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NATIONAL AUDIT OFFICE

INLAND REVENUE

Inheritance Tax

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 17 Session 2004-2005 | 3 December 2004

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This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

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Comptroller and Auditor General
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8 November 2004

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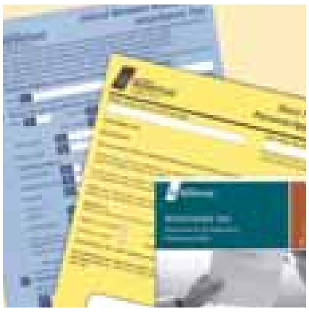


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EXECUTIVE SUMMARY

1 When someone dies, their estate may be liable to Inheritance Tax. Bequests to spouses and charities are exempt, as are some heritage assets while certain preservation and public access conditions are met. Reliefs are also available for many agricultural and business assets. The tax is charged at 40 per cent of the value of other assets, above a nil-rate band (£255,000 in 2003-04). 30,000 estates, one in twenty, were liable for the tax in 2003-04.[1] The number of estates paying the tax has grown in recent years, reflecting the rising value of assets and estates, while Inheritance Tax revenues have remained at around 0.2 per cent of Gross Domestic Product. The Inland Revenue collected £2,504 million in Inheritance Tax in 2003-04.[2]

2 This report examines progress made on recommendations from the Committee of Public Accounts when it last examined Inheritance Tax in 1999, and developments since then. The report shows that the Revenue has made good progress in taking forward the recommendations, as summarised in Appendix 2. Specifically the report covers:

- how the Revenue ensures compliance with Inheritance Tax, including how it tackles artificial avoidance and assesses the compliance 'tax gap', as well as following up the Committee's recommendations on directing investigative resources towards areas of highest risk and using penalties to deter non-compliance;
- the quality of service provided to representatives of estates, including the ease and cost of complying with Inheritance Tax requirements, as well as progress on the Committee's recommendations on speeding up case processing times and clearing case backlogs; and
- progress on the Committee's recommendations on managing the heritage exemption.

Ensuring compliance

3 **The Revenue accepts most tax returns after initial scrutiny, conducting detailed compliance enquiries on five per cent of cases. These enquiries increased the taxable value of assets by £513 million in 2003-04, resulting in an additional tax yield of £126 million. This yield has grown by a third since 1998-99, although remaining at around five per cent of the growing Tax revenue.** The adjustments arose mainly from valuations of land and buildings and shares. The Revenue's Valuation Office Agency checks all land and building valuations where tax is potentially at stake. Staff from the Agency have recently been co-located with Inheritance Tax caseworkers to risk-assess cases which need not be referred to the Agency, to reduce the time needed to deal with them. The Shares Valuation section checks valuations of business and other assets, including unquoted shares. After a decline in the number of referrals, when some cases with unquoted shares were not referred, the Revenue improved procedures to help identify such cases and referrals increased by a third in 2003-04.

4 **The efficiency with which the Revenue deals with its Inheritance Tax workload has improved in recent years.** Compared with 1998-99, it dealt with 66 per cent more taxpaying cases in 2003-04 and has taken on additional tasks, with a similar number of staff.

5 **The Revenue's Capital Taxes department, which manages the tax, has developed stronger links with other parts of the Revenue to help tackle non-compliance.** Supplementing long-standing links with the Valuation Office Agency and Shares Valuation section, the Capital Taxes department has also established links to the Complex Personal Returns teams and Special Compliance Office, and interrogates computerised Self-Assessment Income Tax records.

1 Inheritance Tax is also charged on certain gifts, and on assets held in discretionary trusts.
2 In addition, heritage assets were received in lieu of £17 million of Inheritance Tax liabilities.

6 The Revenue has tested compliance risks in specific areas, but could undertake further statistical analysis to help target individual cases for enquiry. It has examined the risks from undeclared lifetime gifts, which should be added to an estate if made within seven years of death, and from the 'excepted estates' procedures, which allow lower-value estates not to submit returns to the Revenue. The Revenue risk-assesses individual cases, but undertakes little structured statistical analysis of data that it already collects on the composition of estates to target cases for enquiry.

7 Penalties for fraud and negligence and late filing of returns were strengthened in the 1999 and 2004 Finance Acts. The number of penalties for negligence in submitting incorrect returns has fallen in recent years, and the Revenue recently secured its first prosecution for Inheritance Tax fraud. The Revenue attributes the level of sanctions to: the deterrent effect of publicising the penalties that could be applied; its approach of encouraging voluntary disclosure of errors; and inherent difficulties in establishing culpability because representatives are dealing with the financial affairs of a deceased person. In 2003-04 the Revenue considered penalty action in nearly 700 cases – five per cent of those where the value of estates was adjusted. It imposed penalties for negligence, averaging £3,700, in only 100 cases because of its difficulty in demonstrating negligence. Professional representatives[3] perceive a tougher attitude on the part of the Revenue. However the penalties imposed typically amount to only 7 per cent of the maximum penalty available, in recognition of representatives' co-operation and the relative gravity of the negligence involved. In cases where the Revenue discovered the negligence it abated the maximum available penalty by 88 per cent on average, compared with 95 per cent on average in those cases where the errors were voluntarily disclosed by a representative.

8 In line with its normal practice with other taxes, the Revenue has not set out guidance in advance about the acceptability of specific Inheritance Tax avoidance schemes, but it is changing its approach to tackling some types of Inheritance Tax avoidance. It has tackled schemes once accounts have been presented after death, taking some cases through the courts. It has begun taking a tougher approach, and from April 2004 the Government introduced measures to tackle at an earlier stage avoidance schemes that seek to sidestep the rules on 'gifts with reservation'. People who have made such gifts will have the option of declaring that the assets that they have given away are still part of their taxable estate, or paying an income tax charge on their continued benefit from those assets.

9 The Revenue has no overall measure of the 'tax gap' on Inheritance Tax. The tax gap is the gap between the theoretical tax payable and the amount collected, and provides a measure of the level of tax non-compliance. A calculation of the tax gap for Inheritance Tax is complicated given the range of reliefs and exemptions available and the variety of acceptable ways estates can be structured to reduce their tax liability. Nevertheless the United States Internal Revenue Service has been able to assess the tax gap on its Estate Tax, concluding that under-declaration or under-valuation of assets resulted in a gap of 13 per cent of tax receipts.

Improving the quality of service

10 The Revenue has made Inheritance Tax procedures more straightforward by, for example, rationalising the main tax return form and introducing a short form for those with lower value estates. It has also made the forms more user-friendly, and provisions in the 2004 Finance Act mean that around 30,000 fewer representatives each year will have to complete the main form. The Revenue has worked with professional representatives on the re-design of Inheritance Tax forms, but has not consulted non-professional representatives who are often a relative of the deceased. Our own review of the forms and guidance notes found that while the short form was straightforward to complete, the main form was difficult for a non-professional representative. While some of that complexity stems from the tax system itself, rather than the design of the forms, there is scope for improvements in design.

11 The complexity of the Inheritance Tax processes for representatives has depended on the size of the estate and whether they have to deal with the Revenue as well as the Probate Service. Recent changes will simplify procedures, with more estates having to deal only with the Probate Service. In 2003-04 the representatives of 67,500 estates above an 'exception' threshold of £240,000 had to fill in the main Inheritance Tax form. The representatives of the remaining 300,000 or so estates that needed probate filled in a short form for the Probate Registries. The 2004 Finance Act introduced procedural changes, however, whereby most estates below the nil-rate tax band will only have to submit a short form to the Probate Registries, reducing the number of representatives filling in the main form by around 30,000 a year.

3 In this report we differentiate non-professional 'personal representatives' from 'professional representatives' (such as solicitors, accountants and banks).

12 **Help for representatives is available from a number of sources, including a joint probate/Inheritance Tax telephone helpline and the websites of the Revenue and other government departments.** The helpline, launched in April 2003 is a well-used and much appreciated service provided by the Revenue. It is not easy however to find Inheritance Tax forms and information on the Revenue website, and the quality and accessibility of information on other Government websites is mixed.

13 **The Revenue has made it easier to pay Inheritance Tax as representatives can now use funds held in the estate to pay the tax due, which is required before probate can be granted. The tax due on some assets can be also paid by instalment.** The Direct Payments scheme negotiated with the banks and building societies allows some representatives to pay Inheritance Tax from funds held in the deceased's accounts before securing probate, eliminating the need to take out a loan to pay the tax due. The ten year instalment option is available for tax on land and property, to help reduce the need to sell such assets to pay the tax.

14 **The Revenue is processing Inheritance Tax cases more quickly, and it has continued to make progress in reducing backlogs of long-outstanding cases.** The number of cases over three years old has reduced from 1,498 in 1999 to 882, and 90 per cent of Inheritance Tax cases are settled within 12 months.

