. Only 19 per cent of respondents agreed; 69 per cent disagreed. 57 per cent thought the threshold should be increased (41 per cent thought it should be much higher) while only 11 per cent thought it should be reduced. A Populus poll[13] in 2006 produced very similar results: 25 per cent said that Inheritance Tax was fair, but 73 per cent said it was not; 76 per cent thought the starting rate should be much higher. The lowest support for Inheritance Tax was not among those in the AB social groups, who might be expected to be most at risk of having to pay it, but among those in the C2 group, of which only 19 per cent thought it a fair tax. What is more, when asked whether Inheritance Tax should be scrapped and replaced by an extra 1p on the basic rate of income tax, 59 per cent of respondents agreed and only 37 per cent disagreed. Given that, at the time, just over 30,000 estates a year were paying Inheritance Tax, while 30 million people were paying income tax, this is a rare example of the majority of people saying they would willingly pay more tax themselves, so that a minority could pay less. This might be said to reveal the deep unpopularity of Inheritance Tax, but it also probably says something about the degree of ignorance of the majority of the public about its workings and incidence.

12 See http://www.ipsos-mori.com/researchpublications/researcharchive/poll.aspx?oItemId=651
13 See http://www.populus.co.uk/bbc-inheritance-tax-poll-120306.html

The unpopularity of Inheritance Tax is the result of several factors. Although strictly a tax on the estate of the dead person, it is probably seen by the inheritors as a tax they have to pay out of 'their' assets. It is more visible than, say, income tax or VAT. (Council tax, which is also a very visible tax, is similarly unpopular.) However, if no more than six per cent of estates have been liable to Inheritance Tax in any year, few people will have been in the position of seeing their inheritance reduced by its payment.

Another possibility is that Inheritance Tax is unpopular because it is perceived as 'double taxation' – a tax paid on assets saved out of income that has already been taxed. While this might be the perception, it is a very weak argument against Inheritance Tax. Double taxation is a common feature of the UK – and most other – tax systems. In the UK, tax is paid on incomes, and then paid – in the form of council tax, VAT and various duties – when post-tax incomes are spent. The interest earned on savings made out of post-tax income is also taxed. If the argument is that there should be no double taxation, then the UK would have to move to a pure income tax, or pure expenditure tax, system.[14]

In any case, it is wrong to regard all assets in an estate as having derived from earned income. A large part of an estate will normally represent capital gains, and Inheritance Tax is very definitely not double taxation when it comes to the treatment of capital gains. Realised capital gains are subject to tax during a person's life but unrealised capital gains on death are not taxed. (One crucial difference between Inheritance Tax and a capital gains tax is that a person's main home is not subject to capital gains tax but is subject to Inheritance Tax. However, the Inheritance Tax threshold is the equivalent of 37 years of capital gains tax allowances and fully covers capital gains made on the majority of homes.)

Other possible explanations are that Inheritance Tax is so strongly disliked because it is seen as a tax on success or aspiration. It may simply be that people believe strongly that property belongs to all the generations of a family and not just to an individual (the 'family principle'). Or there could be a strong bequest motive – a desire to determine what happens to all our assets when we die. Alternatively, perhaps people just overestimate its incidence. One survey found that people believed between one in four and one in two households will be affected by Inheritance Tax (Rowlingson and McKay 2005). The actual figure in any one year has never been higher than one in sixteen.

Whatever the reasons for its past unpopularity, the latest evidence suggests that, at least relative to other taxes, Inheritance Tax is not as strongly disliked as it once was. In September 2009, Ipsos MORI asked people, if taxes had to be increased, which they would most and least like to see go up.

Table 8: If taxes were to rise, which of these, if any, would you be most/least in favour of being increased? (percentage)

	Most in favour	Least in favour
Taxes on business	25	3
Inheritance tax	24	6
Income tax	12	25
VAT	8	10
Fuel duty	5	21
Council tax	2	26
Other	5	–
None of these	11	3
Don't know	7	5

Source: Ipsos MORI http://www.ipsos-mori.com/Assets/Docs/Polls/poll-voters-not-yet-ready-for-spending-cuts-rsa-2009-topline.pdf

Inheritance Tax came a close second to taxes on business – and, therefore, first among taxes paid directly by households – as the one people would most favour increasing. Whether this apparent change of view, compared for example to the 2006 Populus poll, is due to the changes made to Inheritance Tax in October 2007, which greatly reduce its incidence, or to some other factor, is not clear.

14 It has even been suggested that Inheritance Tax represents 'triple taxation'. Richard Wellings of the Institute for Economic Affairs argues that 'tax is paid on initial income, then on savings and then again on death (IEA 2010). This is not strictly true. Tax is paid on the interest (and possibly the realised capital gains) made on savings, but not on the savings themselves.

