**STEP Response to Office of Tax Simplification Inheritance Tax Review Call for Evidence**

**About us**

STEP is the worldwide professional association for those advising families across generations. We help people understand the issues families face in this area and promote best practice, professional integrity and education to our members.

Today we have over 20,000 members across 95 countries, with over 7,000 members in the UK. Our membership is drawn from a range of professions, including lawyers, accountants and other specialists. Our members help families plan for their futures: from drafting a will or advising family businesses, to helping international families and protecting vulnerable family members.

We take a leading role in explaining our members' views and expertise to governments, tax authorities, regulators and the public. We work with governments and regulatory authorities to examine the likely impact of any proposed changes, providing technical advice and support and responding to consultations.

STEP welcomes the opportunity to respond to this call for evidence.

**Response**

IHT forms, administration and guidance

*Payment and forms*

1. **If you have completed an IHT form, please state which form(s) you completed and whether you completed them in your professional or individual capacity. Please describe any problems you had in navigating the form(s) and provide any suggestions you have on how the forms or related guidance could usefully be simplified, made clearer or made easier to complete.**

Members of STEP are familiar with completing all the Inheritance Tax forms available.

In general terms we would advise that, as we believe HMRC agree, Form IHT100 is not fit for purpose. It has not been updated to take into account the changes that were brought in, 12 years ago, by Finance Act 2006. It is overly complicated and adds to the problems in calculating what is already an overly complex tax (and this is aside from the delays and issues which HMRC have in dealing with these forms when submitted to them which have grown as HMRC use their limited resources to address the form IHT 400 delays).

With regard to the forms most often used, Forms IHT205 and Forms IHT400, there are issues. For example Form IHT 409 seems to have little value - usually creating a nil return. Several forms have not yet been updated to incorporate reference to the Residence Nil Rate Band and the Transferable Residence Nil Rate Band.

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The main problem however is the need to complete form IHT400 where there is no tax to pay but where, for example, the Transferable Nil Rate Band is being claimed, or where the estate is in excess of £1m but spouse exemption applies. This adds to the complexity and cost of dealing with what should be a straightforward estate.

We submit that perhaps a better way to approach the forms would be based not on the extent of the estate but rather on whether tax is payable. For example, there could be the following forms:

1. Form A where there is no tax to pay because the assets owned as at date of death are below the Nil Rate Band.
2. Form B to complete where the estate for IHT purposes is below the Nil Rate Band.
3. Form C to complete where there is no tax to pay because of allowances which are available - this would include claims for the Transferable Nil Rate Band, the Residence Nil Rate Band and the Transferable Residence Nil Rate Band.
4. Form D to complete where there is no tax to pay because of the exemptions which are available - where those exemptions are spousal exemption or charitable exemption.
5. Form E to be completed where there is tax to pay or there would be tax to pay if it was not for the reliefs that are being claimed.

We further suggest that a preliminary form accompany this proposed system. Along with the personal details of the deceased the form would include a multiple choice section to help guide those completing it to the correct process for their situation; for example: '*Did the deceased make any gifts in the last seven years? If yes, then use supplemental form X*'.

Please note that we are not commenting on the related guidance and how this could be simplified.

2. **In general, the deadline for payment of IHT is 6 months after death, whilst the deadline for submitting the relevant IHT form is 12 months after death. Please describe any problems or issues that arise because of this.**

Generally STEP members have no issues with the current system, although it does strike us as illogical. We would perhaps welcome a harmonisation of the time limits. This said, there are particulars issues where it is very difficult to obtain the necessary information within six months - for example where there is foreign property, an asset which is difficult to value or un-co-operative trustees or beneficiaries of lifetime gifts. Thus we feel that the harmonisation could be at 12 months.

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*Probate*

3. **<u>Does this process create practical difficulties? Bearing in mind the benefit of this mechanism, what could be done to address any such difficulties? To what extent does the instalment payment option where the IHT is attributable to certain assets in instalments help mitigate any issues?</u>**

Whilst we understand why HMRC would want to seek payment of IHT before probate is granted, this can have adverse consequences for many clients.

The direct payment scheme (where banks pay direct to HMRC before probate has been granted) has helped but it doesn't work if the cash and investments in the estate are insufficient. It is relatively common for estates to comprise mainly illiquid assets, such as land or shares, with the deceased's cash being insufficient to pay even the first annual instalment where that option is available. This may be particularly the case where the deceased's cash has been used up paying for care home fees or medical expenses.

It is also common for the deceased to hold funds abroad, but the direct payment scheme does not apply outside the UK.