15 **The costs for representatives of complying with Inheritance Tax requirements are difficult to measure because they are hard to separate from the costs involved in obtaining probate and administering an estate.** Estimates suggest that the cost of using solicitors to deal with a deceased's estate should not typically be more than 2 to 3.5 per cent of the estate's value. The Revenue has not assessed the cost for representatives in complying with the requirements of the Tax. Professionals are engaged in around 70 per cent of cases.

16 **The Revenue is developing how it assesses quality of service, through surveys of representatives and monitoring performance indicators.** Its last major surveys of personal and professional representatives were in 2001 and 2002 respectively, and both indicated a high degree of satisfaction with the Revenue's service. To get prompter feedback and to be able to respond more quickly to any problem areas, the Revenue plans to launch a new rolling telephone survey by December 2004.

The heritage exemption

17 **The 1998 Finance Act raised the criteria by which chattels are given an Inheritance Tax exemption, so that now only items of pre-eminent heritage importance are eligible for exemption in their own right. It also requires some degree of open access for the public.** Before that, items could be of a lower 'museum' standard, and agreements with owners often only required access by prior appointment. As a result, the Revenue is making fewer new exemptions, although this, to date, has not led to a fall in the number of exempt items on display to the public. Land and buildings already had to be of outstanding historic, architectural, scenic or scientific importance to be given an exemption.

18 **The Revenue has also used the 1998 Act to propose open access for a small number of *existing* by-appointment-only agreements, and has improved its arrangements for publicising exempt heritage assets.** It has so far renegotiated agreements with 16 owners of nearly 1,900 chattels – a third of 44 owners who between them hold the majority of all exempt items. The cases of two other owners who declined to provide open access were considered by the Special Commissioners, who confirmed that the Revenue could review existing undertakings but did not uphold the specific variations proposed in these two cases. The decision will help the Revenue to determine the extent to which other existing arrangements can be altered. The Revenue's register of heritage assets now contains more up to date information and covers most exempt chattels and buildings, and its website receives nearly half a million 'hits' a year. Visitor numbers to heritage land and buildings have remained constant, at around four million a year.

19 **The Revenue and heritage agencies work more closely in checking that exemption conditions are being met, and there are fewer slippages in the programme of inspections.** Previously, only two-thirds of planned inspections of exempt land and buildings had been carried out, whereas 95 per cent of planned inspections were carried out in 2003-04 with four carried forward to the current year.

RECOMMENDATIONS

To improve compliance, the Inland Revenue should:

- Make better use of existing statistical data in risk assessing estates, for example by highlighting estates with atypical mixes of assets, such as those estates with a particularly high or low proportion of shares, for more detailed scrutiny.
- Ensure abatements of negligence penalties not only provide incentives for representatives to disclose any errors or omissions, but also work to discourage representatives submitting inaccurate or incomplete returns in the first place.
- Use the results of enquiry cases to estimate the tax gap from under-reporting assets, drawing on the Internal Revenue Service's experience in the United States on measuring the tax gap for its similar Estate Tax.
- Following recent improvements in risk assessment procedures for share valuations and the increase in referrals to the Shares Valuation section for detailed scrutiny, monitor the proportion of cases that are referred to ensure all unquoted shares valuations are checked.

To provide a better quality of service, the Inland Revenue should:

- Make the main tax return easier to complete by, for example, using simpler language and a clearer layout, and in future reviews of the form consult personal representatives as well as professionals. In considering the possibility of introducing electronic Inheritance Tax returns, the Revenue should ensure that the costs and benefits for different sorts of representatives and their likely take-up rates are carefully weighed, to tailor the service to match their differing needs.
- Introduce its new surveys as planned in December 2004, to draw together up-to-date and comprehensive feedback on its quality of service.
- Make it easier to access advice on Inheritance Tax, for example by putting all the Inheritance Tax forms and guidance in one place on its website, and working with those responsible for other Government websites to help them ensure that their information is kept up-to-date.

- Consider highlighting for representatives the various databases and websites that are available that might help with making property valuations.
- Explore the scope for a direct payments scheme to unlock funds in quoted shares before probate is granted, similar to that recently introduced for bank and building society accounts.
- Extend existing performance indicators on the speed of processing cases to differentiate between estates of different sizes.
- Monitor the proportion of representatives who submit returns without professional help, as a broad indicator of changes in the ease with which personal representatives fulfil their obligations.
- Set targets for further reductions in the number of cases over three and ten years old, to continue the progress made in reducing the numbers of long outstanding cases.

To improve its management of the heritage exemption, the Inland Revenue should:

- Monitor visitor numbers for chattels where it has negotiated open access in existing cases, and use the results to assess the merits of renegotiating other existing agreements where access is by appointment only.
- Consolidate recent improvements in its compliance monitoring of heritage exemptions by promptly following up outstanding questionnaires and inspection visits.

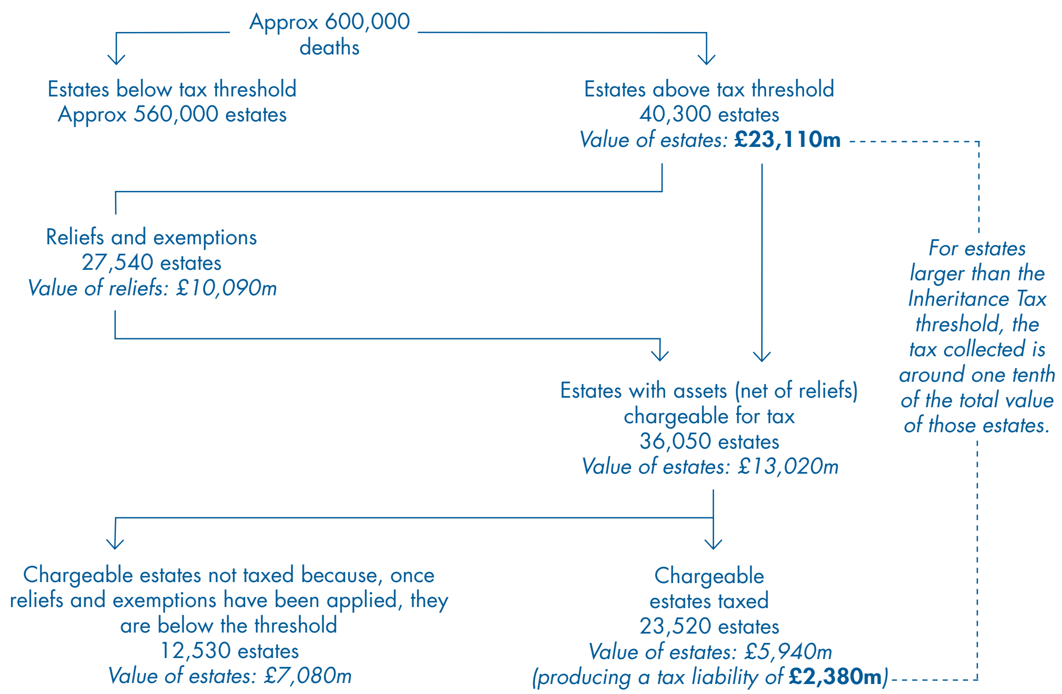
PART ONE
The incidence of Inheritance Tax

Background

1.1 When someone dies the net assets in their estate may be liable to Inheritance Tax. The tax is charged at 40 per cent of the value of any estate exceeding a nil-rate band (£255,000 in 2003-04). Bequests to spouses and charities are exempt, and reliefs are available for many agricultural and business assets. In addition, some assets of sufficient heritage importance may be granted an exemption on condition that public access and preservation requirements are satisfied. The result of these thresholds, reliefs and exemptions is that only 30,000 estates were liable to Inheritance Tax in 2003-04, around one-in-twenty of the 600,000 or so people who died **(Figure 1)**.[4] The number of estates affected by the tax has grown in recent years **(Figure 2)** as values of assets and estates have risen, although Inheritance Tax revenue has remained at around 0.2 per cent of Gross Domestic Product. Tax receipts in 2003-04 were £2,504 million, representing 1.5 per cent of tax collected by the Inland Revenue.[5] For 2004-05, the Revenue forecasts 32,000 estates will be liable for Inheritance Tax, and that receipts will be £2.8 billion.

1 The number and value of estates paying Inheritance Tax, 2001-02

Once the nil-rate band and various reliefs and exemptions are taken into account, fewer than 1 in 20 estates pay Inheritance Tax, and the tax absorbs around one tenth of the value of those estates which exceed the tax threshold.