Replacing Inheritance Tax with a Capital Receipts Tax

In the past, ippr has argued for the reform of Inheritance Tax (Maxwell 2004). Although Inheritance Tax was as unpopular with the general public then as it is now, it was regarded at the time as an important source of revenue for the government. Following the 2007 reforms, it is no longer a significant source of revenue and its enduring unpopularity makes it unlikely that any political party would consider increasing it. Indeed, as the 2007 reforms and the Conservative Party's proposal to increase the threshold to £1,000,000 show, the pressure is all in the other direction. Other than this change, the only reform that is now likely is complete abolition.

A small number of other countries have abolished their inheritance taxes, including Australia, Canada and Sweden. However, Canada replaced its inheritance tax by taxing capital gains at death (which does not happen in the UK) and Sweden by increasing its wealth tax (although that too was subsequently abolished).

Regardless, there remains a strong case for taxing inheritances. If reforming Inheritance Tax is no longer an option, consideration should be given to replacing Inheritance Tax with a Capital Receipts Tax.

The UK's Inheritance Tax is not, in fact, an inheritance tax; it is an estate tax. It is calculated on, and paid by, the estate of the deceased, not by those inheriting. It should be replaced by a tax on the receipt of gifts – a Capital Receipts Tax, or an accessions tax. This is not a new idea. It was put forward by the Institute for Fiscal Studies in 1973 (Sandford et al 1973), the Fabian Commission on Taxation and Citizenship (2000) and more recently by Prabhakar et al (2008). Ireland has had a Capital Acquisitions Tax since 1976.

Other European countries also tax the beneficiaries of estates, rather than the value of estates. In Germany, even the spouse of the deceased pays inheritance tax at a rate of 7 to 30 per cent above an exemption limit of €500,000 (roughly £425,000), while beneficiaries other than parents, children and grandchildren pay at rates from 13 to 50 per cent on amounts above just €20,000. In France, the rate of tax on inheritances can be as high as 60 per cent. The Netherlands and Belgium also tax beneficiaries.

The basic idea of a Capital Receipts Tax is that every person has a threshold amount for gifts that they are allowed to receive during their lifetime. Once this threshold is reached, further gifts are subject to tax. The tax can be made more complicated, for example by exempting gifts below a certain value, having a progressive tax rate scale, or setting different thresholds according to the relationship between the donor and the recipient. Gifts between husband and wife could be completely exempt.

A Capital Receipts Tax would have a number of advantages over the current Inheritance Tax system.

First, it would make a modest direct contribution to reducing wealth inequality. The Inheritance Tax regime favours sole beneficiaries of estates over multiple beneficiaries because the estate pays the same amount of tax irrespective of the number of beneficiaries. Under a Capital Receipts Tax, a sole beneficiary would pay more tax than the aggregate paid by several beneficiaries (unless they had all already received gifts above the threshold amount).[15]

Second, it could indirectly promote a more equal distribution of wealth by creating an incentive for a wider distribution of estates so as to limit beneficiaries' tax bills. Dominic Maxwell reports the results of deliberative workshops that suggest this would not happen (2004: 19). He also argues that tax experts are sceptical about the likelihood of a change in the pattern of bequests. But, in truth, there is no hard evidence on which to judge the likelihood of a Capital Receipts Tax leading to a change in the pattern of giving.

Third, a Capital Receipts Tax would be fairer because it would remove the anomaly created by the ability of the very wealthy to dispose of some of their assets during their lifetime in a way the moderately wealthy cannot. Fourth, it might be less unpopular than Inheritance Tax, particularly if it was presented as a tax on unearned 'income'. It is also less likely to be criticised as 'double taxation', since the recipient is taxed on assets they are receiving for the first time.

15 Under Inheritance Tax a sole beneficiary of an estate worth £1,000,000 (with no transferred nil rate band) receives £730,000, while four equal beneficiaries of the same estate would receive £182,500 each. Under a Capital Receipts Tax with the parameters set out in Table 10 below, a sole beneficiary would receive £705,000 and four beneficiaries £230,000 each.

The Fabian Commission (2000) proposed the introduction of a progressive capital receipts tax, payable on all gifts received during one's life, except that individual gifts with a value of less than £2,000 would be disregarded.

Table 9: Parameters of the Fabian Commission's capital receipts tax proposal, 2000

Size of capital receipt	Marginal tax rate
Up to £80,000	Nil
£80,000 to £160,000	20%
£160,000 to £240,000	30%
Over £240,000	40%

Source: Fabian Commission 2000

Over the last decade, the threshold for Inheritance Tax has been increased by 39 per cent (and effectively by 178 per cent for married couples and civil partnerships) and the average house price in the UK has doubled, so the bands proposed by the Fabians are somewhat out-of-date. A similar proposal today would have significantly higher bands than those put forward in 2000.