This means there are often practical problems in paying IHT before the grant of probate or grant of letters of administration, which then releases the assets of the deceased.

It is no longer always possible to obtain a bank loan. Many banks that used to offer pre-grant loans no longer do so. Others will only lend the funds if they have an existing banking relationship with the deceased and sufficient non-liquid assets in their custody to act as security. The rate of interest is often high.

The facility for obtaining a grant on credit is helpful, but is not widely known about, even within the professions that deal with probate and estate administration. It is also time consuming to have to show HMRC's Grants on Credit section that all attempts to find the funds elsewhere have failed, such as by showing letters from banks refusing to make a loan. It would be far simpler if the probate could be granted on credit automatically.

The instalment option facility certainly helps although many clients do not like having to pay interest. Often this means clients will opt for the instalment option and then pay off the balance of the IHT due as soon as they can, by selling the asset in question. This creates greater administration both for HMRC and for the client.

We would therefore propose that either all grants be issued without payment of IHT upfront, or that the Grant on Credit system be amended so that the grant is given without payment of IHT immediately upon request, rather than only after proof is provided that the funds cannot be found elsewhere. There would also need to be greater publicity about the Grant on Credit system.

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We wonder if there could be an extension of the statutory charge to enable a grant to be issued without payment of the IHT in advance? This would appear to protect HMRC: executors could still be required to wait for a clearance certificate from HMRC, before distributing the estate in full. This would also relieve HMRC of the two-tier system of having to issue an IHT421 so that probate can be obtained, and then having to decide later whether to raise any queries on the IHT return that was filed.

*Estates that do not have to pay IHT*

4. **<u>Are there any disproportionate administrative or compliance burdens in establishing whether the value of the estate is below the NRB, or where the spouse exemption applies? How could these be reduced?</u>**

There are different issues for:

a) low value estates;
b) estates which are wholly, or virtually wholly, exempt, because everything passes to a spouse or to charity.

In both cases we find the present position unclear and disproportionate.

A search on GOV.UK will take lay individuals to https://www.gov.uk/valuing-estate-of-someone-who-died/tell-hmrc-estate-value where the guidance is as set out below in italics:

> ***Report the estate's value to HMRC***
>
> *When you've estimated the value of the estate you can:*
>
> - *start reporting the value in detail to HM Revenue and Customs (HMRC) - you'll find out whether you can report everything online or if you'll need a paper form*
> - *find out if there's tax to pay and when to pay it*
>
> *Report the estate's value*
>
> *You can also continue a report you've already started.*
>
> ***Before you start***
>
> *You need to:*
>
> - *have an estimate of the gross value of the estate*
> - *have told organisations that the person has died - you'll need this to give accurate valuations of the person's assets or debts*
>
> *As part of telling HMRC about the estate, you work out its detailed 'net' value - this is assets plus gifts minus debts. You'll need to know the net value if you need to apply for probate.*

***Getting more accurate valuations***

*When telling HMRC about Inheritance Tax, you'll usually need more accurate valuations of the estate. This includes using a professional valuer for things over £500.*

*You can continue using estimates if:*

- *the estate's gross value is less than £250,000*
- *all the estate passes to the dead person's spouse or civil partner, a charity or organisations like museums or community amateur sports clubs"*

This is not at all helpful. When is "*detailed 'net' value*" needed and when are estimates enough? Should the final two bullet points be joined by "*or*" or "*and*" (we suspect "*or*" but this certainly isn't clear).

*Low value estates*

We find it hard to understand why any details of the assets of the estate are required in many of these cases. The regulations on lifetime chargeable transfers (SI 2008/605) specifically provide that no return is needed when the total of the present transfer and other chargeable transfers in the previous seven years is no more than 80% of the £325,000 threshold. Where only cash and quoted investments are involved, no return is required when the value is no more than 100% of the threshold amount.

In deceased estates there has to be a return, on Form 205, in any case where a grant is required, even when no IHT is payable, however small the value of the assets.

*Exempt estates*

In wholly exempt estates, where a grant is required, there has to be a return on Form 205. If the value of the exempt estate is more than £1 million the return has to be the full one on Form 400, with its schedules.

Surely all that should be required are details of the facts on which the exemption relies? Why are asset details required at all?

5. **<u>Could the guidance on www.gov.uk be improved to support people handling estates on which no IHT will be paid? If so, how?</u>**

No response.

6. **<u>Are there other steps that government could take to raise awareness of the NRB to reduce anxiety around liability to IHT for people who don't have to pay it?</u>**

IHT is a worry for many more people than actually have to pay it. Increased publicity by the government about the allowances would be helpful.