NOTE: Tax returns are due within 12 months of death, and time is then needed to settle accounts, so that in around 10 per cent of cases tax might not be paid until two years after death. There is a two year lag in producing some Inheritance Tax statistics. Details of assets, reliefs and tax liability for the 23,500 taxpaying estates of those who died in 2001-02, shown here, were published in July 2004. By 2003-04, around 30,000 deceased estates had an Inheritance Tax liability.

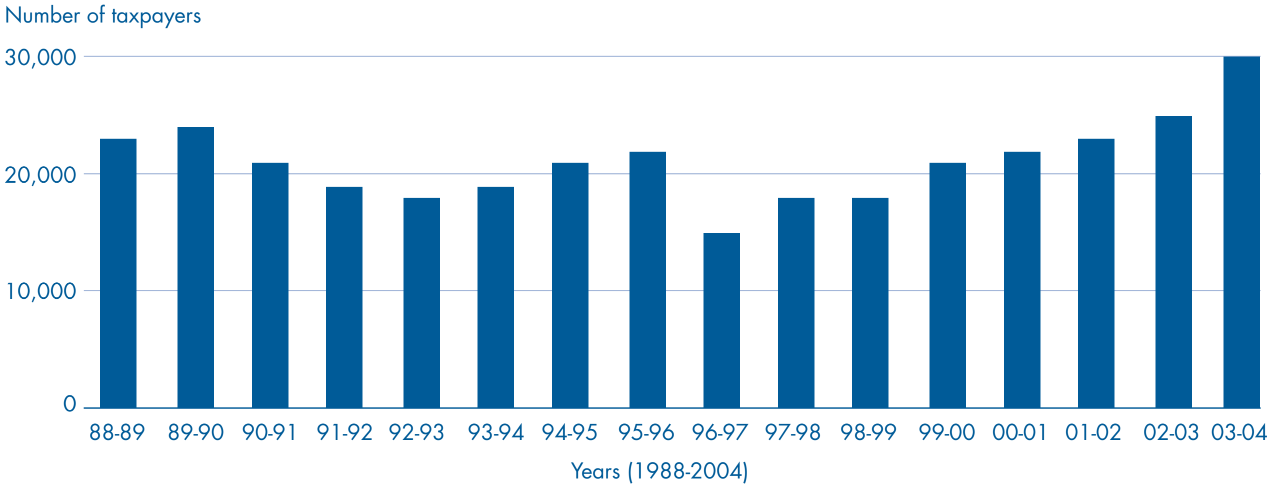
Source: National Audit Office analysis of Inland Revenue data

4 Inheritance Tax is also charged on certain gifts and on assets put into and held in discretionary trusts, with 2,000 such cases in 2003-04.

5 In addition, heritage assets were received in lieu of £17 million of Inheritance Tax liabilities. Because of the lag between death and the submission and finalisation of Inheritance Tax accounts, about 45 per cent of a year's receipts typically relate to deaths in the year before, and 10 per cent for deaths in the year before that.

2 Numbers of estates with an Inheritance Tax liability, since the introduction of a single 40 per cent tax rate in 1988-89

The number of estates paying Inheritance Tax has increased in recent years.



Source: Inland Revenue

NOTE: This Figure shows the number of deaths which left estates with a tax liability, and excludes tax liable on lifetime gifts and discretionary trusts.

1.2 After someone dies, the representatives of their estate must submit an Inheritance Tax return to either the Revenue or to the Probate Registries, to secure a 'grant of representation' (or 'confirmation' in Scotland) to administer the estate and distribute assets in accordance with any Will. Before changes introduced in the 2004 Finance Act, if the estate was below an 'exception' threshold (£240,000 in 2003-04) the Probate Registries could grant probate without the Revenue's prior approval, and only a short form (if a personal representative) or a sworn oath (if a solicitor) was required. For estates above the exception threshold, representatives had to submit the main tax form to the Revenue. The Probate Registries could still grant probate for these estates if they were below the tax threshold, but for those above the tax threshold this could only be granted after any tax due was paid or if the representative confirmed no tax was payable **(Figure 3)**. The 2004 Finance Act introduced changes to the excepted estates procedures, however, so that most estates with no tax liability (because they are below the tax threshold or because of spouse or charity relief) do not have to submit a return to the Revenue. Instead representatives of these estates submit a short form to the Probate Registries.

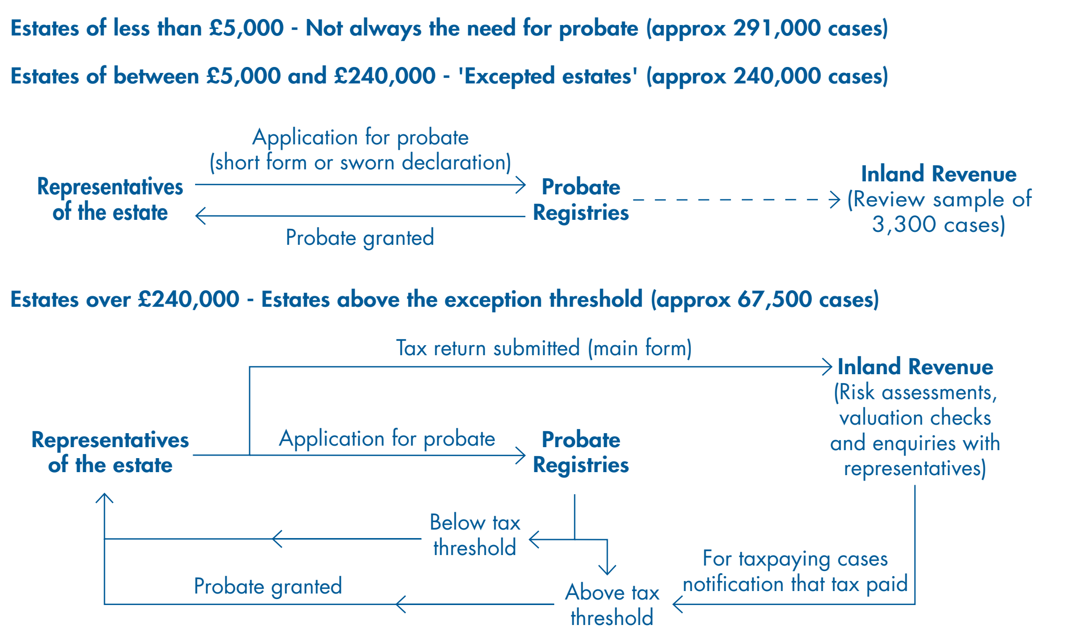
The scope of our study

1.3 This report examines progress on recommendations from the Committee of Public Accounts when it last examined Inheritance Tax in 1999[6] (summarised in Appendix 2), and also covers developments since then. Specifically:

- The remainder of Part 1 outlines the operation of exemptions and reliefs.
- Part 2 examines how the Inland Revenue ensures compliance with Inheritance Tax. This follows up the Committee's recommendations on directing compliance efforts towards areas of risk, and using penalties for fraud or negligence. It also examines the scope for assessing the 'tax gap' in compliance and the way the Revenue tackles avoidance schemes.
- Part 3 examines the quality of service provided to those affected by the Inheritance Tax requirements. It follows up the Committee's recommendations on speeding up case processing times. It also examines the ease of using the Inheritance Tax system and the cost and burden of complying with its requirements.

6 *Inheritance Tax: A Progress Report*, 38th Report from the Committee of Public Accounts, Session 1998-99, HC 474.

3 The probate/Inheritance Tax system, 2003-04



Source: National Audit Office

NOTE: This figure shows the processes and number of cases for 2003-04. After the 2004 Finance Act, the number of 'excepted' cases will be higher because it will comprise those estates below the tax threshold itself or which have no tax to pay because of bequests left to a spouse or charities.

■ Part 4 follows up the Committee's recommendations on the operation of the Heritage exemption, to increase public access to and awareness of heritage-exempt properties, and to tighten compliance checks on tax-exempt heritage assets.

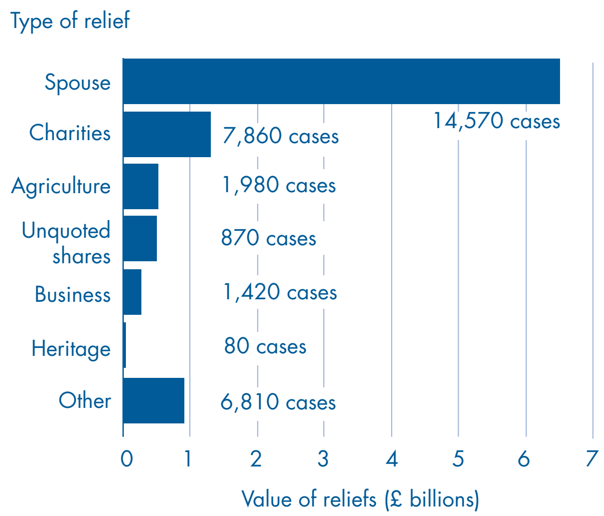
1.4 Our study methodology (Appendix 1) involved data analysis and examining procedures in the Revenue for dealing with Inheritance Tax. We also compared the approach to that applied in eight other countries and consulted various organisations who are involved in Inheritance Tax work. An Advisory Group provided expert advice.