Table 10: Possible parameters for a capital receipts tax, 2010–11

Size of capital receipt	Marginal tax rate
Up to £150,000	Nil
£150,000 to £300,000	20%
£300,000 to £450,000	30%
Over £450,000	40%

Source: ippr

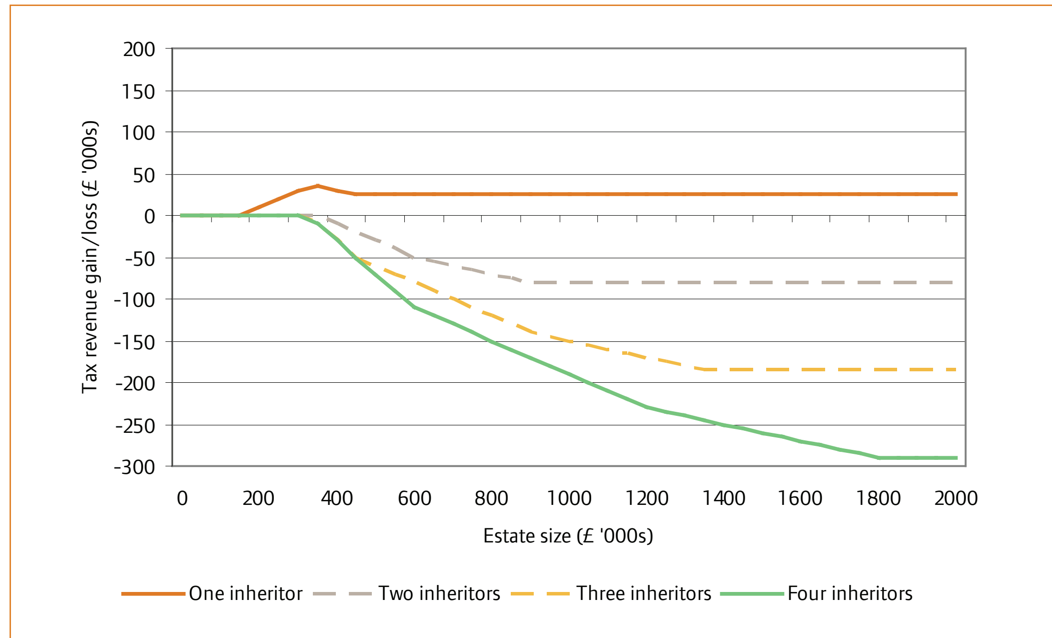
There are potential disadvantages: a Capital Receipts Tax could lead to a fall in revenue, it would create winners and losers, and it would entail higher administration and compliance costs (Maxwell 2004: 17).

Lower revenues should not be a significant concern. Revenues from Inheritance Tax under the present system are now so low that it should be possible to devise a set of thresholds and tax rates for a Capital Receipts Tax that are feasible politically and yet ensure that revenues are protected. In any case, the argument for a Capital Receipts Tax as part of the UK tax system should include some notion of the revenues that are expected to be raised.

It is difficult to estimate accurately how much tax would be raised by the structure proposed in Table 10 as this would depend on how estates were divided and whether the recipients of estates that now escape Inheritance Tax were captured in the Capital Receipts Tax net. But a rough calculation suggests that, in 2010–11, it might raise revenues of just over £3 billion – about £1 billion more than HM Treasury expects to be raised by Inheritance Tax. More work would be required, though, to set the right parameters.

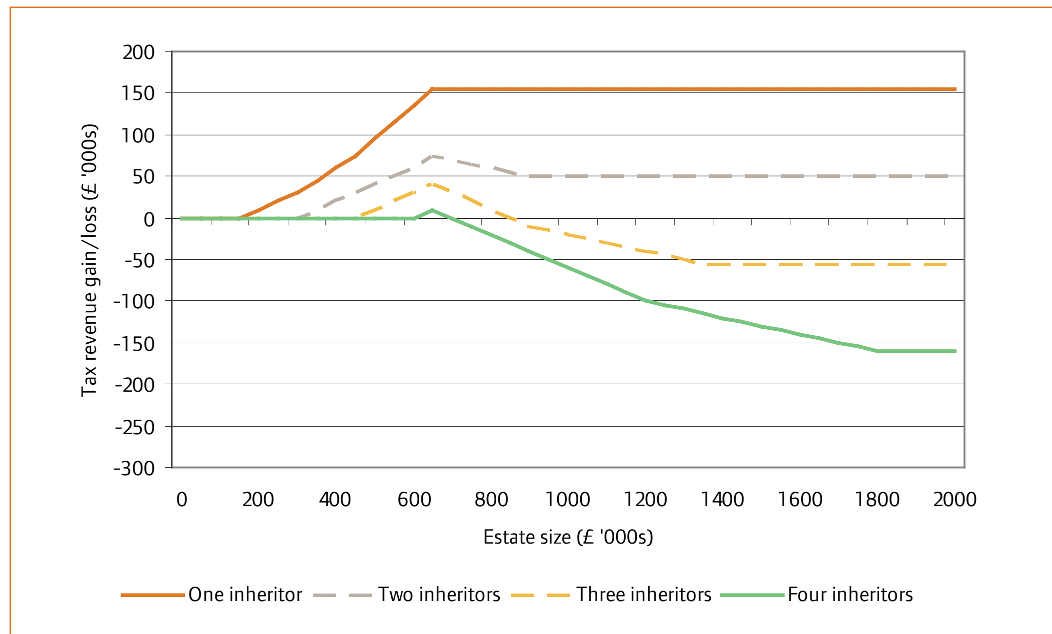
There would, of course, be 'winners and losers' from adopting a Capital Receipts Tax, compared to the Inheritance Tax regime. Generally speaking, less tax would be paid when an estate does not benefit from the 'double threshold' and is distributed to two or more people, or when it does benefit from the 'double threshold' and is distributed to three or more people. In the latter, more common, case, more tax will be paid when only one or two people inherit, particularly when the estate is valued at up to £650,000.