It does not help that the system of allowances, with the Basic Nil Rate Band, Transferable Nil Rate Band, Residence Nil Rate Band, and downsizing relief is now so complicated. It is surprising how many lay individuals do not even realise that there is an unlimited exemption between spouses.

*Administering an estate, record keeping and valuations*

7. **What, if anything, could be done to help executors administer an estate and fulfil their obligations?**

Until a few weeks ago, we would have been asking for more commitments from HMRC on turnaround times. We are, however, most encouraged by the contents of the special Trusts and Estates Newsletter published in April this year (https://www.gov.uk/government/publications/hm-revenue-and-customs-trusts-and-estates-newsletters/hmrc-trusts-and-estates-newsletter-special-edition-april-2018) and look forward to this being carried forward into practice.

Many of our members have reported long delays in dealings with the Department for Work and Pensions (DWP), particularly where DWP have raised questions, answers have been given to those questions but it has then taken months to obtain confirmation that DWP are satisfied.

Tracking down details of lifetime gifts can often be a major problem for executors. Family members are not always forthcoming with details and more understanding of the executors' dilemma in these cases is needed. It would also be helpful for there to be a legal requirement for financial institutions to provide timely information to executors about transactions in the seven years before death.

Some of our members have described questions they have received from HMRC, which seem designed to catch out executors. These seem to be cases where HMRC already have information about the deceased's finances. HMRC need to remember that executors are appointed in all sorts of circumstances and for all sorts of reasons; often they have little knowledge of the deceased's financial history. HMRC must be willing to share such information with the executors.

8. **Have you been required to obtain a valuation of assets for the purposes of completing an IHT form? Was there any difficulty in doing so? Was the cost of the valuation commensurate with any IHT payable? What could be done to simplify this process?**

The need for valuations is linked to the requirement to provide HMRC with details of the deceased's assets, even where no IHT is payable (see our comments in response to question 4). At the moment those requirements mean valuations have to be obtained much more frequently than is necessary.

Where IHT is payable, and a valuation is required to ascertain the amount of IHT, the reasonable cost of obtaining that valuation should be a deductible expense, just as accountancy expenses are deductible in calculating taxable business profits.

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Lifetime gifts to individuals

9. **Are there any aspects of the interaction between the thresholds and exemptions relating to lifetime gifts that you find especially distortive or complex to understand and apply? Please provide examples.**
10. **How, if at all, should these rules be simplified? What could be done to improve public understanding of the rules? Have you found that the joint liability of the estate and the person receiving the gift can cause problems for executors or HMRC?**
11. **How, if at all, could the monetary thresholds and the various lifetime exemptions be simplified?**

Many taxpayers, and indeed some professionals, still do not follow or fully understand the issue of taper relief on tax which may become due on lifetime gifts. There is a common misconception that taper relief applies to the value of the gift rather than any tax paid under it; perhaps taper relief should be adjusted to reflect this?

There are also issues with lay clients understanding that lifetime gifts becoming chargeable does not result in tax being due but rather results in the allowances at death being used up in the lifetime gifts to the detriment of the beneficiaries who inherit under a will or Intestacy.

We suggest more is done to publicise these issues.

The Transferable Nil Rate Band and Residence Nil Rate Band, both available only on death, interact in different ways with transfers of value in the seven years before death. A Transferable Nil Rate Band can help take failed potentially exempt transfers out of IHT, but this is not the case for the Residence Nil Rate Band, which can only relieve IHT on the estate on death.

There is a case for the Transferable Nil Rate Band being available to widows and widowers during their lifetime so that, for example, lifetime chargeable transfers by the widow of a husband who left his entire estate to her, would have double the standard Nil Rate Band.

A suggestion to address the confusion regarding lifetime gifts is suggested in our response to question 19.

STEP members also feel that the interaction between potentially exempt transfers and chargeable transfers covering the 14 year period before death is overly complex and arguably distortive. It seems to go against the commonly held perception that it is only gifts in the last seven years which count.

We also believe that the values of the allowances are well overdue for a rethink - £250 and £3,000 in 1984 terms would be worth around £800 and £9,500 in today's prices.

We believe there should be more publicity surrounding section 11 of IHTA 1984 on the issue of maintenance for children.

We also believe that it is inequitable that the executors are ultimately liable for payment of tax due from a lifetime donee of a gift if that donee refuses to co-operate. We believe at the very least the executors should have a statutory right of recovery from that beneficiary.

