

TAX BRIEFING NOTE

INHERITANCE TAX

JANUARY 2023

What is it?

Inheritance tax (IHT) is an estate tax charged on the estates of the deceased. The probate duty was introduced in 1694 and was replaced in 1889 by estate duty. That was replaced in 1975 by the capital transfer tax which included lifetime gifts in its scope. In 1986, lifetime gifts were removed (subject to partial tax on gifts made within seven years of death) and it was renamed as inheritance tax. Rates initially ranged from 30 to 60 per cent but in 1988 all were abolished except the 40 per cent rate, which remained unchanged ever since.

What's the problem with it?

Inheritance tax is distortionary, unfair and very unpopular.

The structure of inheritance tax means that it is distortionary in several ways. Exemptions for items such as agricultural property, heritage assets and certain business assets prompt people to take, buy and sell assets to avoid tax, sometimes outweighing other objectives. This distortion of decision-making generates a net loss to society. Exemptions for lifetime gifts encourage premature transfer of assets, leading people to transfer assets earlier than they would ideally like. Finally, it discourages saving on your heirs' behalf in favour of immediate consumption or cash transfers. A new, special higher threshold specifically for residential property encourages people to invest in houses instead of other assets, adding inflationary pressure to house prices while reducing the capital available for other uses, such as business investment.

The scope for avoidance through tax planning means that often inheritance tax is a tax on unlucky people whose benefactors either died unexpectedly early or who felt unable to afford professional advice. It is also levied at a difficult time for families, on the death of a relative.

Unsurprisingly, given that many people hope to be able to bequeath to their children an inheritance, and payment is associated with a death in the family, inheritance tax is highly unpopular. A 2022 YouGov poll found that 49 per cent thought inheritance tax was unfair or very unfair, compared to just 21 per cent who thought it was fair or very fair.¹

What should be done?

1. Abolish inheritance tax entirely.
2. In the meantime, remove the residential property distortion by raising the standard threshold to match it (from £325,000 to £500,000) and halve the rate to 20 per cent.

¹ YouGov, *How fair is inheritance tax?*, October 2022, <https://yougov.co.uk/topics/politics/trackers/how-fair-is-inheritance-tax>, (accessed 8 November 2022).