Exemptions and Reliefs

1.5 For those estates initially above the tax threshold in 2001-02, reliefs, exemptions and use of the nil rate band reduced the chargeable value by 74 per cent from £23,110 million to £5,940 million (Figure 1). Two-thirds of estates which exceed the tax threshold claim reliefs and exemptions to reduce their Inheritance Tax liability, including 10 per cent which are able to eliminate it altogether. The use of reliefs and exemptions **(Figure 4)** varies from case to case. While spouse relief – the most significant – is used by estates of all sizes, the types of assets needed to qualify for other reliefs means that these are used more extensively by wealthier estates, so that these have a greater proportion of their value offset by reliefs **(Figure 5)**.

4 Inheritance Tax reliefs on estates exceeding the tax threshold, 2001-02

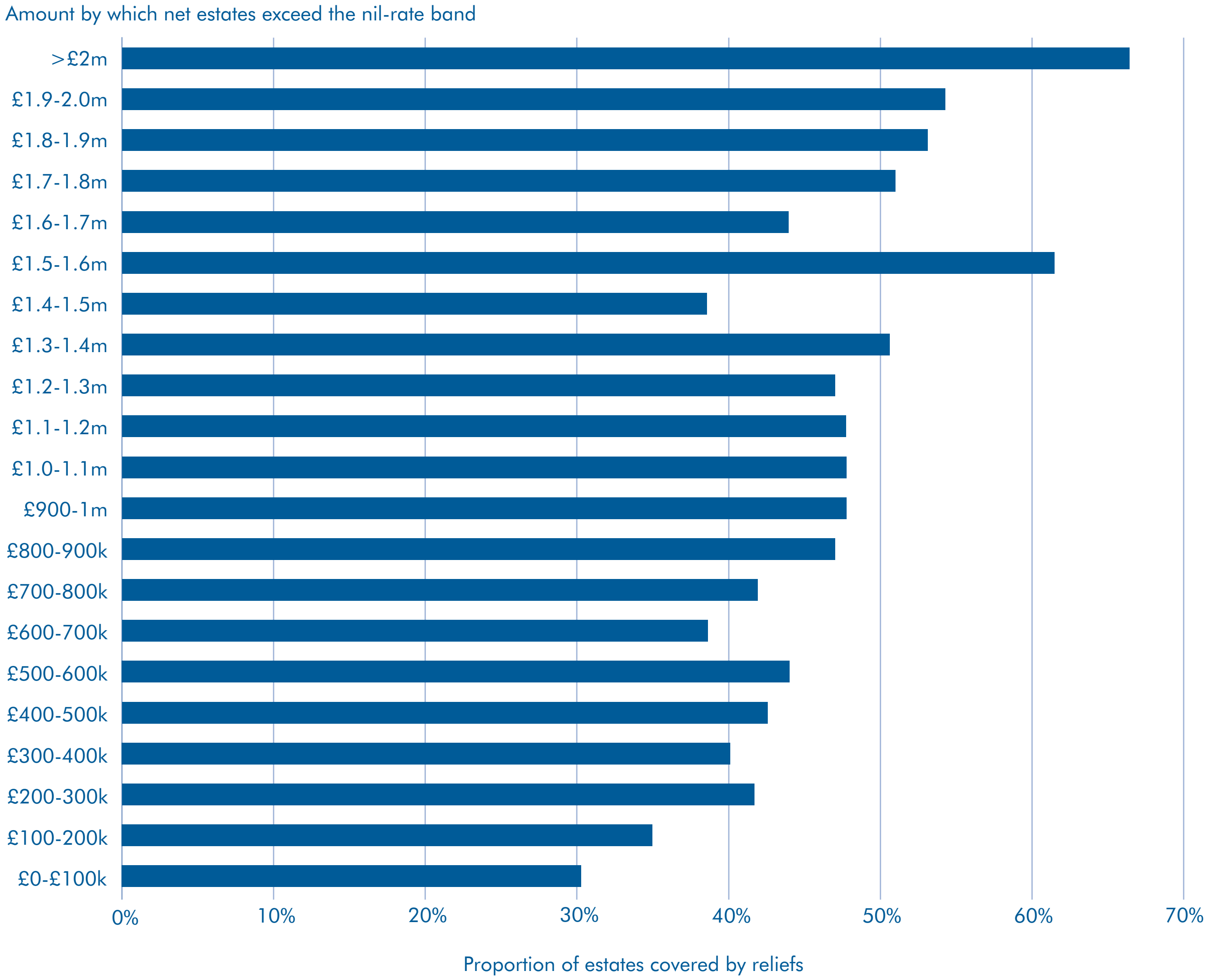
The most common relief used is spouse relief, reducing the value of estates otherwise liable to tax by over £6 billion.



Source: National Audit Office analysis of Inland Revenue data

5 The proportion of the value of estates covered by reliefs, by size of estate, for the 40,300 estates exceeding the tax threshold in 2001-02

Wealthier estates are generally able to take greater advantage of reliefs and exemptions. While the 17,200 estates which were up to £100,000 above the tax threshold had on average 30% of their value offset by reliefs, the 800 estates of £2 million or more above the threshold had reliefs worth 66%.



Source: National Audit Office analysis of Inland Revenue data

NOTE: This is an analysis of the 40,300 estates above the tax threshold in 2001-02, noted in Figure 1, extrapolated from the Revenue's statistics collected for some 16,000 estates.

1.6 The National Audit Office surveyed the Inheritance Tax regimes in eight other countries (Appendix 3), many of which have similar reliefs and exemptions to those in the UK. The UK's are long-standing and have evolved over many years (Appendix 4). In 1998 the Government tightened up the *Heritage* exemption, which is examined in Part 4, confining its use to assets of a higher ('pre-eminent') standard and where the public will have some open access. *Business* reliefs have evolved over the last 30 years. They complement the aims of a range of initiatives sponsored by the Department of Trade and Industry to encourage investment in small and new venture companies. Thus the Government provides reliefs on Capital Gains Tax and Income Tax for such businesses, as well as Inheritance Tax relief for estates with investments in these and other unquoted companies.

1.7 Successive governments have also changed *Agricultural* reliefs over many years (Appendix 4), but the link between the reliefs and agricultural policies has been less straightforward. To support reforms aimed at maintaining a flexible market in agricultural tenancies, the Government extended Inheritance Tax reliefs to tenanted farms to encourage landlords to make new tenancies available. However, this relief has also had an impact on another policy, of removing barriers to diversification out of agriculture. Before the Agricultural Tenancies Act 1995 introduced Farm Business Tenancies, landlords could be tied to a three-generation tenancy agreement and tenants were reluctant to vary the type of use permitted in the tenancy contract for fear of losing that security. Some diversification is still being curtailed, however, because the availability of Inheritance Tax relief gives landlords a disincentive to allow their tenants to diversify out of the types of agriculture that qualify for it.[7]

1.8 Since 1975 assets left to a surviving *spouse* have been exempt from Inheritance Tax, so that they are not faced with selling their home to raise the tax (Appendix 4). Previously the exemption applied on the death of the surviving spouse, whose estate could offset the tax already paid by their spouse's estate. Unlike Belgium, the Netherlands and Sweden, the UK does not explicitly give relief to unmarried cohabitants. However, the valuation of a home can sometimes reflect the stake of others living there, as **Case Example 1** illustrates. The recently passed Civil Partnership Act establishes a new legal relationship for same-sex couples. The Act does not address the spouse exemption or other Inheritance Tax implications for such couples, which will be dealt with in a future Finance Bill.

1.9 Inheritance law in Scotland can limit the extent to which spouse relief might be used because children have a legal entitlement to inherit some of their parents' estate. Some religious codes can also affect the way spouse relief might be used. For Muslims and Jews following traditional codes of Sharia and the Halakha, for example, these guide how an estate might be left to various relatives, limiting the extent to which married couples can take advantage of the spouse exemption. Sharia requires that male inheritors receive twice the share that is left to a female of an equivalent relationship, and a husband or a wife cannot leave all of their estate to the other. For example, a wife with children would leave her husband a quarter share of her estate, while if her husband died first she would receive an eighth share of his estate. The Halakha requires estates to be passed through the male line, although (as with Sharia) giving assets to a spouse or any other recipient before death is not circumscribed. The Halakha also encompasses a general principle that Jews may follow local laws and practices wherever possible. The interaction of the Inheritance Tax regime and religious codes has not been presented as a significant issue in professional representatives' discussions with the Revenue and has not been a focus for complaints.