HMRC are well aware of the increase in the use of the exemption for gifts which are termed to be regular gifts out of surplus income. We believe that the form upon which this is claimed could be simplified. The form requests information for tax years, although the relevant period is the seven years from date of death, on a yearly basis. HMRC also must surely have the majority of the information with which to set out the income which has been declared to it (and upon which Income Tax has already been paid). We therefore suggest that the information is provided to the executor on request.

There is confusion over drawdowns from policies. HMRC now seem to have adopted the stance that drawdowns are not income for the purposes of the relief, despite the fact that many clients regard such payments as income, and the fact that they are income for Income Tax purposes (even if not immediately taxable). We believe these withdrawals from policies should be accepted as income for this purpose.

With regard to expenditure, we believe that the form appears to be too detailed in respect of minimal amounts (for example having a separate element for council tax).

We suggest that perhaps there could be a *de minimis* figure shown for this exemption – for example, a presumption of a fixed percentage over an income earned of a fixed amount. Alternatively, the *de minimis* could apply to the payment made – for example, this exemption is frequently claimed for payments of a premium paid on a life insurance policy. STEP do not have figures for when such a premium is not considered to have been paid on a regular basis out of surplus income but we suggest that this would be very infrequent. Perhaps a presumption could be made that if the monthly premium is say 5% of the monthly income, this exemption would apply.

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12. **<u>How, if at all, does the IHT framework, including the related tax considerations set out above, make business decisions challenging? For example, does it affect or distort decisions regarding:</u>**

    **<u>a) whether to sell or transfer a family business to another vehicle or directly to the next generation during lifetime or wait until death,</u>**

    **<u>b) the structure of the business (for example, how to hold non-trading assets),</u>**

    **<u>c) the choice of business vehicle (for example a corporate entity, partnership, unincorporated business), or</u>**

    **<u>d) investment in unlisted trading companies (including those traded on the alternative investment market (AIM))?</u>**

<u>Businesses</u>

We feel that on the whole the BPR regime works reasonably well. It is right to offer relief to family businesses and to smaller, unquoted companies. Such businesses constitute a vital part of the economy and employ a significant proportion of the workforce. To tax them on the owner's death would seriously affect their continuity.

There are, however, various elements which cause complexity and/or are anomalous, for example:

- There is frequently uncertainty over what constitutes "making or holding investments", hence the large number of reported cases on this point. Could the legislation make this clearer?
- The rate of BPR is generally 100%. However, land, buildings, machinery or plants held by the transferor but used by a company he controls or a partnership of which he is a partner only qualify for 50% BPR. There is therefore an artificial incentive to hold such assets within the company/partnership, where they would qualify for 100% BPR.
- It is hard to see why a furnished holiday let business should be treated differently from a bed and breakfast business. Only the latter qualifies for BPR.
- Generally unquoted shares in non-investment companies qualify for BPR. However (at least in HMRC's view) such shares held through a partnership do not.

The availability or otherwise of BPR is a major factor in many business decisions.

a) Often a business owner will retain his interest simply to ensure that there is a CGT-free uplift on death. His heirs can then sell the business tax free.

b) BPR has a significant impact on how non-business assets are held.

c) We think it is comparatively rare that the choice of business vehicle is dictated by BPR, though it is certainly true that many substantial companies remain unlisted to preserve BPR.

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d) People often invest in e.g. AIM-listed companies at least partly to obtain the IHT benefit. This is very beneficial for the businesses concerned and helps them grow.

13. **Do the different requirements for trading across BPR, CGT gift relief and entrepreneurs' relief cause complexity and, if so, how could this be addressed? Are there any other inconsistent definitions or approaches either within IHT, or across IHT and CGT and if so, does this cause complexity? Do you have any other suggestions as to how to remove complexity around the interaction between CGT and IHT?**

It is difficult to see a reason why the requirements for trading across BPR, CGT gift relief and entrepreneurs' relief should be different, and such differences do add complexity.

14. **The availability of BPR is not generally dependent on the size of a person's interest in a business or holding it for any period after death. Does this feature of BPR add to or reduce complexity?**

We feel that imposing a condition as to the minimum size of an interest in a business and/or that it has to be retained for a specified period after death would only add to the complexity.