Figure 6:
Change in tax paid on an estate not benefiting from the transferable threshold



Source: ippr

Figure 7:
Change in tax paid on an estate benefiting from the transferable threshold[16]



Source: ippr

However, the language of 'winners and losers' is unhelpful when looking at changes to the tax system. If the tax system is changed to make it in some way fairer, anyone who has to pay more tax as a result should be presented as having gained unfairly from the old system, rather than as losing out as a result of the switch to a new system.

The biggest drawback to a Capital Receipts Tax is likely to be its high administrative and compliance costs. It requires every individual, whether currently a taxpayer or not, to keep a detailed record throughout their lifetime of all gifts that they receive (above a certain value), in case they should ever amass gifts in excess of the tax threshold. HMRC would have to check these records. Administrative costs would, therefore, increase compared to Inheritance Tax. Nevertheless, Ireland's Capital Acquisitions Tax is complex yet operates 'at about the same level of costs per unit of revenue as that of income tax on the self-employed' (Boadway et al 2010: 796). The very fact that it has survived for 34 years might also suggest the costs of its administration are not prohibitive.

16 Assumes no previous gifts have been received (as does Figure 6).

Conclusion

Inheritance Tax in its current form is unpopular and unfair and, once the government's finances are in a better state, it is unlikely to survive for very long. There is a strong case, on the grounds of increasing equality of opportunity and social mobility, for replacing it with a progressive Capital Receipts Tax. This would make a small contribution to reducing wealth inequalities in the UK. In addition, depending on the precise formulation in terms of thresholds and tax rates, this tax could raise £1 billion more in revenue for the Treasury. Generally speaking, less tax would be paid when estates were divided between a number of beneficiaries, but sole beneficiaries of large estates, particularly those who would currently benefit from the transferability of Inheritance Tax allowances between husband and wife, would pay more.

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Appendix: Inheritance Tax Parameters

Year	Threshold	Rate of tax
1986–87	£71,000	30 to 60%[1]
1987–88	£90,000	30 to 60%[2]
1988–89	£110,000	40%
1989–90	£118,000	40%
1990–91	£128,000	40%
1991–92	£140,000	40%
1992–93	£150,000	40%
1993–94	£150,000	40%
1994–95	£150,000	40%
1995–96	£154,000	40%
1996–97	£200,000	40%
1997–98	£215,000	40%
1998–99	£223,000	40%
1999–2000	£231,000	40%
2000–01	£234,000	40%
2001–02	£242,000	40%
2002–03	£250,000	40%
2003–04	£255,000	40%
2004–05	£263,000	40%
2005–06	£275,000	40%
2006–07	£285,000	40%
2007–08	£300,000	40%
2008–09	£312,000	40%
2009–10	£325,000	40%
2010–11	£325,000	40%
2011–12[3]	£325,000	40%
2012–13[3]	£325,000	40%
2013–14[3]	£325,000	40%
2014–15[3]	£325,000	40%

Notes

[1] 30% between £71,000 and £95,000, 35% between £95,000 and £129,000, 40% between £129,000 and £164,000, 45% between £164,000 and £206,000, 50% between £206,000 and £257,000, 55% between £257,000 and £317,000 and 60% over £317,000

[2] 30% between £90,000 and £140,000, 40% between £140,000 and £220,000, 50% between £220,000 and £330,000 and 60% over £330,000

[3] It was announced in the March 2010 Budget that the Inheritance Tax threshold would be frozen at £325,000 until 2014–15. This could change as a result of future budgets.

Source: HMRC 2010b and HM Treasury 2010b