CASE EXAMPLE 1

Adjustment to the valuation of a home to reflect the stake of another occupant

The open market value of the main residence in the estate was £275,000. Because the deceased's Will stated a wish for her infirm son to remain in the property, the representatives of the estate successfully argued that the house should be valued subject to the right of the son to live there. That value, which depended on the life expectancy of the son, was agreed at £100,000, reducing the estate's tax liability by £70,000.

Arrangements which reduce Inheritance Tax liability

1.10 Inheritance Tax liability is influenced by the way in which people arrange their financial affairs, which may include measures to utilise the Tax's reliefs and exemptions. **Figure 6 overleaf** describes some of the approaches that are commonly used.

7 Tenancy Reform Industry Group, Final Report (May 2003), Department for Environment Food and Rural Affairs, section 5.2.

6 Some methods used to reduce Inheritance Tax liabilities

Consuming or spending wealth before dying

Every £1 spent before death reduces the inheritance left by only 60 pence, net of tax.

Optimising use of the Spouse Exemption

If a couple wish to leave their wealth to their children or to others, the tax due on their respective estates can be reduced by the first spouse leaving only part of his estate to the surviving spouse, allowing both to make full use of their nil-rate bands on each of their deaths.

Example: Mr and Mrs Green each had estates of £350,000. If Mr Green left his estate of £350,000 to his wife his estate would have no Inheritance Tax to pay because of the spouse exemption. When his wife subsequently dies and leaves her £700,000 estate to her son, 40 per cent tax would be due on the £437,000 above the current threshold – £174,800 tax. If Mr Green had instead left assets up to the threshold to his son, and the remaining £87,000 to his wife, his estate would still not have paid Inheritance Tax but when his wife died her estate would have paid only £69,600 (on her £174,000 estate above the tax threshold), a saving of £105,200.

Investing in agricultural or other business assets

Certain types of business and agricultural holdings have reliefs from Inheritance Tax. Assets of certain types of businesses operating as sole traders or partnerships, or holdings of unquoted shares, attract 100 per cent relief, with 50 per cent relief available for a controlling holding in a quoted company. Agricultural relief is available for the value of the land and buildings for agricultural purposes (equipment and stock may qualify for business property relief). 100 per cent relief is available for a farm used as such for at least two years by the deceased, or seven years by a tenant farmer.

Example: Mr Smith has £200,000 of liquid assets and wishes to invest this in his daughter's business. If he gave her the money he would need to survive a further seven years to escape Inheritance Tax on the gift. If he invested it directly into the business, by becoming a partner or by purchasing share capital, he would only need to survive two years for the investment to qualify for business relief.

Making gifts within tax-free allowances

£3,000 in gifts can be made each year free of Inheritance Tax, and any unused allowance carried forward for the subsequent year to a maximum of £6,000. Small gifts of up to £250 to an individual can be made in any year to an unlimited number of people. A parent can also give up to £5,000 in wedding gifts to a son or daughter, and a grandparent can give up to £2,500.

Making gifts as a regular outlay

Regular gifts made out of income (rather than running down capital) are exempt from Inheritance Tax, provided that the representatives can show that the deceased had enough income left to meet day-to-day living expenses. If the gift is made out of capital or savings rather than income, it is a Potentially Exempt Transfer, and would be taxed at death if the donor did not survive for a further seven years.

Making an 'Instrument of Variation' after death

The destination of any assets dictated in a Will can be changed within two years of a person's death. This can reduce Inheritance Tax otherwise due, but only if the Variation is agreed by all beneficiaries.

Example: The Will of a farmer was adjusted by a Deed of Variation, so that rather than all of his assets being passed to his sons with a potential tax bill of £50,000, some were left to his wife, eliminating the tax liability. This took time to arrange, and the tax return (with its accompanying Deed of Variation), was delivered over 9 months after the farmer's death.

Example: A daughter died eighteen months after her parent. Her estate comprised net assets worth £418,000, on which Inheritance Tax of £73,600 would have been due, and included a house worth £230,000 which was inherited from her parent. To avoid the Inheritance Tax due on the second death, the beneficiaries of the parent's estate (who included the daughter's representatives) made a Deed of Variation to the parent's Will, to leave the house instead to another relative. This reduced the daughter's estate to £188,000, leaving no Inheritance Tax liability.

6 Some methods used to reduce Inheritance Tax liabilities *continued*

Equity Release schemes

Equity tied up in a house can be released and the proceeds given away or spent, by taking out a mortgage or by selling a share of the property to an equity release purchaser (who would have a reversionary share in the property when the homeowner dies). Provided the homeowner lives for another seven years, any proceeds given away would no longer form part of their estate.

Example: Mr Jones has a home worth £300,000. With a £263,000 tax threshold, £37,000 of his house would be liable to tax when he died. He sells a one-third share of the property to a reversionary mortgage company, for £80,000 which he spends. On his death, his two-thirds share of the home is worth £200,000, leaving no Inheritance Tax liability.

Trusts

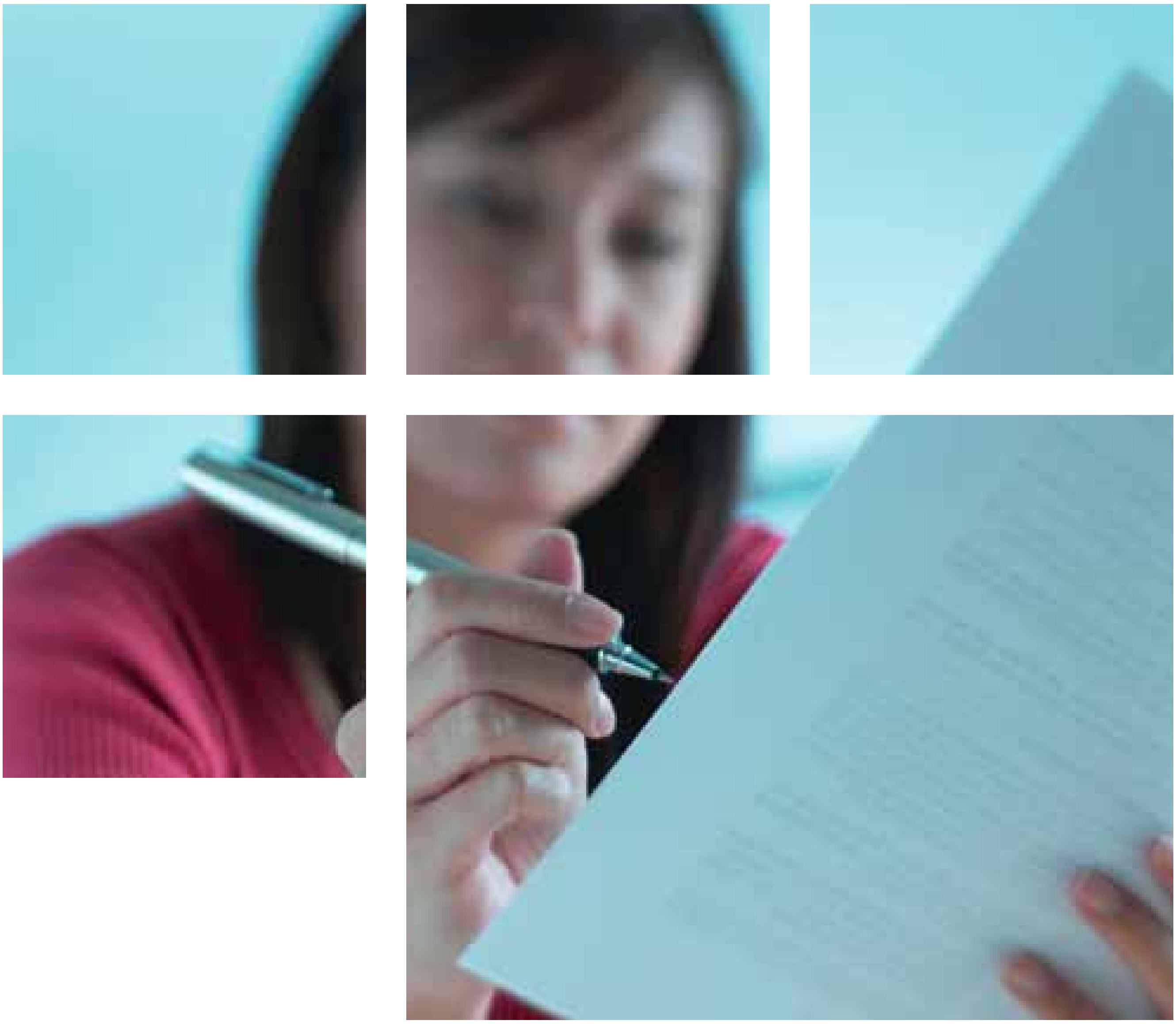
Trusts are used for a number of reasons, including allowing a person's assets or the income these produce to be made available to beneficiaries after they have died. Discretionary trusts (where the trustees have discretion about who will benefit from it) have been an attractive means of reducing Inheritance Tax because the rate of tax on such trusts has been lower over the short term than on assets transferred on death. Also a person setting up a discretionary trust can have some influence on the type of people who will be its beneficiaries and can therefore perhaps include people to whom they would otherwise leave their estate.