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Farming businesses

15. **How, if at all, does the IHT framework, including related tax considerations set out above, make business decisions challenging? Does it affect or distort decisions regarding:**

    **a) whether and when to sell or transfer the farm to another vehicle or to the next generation, or downsize during one's lifetime, or wait until death,**

    **b) the choice for farm owners of letting out farmland versus farming themselves or via a contract farming arrangement,**

    **c) the inhabitants and use of the farmhouse,**

    **d) the choice of business vehicle for the farm (for example a corporate entity, partnership, unincorporated business), or**

    **e) the structure of the business (for example, how to diversify or hold non-trading assets)?**

16. **Could the criteria for being a farmhouse or the process of determining the agricultural value of the farmhouse be simplified? If so, how?**
17. **What, if any, complexities arise from the fact that BPR and APR overlap, at least in part? Are there discrepancies in the way that they operate? Would it help if APR was replaced by BPR or if the two were merged?**

As we believe has been acknowledged by prior research, it is extremely unusual for a taxpayer to invest in Agricultural Property Relief assets as part of a tax planning exercise and in most cases, the issue of the availability of Agricultural Property Relief relates to working farmers and their families.

Given that the purpose of Agricultural Property Relief is to preserve the farm for the good of all, we believe that the constant refining of the eligibility of individuals to claim Agricultural Property Relief works against the working farmer and their families. This is particularly true in relation to the criteria for being a farmhouse - there are instances of farmers effectively being forced out of their home on retirement, or alternatively, continuing to farm long after they wished to retire, in order for the farmhouse, which provides a base for the family to farm, being retained as part of the business.

In addition, little weight is now given to how a deceased taxpayer may have used the land, and more focus is placed on how a hypothetical individual may use the land - even where there is no intent on the part of those who are inheriting to change the use of that land.

STEP members do indeed find issues with the fact that BPR and APR overlap. It is an inconvenience that APR must be claimed first and then BPR when it is known that BPR would cover the operation. We believe that it should be possible to opt as to which relief is being claimed.

Charitable giving

18. **How well do you think the charitable exemption and the lower rate of tax on death is understood by advisers or the public? Please tell us about any areas of complexity in the application of this rate, or the charitable exemption, along with any suggested improvements.**

The lower rate of 36% is a useful relief but there is still too little awareness of it.

The statutory rules are extremely complex, but, in this case, this is the result of a laudable attempt by the parliamentary draftsmen to recognise the different circumstances in which IHT can arise. One point that has been missed is that the Residence Nil Rate Band, in force since 6 April 2017, is not deductible in calculating the "*baseline amount*" against which a 10% charity gift is measured.

The example below highlights the difficulty, unperceived by most lay individuals, of dividing an estate between charities and taxable beneficiaries. There is no easy balance between minimising IHT and fairness.

Suppose Florence has assets worth £2.4 million and wants to leave a quarter to her nephew Jim and the other three-quarters between three charities.

> *If Florence's will divides everything into quarters then, if she makes no special provision, Jim pays all the IHT. Suppose Florence's only IHT allowance is the £325,000 Nil Rate Band. Jim's £600,000 has to meet 36% IHT (clearly the charity gifts are much more than 10% of the baseline amount) on the £275,000 over the Nil Rate Band, which is £99,000. Jim gets £501,000 while the charities get £600,000 each.*
>
> *On the other hand, if Florence's will gives a cash legacy of £600,000 to Jim, while dividing the rest of her estate equally between the three charities, that £600,000 is treated as free of IHT. This means that the gift has to be grossed up to the amount which, after deduction of 36% IHT on the amount over £325,000, leaves £600,000. This is £754,687.50 on which IHT is £154,687.50. This time the charities have to pay all of the (much bigger) IHT bill. Jim gets his £600,000, but the charities only some £548,000 each.*
>
> *If Florence wants the division to be fairer, so that each of Jim and the charities end up with the same amount, her will has to say that specifically. In round figures, each of Jim and the charities ends up with about £566,000 and the IHT is some £136,000.*

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Other areas of complexity

19. **Please tell us about any other areas of complexity in applying any IHT rules, reliefs or thresholds not already mentioned in your response, along with any suggested improvements. You may, for example, wish to comment on the residence nil rate band, the IHT treatment of trusts, the IHT treatment of personal pensions and life insurance products, or the conditional exemption for certain works of art or heritage assets.**

**Residence Nil Rate Band**

Whilst a good idea in principle, the Residence Nil Rate Band is, in practice, hugely complicated, is discriminatory, contains anomalies. In relation to some aspects is overly restrictive so that the relief does not apply when clearly it should and yet in relation to other aspects appears surprisingly generous.

The result of the complexity is that very few advisers and probably equally few HMRC employees understand the relief. This is illustrated quite well by the fact that HMRC's guidance contains an example which is incorrect and that HMRC's reaction to this is that it is the legislation rather than their guidance which is defective - i.e. the legislation does not deliver the intended result.