A beneficiary of a discretionary trust, other than the person putting assets into the trust, would not be liable to Inheritance Tax on that benefit when they died. Instead, assets put into such a trust are taxed every 10 years, to maintain a broad long-term balance between the taxes paid on assets passed from one generation to the next on death with assets held in such a trust.[8]

Source: National Audit Office

8 Introduced with Capital Transfer Tax in 1975, to counter avoidance of the previous Estate Duty (Appendix 4).

PART TWO
Ensuring Compliance



2.1 This Part examines the way the Revenue investigates Inheritance Tax returns and ensures compliance.

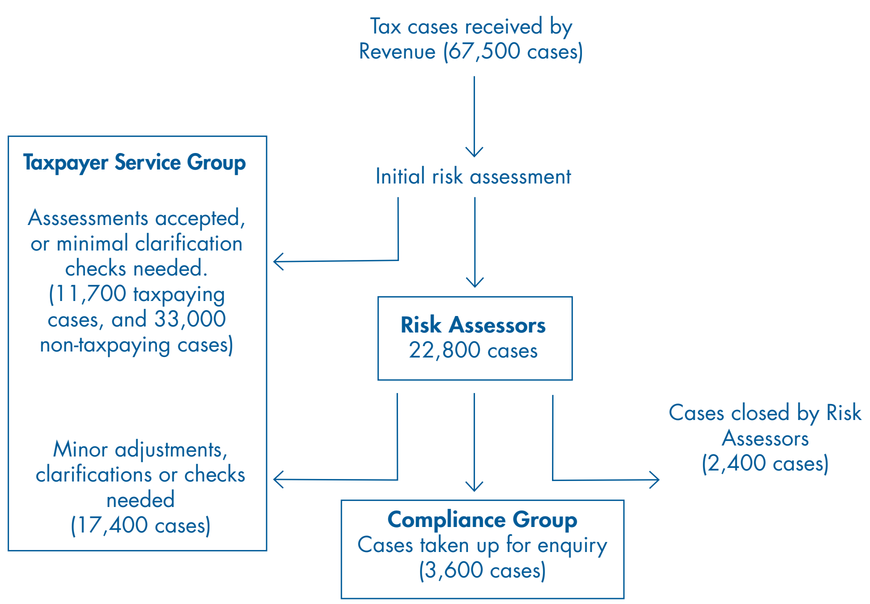
Compliance investigations on Inheritance Tax returns

2.2 Following risk assessment and the resolution of minor queries, most tax returns are accepted by the Revenue's Capital Taxes department and require no further action. It launched enquiries on some 3,600 cases in 2003-04 – around five per cent of the 67,500 tax forms it received **(Figure 7)** – to pursue uncertainties with the representatives or to check aspects of the return in more detail with various specialist departments within the Revenue. These include the Valuation Office Agency and Shares Valuation section, as well as other parts of the Revenue with whom the Capital Taxes department has developed better and more focussed links since our previous report **(Figure 8 overleaf)**.

2.3 The additional yield secured from the Revenue's compliance investigations has increased by 32 per cent between 1998-99 and 2003-04, although remaining at around five per cent of the growing Tax revenue. In terms of Inheritance Tax revenue received, the average cost of managing and collecting the Tax has fallen by 20 per cent between 1998-99 and 2003-04. The cost in 2003-04 was £31.4 million which, with total receipts of £2,504 million, equated to 1.25 pence per £1 of the Tax collected. This was less than for other personal taxes – 1.41 pence for Income Tax, and 2.14 pence for Capital Gains Tax. The efficiency with which the Revenue has managed Inheritance Tax has increased in recent years. Despite taking on new work – providing new services such as a joint Probate/Inheritance Tax telephone helpline and assisting investigations of undeclared offshore trusts – and a 66 per cent growth in the number of taxpaying cases since 1998-99, the number of staff in the Capital Taxes department managing Inheritance Tax has remained at 410.

2.4 From its compliance work, the Revenue increased the net taxable value of estates by £513 million in 2003-04 **(Figure 9 overleaf)**, resulting in additional tax of £126 million; five per cent of Inheritance Tax receipts. The most significant adjustments were to land and buildings (£201 million) and shares and business assets (£82 million), and these are mainly established by the Revenue's Valuation Office Agency and Shares Valuation section.

7 The assessment of Inheritance Tax returns within the Revenue, 2003-04



Source: National Audit Office analysis of Inland Revenue data

NOTES: Following the 2004 Finance Act, the Revenue will in future receive around 40,000 returns a year. The process shown was redesigned in April 2004, bringing forward the second-stage of risk assessment and integrating it with the first sifting stage, using Taxpayer Service Group and Compliance Group staff operating as co-located teams. The aim is to identify at an earlier stage those cases where the presentation of returns disguises non-compliance and to give earlier feedback to representatives.

The figures opposite do not balance precisely because some enquiry cases are generated from outside the returns system, and some may be picked up in the year after returns were received.

8 Links between the Capital Taxes department and other parts of the Revenue, to investigate Inheritance Tax compliance

Long-established links used by the Capital Taxes department to check Inheritance Tax compliance:

Valuation Office Agency

To check land and buildings valuations, and to assess the qualification and valuation of agricultural property for tax relief.

Shares Valuation section

To check valuations of shares, and other business assets.

Links which have been further developed since 1999, for investigating Inheritance Tax compliance:

Income Tax return database

To retrieve data on the deceased's returns for the last six years, and if necessary to call for the individual's tax file, for all enquiry cases. Information on income tax returns can help to identify large reductions in income-generating wealth, for example, indicating the possible gifting of assets in the years before death.

Complex Personal Returns Teams

Deals with the tax affairs of 40,000 individuals with income of over £200,000 a year or with complex Income Tax returns. When such an individual dies the teams inform the Capital Taxes department who may call for the case files to identify items which should appear on the Inheritance Tax return.

Special Compliance Office

Investigates corporate and personal tax cases with potential high enquiry yields. Inheritance Tax is charged on discretionary trusts when they are first set up, and then every ten years, but in 2002 a financial institution disclosed that an off-shore subsidiary had acted as trustee for several hundred undeclared trusts. The Special Compliance Office set up a team in April 2003 to investigate the potential tax yield in these and other similar off-shore trusts, and are working with a Special Investigations team in the Capital Taxes department.

9 Number and value of compliance adjustments by category, 2003-04

More than half of the adjustments made by the Revenue were concerned with land and buildings and shares/business reliefs.

Asset type	Number of cases adjusted	Uplift (£ millions)	Reduction (£ millions)	Net value of adjustments (£ millions)
Land and buildings	6,680	242	41	201
Unquoted shares and business relief	770	93	11	82
Foreign assets	10	31	0	31
Agricultural relief	720	45	18	27
Lifetime gifts	250	18	2	16
Chattels	650	18	4	14
Insurance policies	180	8	2	6
Charity and spouse relief	840	31	28	3
Liabilities and debts	1,180	9	10	-1
Other assets and reliefs	2,820	154	20	134
TOTAL	14,100	649	136	513

Source: National Audit Office analysis of Inland Revenue data

NOTE: This data reflects asset revaluations. The total tax effect of these adjustments is £126 million.

Checks by the Valuation Office Agency

2.5 Eighty per cent of taxpaying estates include residential land and property in the UK, so inaccurate valuations could have a significant impact on Inheritance Tax receipts. From 27,300 checks, the Valuation Office Agency increased property valuations by £201 million in 2003-04, enabling the Capital Taxes department to secure an additional tax yield of around £49 million. These checks help deter undervaluations, and for some 75 per cent of referred cases the Agency was able to accept the figure provided by the representative. It made adjustments in 25 per cent of cases examined with the average net adjustment being £30,000. Uplifted valuations averaged £43,000 and reductions averaged £39,000. In a pilot exercise to improve case turnaround times and provide better information for risk-assessing cases, the Revenue is co-locating a team of eight Agency staff within the Capital Taxes department. The Revenue will evaluate the results in December 2004, when it will consider extending the pilot more widely.