The following illustrates some of the problems:

- A testator gives their unmarried partner a life interest in the house with the reversion going to the testator's children from a prior relationship. No relief is available on the death of the partner whereas relief would be available if the life tenant were the parent of the children.
- A testator leaves half of residue to charity and the remaining half to his children. The executors allocate the house to the children's share of residue. HMRC's view is that the children have only inherited half the house (because they were only entitled to half of residue) and so relief cannot be calculated by reference to the full value of the house.
- An individual's estate is worth £5 million and so, in principle, no relief is available. However, just before the individual dies, they give £3 million of assets to the children as a lifetime gift. The remaining £2 million of assets (including the house) pass to the children under the will. The lifetime gift is of course taxable on death but, as the individual's estate on death does not exceed £2 million, the full Residence Nil Rate Band is available.

***Our suggestion***

It would of course be much simpler if the Nil Rate Band was increased to £500,000 rather than it being linked to the transfer of a residence to a descendant.

We do understand that this would have financial implications and so is likely to be unacceptable on its own.

Our suggestion therefore is that the Nil Rate Band is increased to £500,000. Of this (say) half (i.e. £250,000) is available to set against gifts during an individual's lifetime or, if not used during the individual's lifetime, is available to set against the estate on death. The other £250,000 of the Nil Rate Band would only be available to set against the estate on death and, like the Residence Nil Rate Band, is reduced if the death estate exceeds a set threshold (say, £2 million). This would mean that if the death estate exceeded £2.5 million, the £250,000 of the Nil Rate Band which is only available on death would be eliminated completely.

This would result in a reduction in the Nil Rate Band for many people who are within the scope of IHT on death (from £325,000 to £250,000). We do not have the data to calculate the fiscal effect of this but it may well be that it would be broadly revenue neutral (or the suggested thresholds could be adjusted to make it revenue neutral).

**IHT treatment of trusts**

The way in which trusts are treated for IHT purposes is a significant area of complexity where there is definite scope for simplification.

There are a number of different categories of trust for IHT purposes:

**Relevant property trusts -** most trusts which are created during an individual's lifetime will be "relevant property" trusts. These are trusts where the assets are not treated as part of the estate of any individual. Instead, there are IHT charges every ten years and also when assets are distributed out of the trust.

The main problem with this regime is that the mechanism for calculating the IHT charges is incredibly complicated and time consuming, both for the taxpayer and for HMRC. It is almost impossible for any taxpayer to get it right without professional help. Significant amounts of historic information are required which is often not easy to obtain. The amounts of tax due are often relatively small (in many cases hundreds, rather than thousands of pounds) and it is not at all uncommon for the cost of completing the required IHT returns to exceed the amount of tax due.

There is also one area of significant unfairness which is that assets in a trust where the settlor is also a beneficiary are not only subject to the relevant property regime but are also deemed to be part of the settlor's estate and therefore subject to an IHT charge on his or her death.

We set out below some proposals for simplifying the taxation of relevant property trusts.

**Interest in possession trusts** – there are three categories of interest in possession trusts:

- Trusts set up before 22 March 2006 where an individual has an interest in possession (broadly speaking the right to the income from the trust property).
- Immediate post-death interests – this is where a trust is set up on death and an individual has an interest in possession in that trust.

- Transitional serial interests – this occurs where there was a pre-2006 interest in possession trust and the spouse or civil partner of the person entitled to the interest in possession themselves becomes entitled to an interest in possession on that person's death.

The great benefit of the interest in possession regime is that it is very straightforward. The assets of the trust are simply treated as part of the estate of the beneficiary who is entitled to the interest in possession and are taxed on that person's death. This is much simpler than the relevant property regime.

However, it is not possible for an individual to establish an interest in possession trust during their lifetime. Any such trust is, as mentioned above, likely to be a relevant property trust even if it is established on the basis that there is a beneficiary who is entitled to the trust income.

At best this creates more complexity given that the relevant property regime is much more complicated than the interest in possession regime. At worst, it distorts behaviour in that it inhibits individuals from setting up trusts in circumstances where they might otherwise wish to do so for perfectly good, non-tax reasons, such as passing assets to their children without their children having unfettered access to large amounts of money. Alternatively providing for a vulnerable (but not disabled) beneficiary in a way in which the assets set aside to look after that individual are protected.

One significant difference between the relevant property regime and the interest in possession regime is that a gift to a relevant property trust incurs an immediate 20% inheritance tax charge if it exceeds the amount of the Nil Rate Band whereas a gift to an interest in possession trust would be treated as a gift to the interest in possession beneficiary (as the trust assets are treated for inheritance tax purposes as belonging to that beneficiary) and so would qualify as a potentially exempt transfer in the same way as an outright gift to that beneficiary.

There is however nothing objectionable in this. If an outright gift were made to an individual, the assets would be part of that person's estate for IHT purposes and would be subject to IHT tax on that person's death. No other IHT liabilities would arise. In exactly the same way, with an interest in possession trust the assets are treated as part of the estate of the interest in possession beneficiary and will be subject to IHT on the death of that beneficiary.

Allowing individuals to establish interest in possession trusts during their lifetime would be an enormous simplification for taxpayers across a range of financial circumstances. Many (if not most) of the trusts which are currently established as relevant property trusts would instead be established as interest in possession trusts which, from an IHT point of view, would be much simpler to administer both for taxpayers and for HMRC.

In the past there have been concerns that trusts can be used for tax avoidance. However, over the last 15 years, significant additional anti-avoidance provisions have been introduced (such as pre-owned assets tax and ensuring that trustees are taxed at the highest rates of income tax and capital gains tax) so that any scope for tax avoidance using trusts is negligible. The reasons why people want to use trusts in the UK are for non-tax purposes and it must be better to allow them to do so in the simplest way possible as long as this does not open up avenues for tax avoidance.

This is an issue which applies both to individuals of moderate wealth (who might consider setting up a trust containing assets below the value of the IHT Nil Rate Band) and also to more wealthy individuals. There is however a separate issue which applies to individuals who might otherwise consider setting up a trust in excess of the Nil Rate Band.

Due to the 20% entry charge for relevant property trusts in excess of the Nil Rate Band mentioned above, individuals have instead turned to alternative estate planning vehicles such as family investment companies. Although a family investment company can be structured so that voting control and economic benefits are split (thus allowing the donor to retain some measure of control), these sorts of vehicles however have a number of problems when compared with trusts including, potentially, loss of tax to the Exchequer:

- A company does not provide the same (non-tax) estate planning advantages of a trust. This is because, although the holders of the economic shares do not have control, they do still hold a valuable asset whereas a beneficiary of a trust generally speaking does not hold rights which have a significant value or which could potentially be turned to account.
- Interests in a family investment company are fixed at the outset. They cannot generally be changed to reflect changing family circumstances (for example, where one beneficiary has greater needs than another) without the consent of the holders of the interests. Trusts, on the other hand, are more flexible as the trustees will normally have power to reallocate benefits, albeit that this may have a tax cost.
- Income and gains of family investment companies are taxed at lower rates than the income and gains of trustees. The current rate of corporation tax is 19% (reducing to 17%) and UK companies generally do not pay tax on dividends which they receive. Trustees on the other hand pay tax on dividends at 38.1% and on other income at 45%. The mismatch as far as capital gains are concerned is smaller as trustees pay tax at 20% compared to the 19%/17% paid by a company.

Whilst it is true that further tax would in due course have to be paid in order to extract funds from a company (by way of dividend or liquidation), the benefit of tax deferral can be significant.

Despite this, in our experience, clients would much prefer to use a trust for their estate planning needs than a company for estate planning purposes given the non-tax advantages offered by a trust.

Allowing lifetime interest in possession trusts to be created therefore has a number of advantages as well as giving individuals more choice when considering their estate planning needs:

- Many more trusts will be created which are within the simpler interest in possession regime rather than the more complicated relevant property regime.
- Individuals will not be forced into using vehicles which were not really designed for estate planning purposes such as family investment companies.
- As a result of this, more income and capital gains tax will be collected as trustees will pay tax on income and gains as they arise at the highest rates.

Should the ability to create lifetime interest in possession trusts be introduced, it is likely that a significant number of relevant property trusts will be converted to the interest in possession regime due to its greater simplicity. This will bring a one-off IHT benefit for the government as the consequence of transferring from the relevant property regime to the interest in possession regime will be an IHT exit charge under the relevant property regime.

**Trusts for children** - there are two special IHT regimes which apply to trusts for children:

- Trusts for bereaved minors - these are trusts set up on the death of a parent where the child becomes entitled to the trust assets on reaching 18. Effectively, such trusts are outside both the relevant property regime and the interest in possession regime as there is no ten year charge, no IHT to pay when the beneficiary reaches 18 and no IHT if the beneficiary dies under 18.
- Age 18-25 trusts - these trusts again can only be set up on the death of a parent. They are similar to a bereaved minor's trust except that the entitlement of the beneficiary can be deferred up to age 25. The only significant difference between the two regimes is that there is an IHT charge (rather like the relevant property regime exit charge) when the beneficiary becomes entitled to the trust assets assuming this happens after the beneficiary is 18. This exit charge is the subject of different legislation, which uses different terminology, from that applying to relevant property exit charges. 12 years after this charge was introduced, Form IHT100 still does not provide for it.