2.6 The Valuation Office Agency also assesses reliefs claimed for agricultural land and buildings, which attracted £528 million of relief from tax in 2001-02 (the latest data available). The Agency checks every claim for agricultural relief where tax is potentially payable and made adjustments in 90 per cent of cases in 2003-04. The Agency checks the value of the land for agricultural purposes and its usage for agricultural purposes, and gives initial advice on whether any residential property on the farm is of an appropriate character to the rest of the farm. Such cases take many months to resolve because there are often difficult judgements to make and the tax at stake is significant. **Case Example 2** shows how some of these factors are examined, the time this takes and how the effect on tax revenue may not be apparent at the outset.

Checks by the Shares Valuation section

2.7 The Capital Taxes department also refers Inheritance Tax cases to its Shares Valuation section, where enquiries produced valuation adjustments of £54 million in 2003-04. These enquiries have to deal with complex issues, as **Case Example 3** illustrates, particularly when valuing unquoted shares and establishing that assets qualify for business relief, as assets acquired as investment or held in

CASE EXAMPLE 2

Agricultural relief

As well as the deceased's home which had recently been given away, a significant part of an estate comprised shares in the ownership of three farms. The representative valued these at £103,000, bringing the estate £30,000 above the tax threshold. Full agricultural relief was claimed, eliminating a tax liability of £12,000. As a result, the case was referred to the Valuation Office Agency. The Agency noted that one of the farms had been unoccupied at the time of death, which could jeopardise its qualification for agricultural relief. Subsequent enquiries with the solicitor acting for the estate established that there was only a two month gap between one agricultural tenancy and the next, which the Capital Taxes department could accept, and that the new tenant had changed the use of part of the farm to rearing pheasants for shooting, which does not qualify for relief. Although the market value of the shares in the three farms was £131,000, for which relief of £103,000 had been claimed, further enquiries by the Agency identified that their value for relief-qualifying agricultural purposes was only £61,000.

These changes brought the estate narrowly above the taxpaying threshold, and the representatives had to pay £73. Overall, the various enquiries with the Agency took 15 months.

CASE EXAMPLE 3

A complex Shares enquiry

An unmarried company director died leaving £4.4 million of assets, including £2.9 million in shares. The Shares Valuation section already had a file open on his affairs in relation to his sale of shares ten years earlier, and with his death his entire shares portfolio was examined. Its enquiries with Companies House found some shares that had not been included in the Inheritance Tax return. It also identified unquoted shares in another company which had been sold 13 years ago to a trust set up by the deceased for what appeared to be a low price (and thereby including an element of gift), when compared with another sale of the same company's shares at that time. Its enquiries centred on (i) whether the sale to the trust was a genuine transaction or involved a transfer at a subsidised price, and (ii) if at arms' length whether the shares were valued for Inheritance Tax purposes at their value to the deceased, fully reflecting the loss of control of the company resulting from the sale. When the National Audit Office examined this case it was still underway after three years, and it illustrates the complexities of identifying genuine market transactions; valuing control of a company; and investigating such matters nearly 14 years after the event without the deceased to shed light on the events (if certain thresholds are breached for gifts made in the seven years before death, gifts can be added to the value of an estate up to 14 years before the death).

an investment business do not attract relief. In 2002 the Revenue considered that a decline in referrals to the Shares Valuation section, which had fallen by a quarter from 1999-00 levels, reflected a failure of some caseworkers to refer all appropriate cases, in particular those with unquoted shares which are difficult to distinguish from quoted shares. The Capital Taxes department developed more detailed guidance and Internet facilities to help staff identify unquoted shares, and 6,000 cases were referred during 2003-04 – an increase of a third on the year before. In its recent restructuring of risk assessment processes (Figure 7 note), it has also included staff experienced in shares valuation issues in each team, to further help identify cases for referral.

Identifying compliance risks

2.8 The Revenue has conducted various exercises to test particular areas of possible risk:

- The value of any gifts made in the seven years before a person dies is part of the taxable estate. In 1999 the Committee of Public Accounts identified a need for the Revenue to be able to demonstrate compliance in such gifts being declared. Legislation was subsequently introduced in 1999 explicitly requiring these to be declared in Inheritance Tax forms. The Revenue also carried out a review of 100 mainly higher-risk cases to examine the extent to which gifts were still being undeclared. This did not find significant tax losses – £475,000 – but the results were used to produce guidance on indicators for this type of risk.
- To test the effectiveness of its system for risk-assessing individual cases, the Revenue has been re-examining a sample of cases for all aspects of potential non-compliance. These test enquiries have yet to be completed or their results analysed. Very few enquiries are 'full' enquiries, where all aspects are examined, so the Revenue developed guidance for staff in examining the sample, which is now used as a tool for checking all cases.
- The 'excepted estate' procedures, described in Part 1, allowed representatives not to submit a tax return if the value of the estate was below £240,000 (in 2003-04) – £15,000 less than the then tax threshold. The Revenue tested whether this provided a sufficient margin of safety if representatives understated asset values. By using information on the prices paid for residential property purchases, held on a Land Registry database, the Revenue examined estates within £10,000 of the exception threshold where the Revenue considered that the property might have been undervalued. Of 33 such cases examined, it secured additional tax revenue from three of them, amounting to £65,000. This provided the Government with the confidence to remove the exception threshold in the 2004 Finance Act, to minimise the form-filling burden for estates which would not generate a tax liability. Without an exception margin under the new regime, however, any undetected undervaluation of estates that are near the tax threshold would produce a loss of tax revenue. To monitor this risk the Revenue is planning to undertake some random sampling of cases, and to help deter non-compliance the Government introduced new penalties for failure to submit tax returns in the 2004 Finance Act (paragraph 2.12).

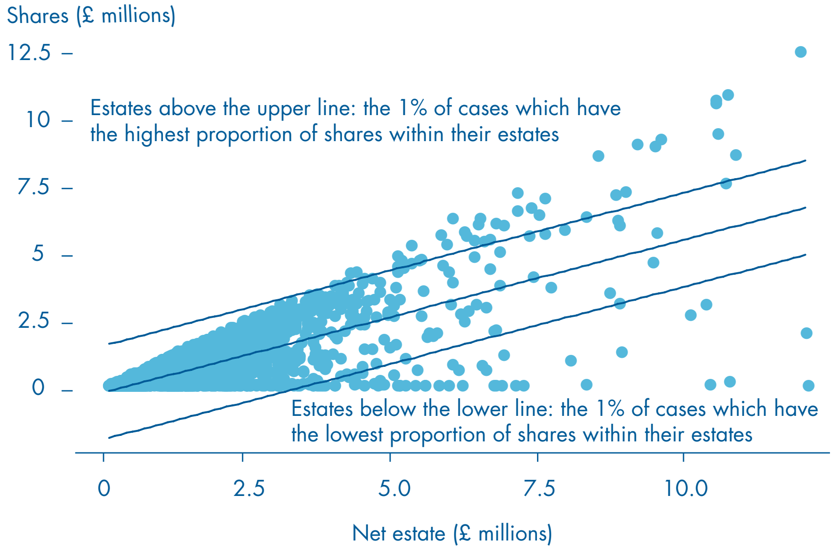
2.9 The Revenue makes little use of computerised data in Inheritance Tax risk assessments. It is in the early stages of considering the case for electronic submission of the returns, which might allow computerised analyses in risk assessments, which are currently done manually. Even without electronic returns, however, there is scope to make use of statistical data already collected by the Revenue to highlight estates with mixes of assets which fall 'outside the norm'. Our analysis of such data showed, for example, that for one group of estates there was a strong correlation between the size of the estate and the value of shares within it. Using that relationship, the Revenue could focus enquiry efforts on cases which most deviate from the norm. As shown in the example in **Figure 10**, this might be directed at the one per cent that have the lowest proportion of shares for possible under-declaration, and the one per cent with the highest proportion for possible under-valuation of other assets.

Matching resources to workloads

2.10 The Revenue monitors trends in house, shares and other asset values, to estimate future numbers of taxpaying cases, allowing it to assess future staffing and resource needs. It uses forecasts for these types of assets, and because its modelling does not take account of regional variations in house prices it does not fully reflect the impact of changing house prices on Inheritance Tax caseload (**Figure 11 overleaf** illustrates how national and regional house price indices have followed different trends in recent years). While workload forecasts are sensitive to changes in house and other asset values, the speed with which the Revenue needs to match additional resources to any expected increase in taxpaying cases is tempered by the time lag after death in representatives submitting

10 Correlation between the overall value of estates and the value of shares in those estates, highlighting outlier cases

This illustrates how analysis of the value of assets in estates can highlight cases for compliance enquiry. In this example, cases could be identified with a particularly low proportion of share-holdings which might be examined for possible under-declaration of shares, and those with a high proportion for possible under-declaration of other types of assets.