In our view, these provisions could be simplified by having a single category of trust for children (which could be established during lifetime or on death) which is outside both the relevant property regime and the interest in possession regime whilst the child is under a specified age (which could be 18 or 25) but that, if the assets remain in trust after that date, the trust would then be brought within either the relevant property regime or the interest in possession regime (depending on whether the beneficiary is entitled to an interest in possession on or after reaching the relevant age).

**Simplification of the relevant property regime**

Much of the complexity of the regime arises from linking exit charges to the rate payable when there was last a 10 year charge, but this is done by postulating an imaginary chargeable transfer by an imaginary individual. This theoretical calculation seems to have been designed, as a means of aggregating the assets of the trust being charged with the assets of other trusts created by the same settlor on the same day. The changes introduced by Finance (No 2) Act 2015 have compounded the difficulties by also aggregating trusts to which "same day transfers" have been made.

Finance (No 2) Act 2015 has, at least, removed the previous requirement to bring into account assets in the same trust which were not relevant property, but a settlor's history of earlier chargeable transfers still has to be counted in on every 10 year anniversary, for the lifetime of the trust.

Nor have the rules been updated to reflect the fact that, since 1988 (30 years ago) there has been only one lifetime rate of IHT on chargeable transfers. IHTA section 66(1) still refers to three tenths of the lifetime rate. Since 1988 the result has worked out as 6% and it would be better if the rules were based on a single rate.

There is a, largely hidden, double charge in the current rules. If there is a taxable exit from a trust, it is charged, at the time, at n/40ths of the notional rate payable on the last 10 year anniversary. But that exit is, effectively, taxed again on the 10 year anniversary because the amount of the exit is deducted from the Nil Rate Band then available, so increasing the part of the trust on which a full 6% is then payable.

If the rules were reformed along the following lines, these difficulties would be eliminated. While we do not have the facilities to calculate the financial consequences for HMRC we believe that larger receipts from exit charges might allow the basic 6% rate to be reduced to 5%.

- On ten-yearly charges, apply a flat rate of 5 or 6% on the value of the trust above the basic IHT threshold (£325,000);
- To prevent settlors taking advantage by the creation of multiple trusts, divide that threshold among the trusts created by any individual settlor after the date the new rules come into effect; (we have in mind a system similar to that for the reduced CGT annual allowance for trustees, where only trusts created on or after 6 June 1978 are brought into account, so saving the need to delve back into historical records, which may no longer exist);
- On exit charges, apply a rate of n/40ths of the flat rate of 5 or 6%, according to the expired quarters since the last 10 year anniversary date (or since creation of the trust); perhaps this could be simplified still further to x/10ths according to the expired years;
- Remove all the other rules aggregating the history of lifetime transfers and other assets settled on the same day;

It would be necessary, for fairness, to keep the rules making a proportionate reduction where assets have not been relevant property throughout the last ten years, or throughout the period since the last 10 year anniversary.

**Summary**

As we have said, the IHT treatment of trusts is a very complicated area and is one which we feel can be simplified significantly. In summary, our proposals are as follows:

- Permit individuals to create lifetime interest in possession trusts where the regime is much simpler than the relevant property regime (where the IHT treatment in effect mirrors the IHT treatment of outright ownership by an individual).

- Simplify the relevant property regime so that those trusts which remain within the relevant property regime are less complex to administer and the cost of IHT compliance is not so disproportionate to the amount of tax which is usually at stake as is currently the case.

- Simplify the IHT regime for children's trusts so that there is a single category of trusts for children which can be created either during the settlor's lifetime or on death. These trusts would be given privileged IHT treatment whilst the beneficiary is under a specified age but thereafter would have to fall within one of the other two IHT regimes for trusts.

- Remove trusts which are treated as forming part of the settlor's estate for IHT purposes as a result of the reservation of benefit rules from the scope of the relevant property regime. This simplifies the tax treatment of such trusts (as the complex relevant property regime would no longer apply).

Wider IHT system

20. **Do you think that the IHT system should be reformed more widely to simplify it? If so, how? Should some IHT exemptions be removed to fund a lower or graduated rate or a higher NRB? If so, which ones? Are there any useful lessons that could be learned from other countries? If so what, and from which countries?**

No response.

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