Source: National Audit Office analysis of Inland Revenue data

NOTE: This chart plots the values of net estate and shares for the 2,800 estates in one of 5 statistical samples collected by the Revenue for 2000-01 – in this case, 'non-excepted' estates of those under 45 years of age at death, or over 45 but with £1 million or more of assets. The relationship between the values of net estates and shareholdings is represented by a line on the chart (the central line), which is defined by the equation: Shares = -£90,700 + 0.54 Net-estate (r=0.75). The outlying lines encompass the 98% of cases closest to that best-fit, so that those below the bottom line are in the 1% that have the lowest proportion of shares, and those above the top line the 1% that have the highest proportion of shares in their estates.

Inheritance Tax returns – representatives do not have to submit a return until 12 months after death. The Revenue is forecasting for 2004-05 a rise in the number of taxpayers to 32,000, and the impact of these cases on the Revenue's workload will be felt in 2005-06 as well as 2004-05.

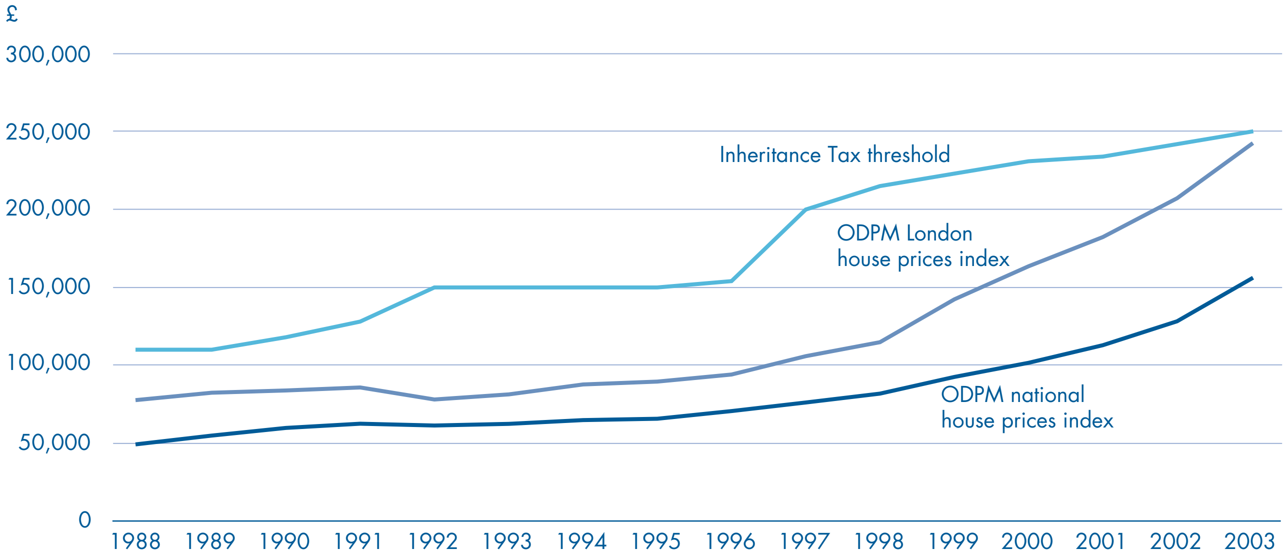
Penalties and directions

2.11 In its 1999 report, the Committee of Public Accounts recommended that the Revenue take a firmer line with representatives to obtain the information necessary to progress cases and to levy penalties for non-compliance, using the powers in the 1999 Finance Act. Directions and penalties are important tools at the Revenue's disposal for encouraging compliance in two main areas – where a tax return is not submitted, and where information in a return is fraudulently or negligently inaccurate. In some areas the 2004 Finance Act has recently strengthened the provisions of the 1999 Act. Specifically:

- the 1999 Act introduced a penalty of up to £100 for late filing of Inheritance Tax returns (more than twelve months after death), with up to a further £100 for a further six months delay. The 2004 Act made these fixed-sum penalties, and introduced a new £3,000 penalty where the failure to submit a return continues for more than two years after death.
- the 1999 Act allowed the Revenue to issue directions for information from people liable to file Inheritance Tax returns without requiring Special Commissioners' consent; and
- the 1999 Act raised the maximum penalty for Inheritance Tax fraud to £3,000 plus 100 per cent of the tax involved, and for negligence to £1,500 plus 100 per cent of the amount involved. The 2004 Act dispensed with this differentiation in penalties, providing instead a £3,000 penalty plus 100 per cent of the tax involved for both negligence and fraud.

11 A comparison of the Inheritance Tax threshold and trends in average house prices

Nationally, average house prices have risen more quickly than the tax threshold in recent years. Once other assets are taken into account, this has increased the number of taxpaying estates.



Source: National Audit Office analysis of Inland Revenue and Office of the Deputy Prime Minister data

NOTE: Office of the Deputy Prime Minister house price indices are calculated using a weighted average of prices paid for a standard mix of dwellings from Survey of Mortgage Lenders data.

2.12 The risk of estates with an Inheritance Tax liability not submitting a return is low, because of the linkages with the procedures for gaining probate. As a safeguard, the Revenue routinely checks lists of probate grants to identify overdue Inheritance Tax returns, allowing it to remind representatives of their obligations and impose late filing penalties. Between 1999 and 2004, the Revenue applied nearly 1,200 late filing penalties, totalling £192,000 **(Figure 12)**. With new procedures allowing most non-taxpaying estates to submit a return only to the Probate Registries (paragraph 1.2), the 2004 Finance Act extended the penalty regime to those failing to submit the short Inheritance Tax form to the Probate Registries.

2.13 The Revenue has publicised its approach to the use of directions and penalties for Inheritance Tax fraud and negligence, including giving presentations to more than 3,000 professionals outlining the implications of submitting late or incorrect accounts. Between 1999 and 2004 it issued 67 directions to representatives, and a further 8 to third-parties such as banks and insurance companies, to obtain information without having to go to the Special Commissioners. The Revenue considers that the threat of issuing directions has made it easier to secure the submission of returns and progress cases where it has faced an initial lack of co-operation.

2.14 Penalties are also applied for fraudulent or negligent inaccuracies in tax returns. In 2003-04, the Revenue applied penalties totalling £366,000 in 100 cases **(Figure 13)** – 0.7 per cent of the 14,100 cases in which adjustments were made. This reflects the fact that many adjustments are corrections of straightforward errors or omissions, or the result of negotiations on valuations of land and other assets, rather than remedying negligent claims. For example, while land and property accounted for nearly half of all adjustments made, an analysis of the 100 penalty cases indicated that this type of asset featured in only 15 of those cases. The level of penalties also reflects the Revenue's overall compliance strategy in which it has sought to promote taxpayer compliance alongside traditional enforcement action against those who are negligent or try to evade tax. In feedback to the Revenue and the National Audit Office, professional representatives have indicated their perception of a tougher attitude on Inheritance Tax penalties. The Revenue believes the number of penalties applied for negligence,

12 Penalties for late filing of Inheritance Tax returns

	1999-00	2000-01	2001-02	2002-03	2003-04
Penalties applied	9	109	236	313	507
Total penalties	£700	£15,800	£34,800	£53,900	£86,900
Average penalty	£80	£150	£150	£170	£170

Source: Inland Revenue

NOTE: 1999-00 data reflect part-year data, as late-filing penalties were introduced during that year. 2003-04 data reflect new procedures introduced that year to identify potential late filing cases as part of revised initial case assessment procedures.

13 The use of penalties for Inheritance Tax negligence

	1999-00	2000-01	2001-02	2002-03	2003-04
Penalty enquiries settled	209	550	430	560	334
Penalties imposed	93	140	124	95	100
Total value of penalties	£452,000	£484,000	£429,000	£217,000	£366,000
Average penalty	£4,900	£3,500	£3,500	£2,300	£3,700

Source: Inland Revenue

which has fallen since 2000-01 (Figure 13), reflects the deterrent effects of its message on penalties being taken on board by representatives.

2.15 The level of penalties applied also reflects a difficulty in establishing negligence or fraud in Inheritance Tax cases. The Revenue did not pursue penalties in half of the 694 potential cases initially identified by Inheritance Tax caseworkers in 2003-04, and of the 334 cases in which the Revenue considered it appropriate to pursue penalty action, penalties were applied in only 100 cases. Representatives often face a difficult task in unravelling the financial affairs of the deceased, with professional representatives in particular often having little knowledge of the deceased's financial affairs. Culpability may be particularly difficult to establish where an estate is administered by representatives who will not themselves benefit from any inaccuracy in the tax return. Legal advice obtained by the Revenue in connection with a case taken to the Special Commissioners in 2001 indicated that there would be limits on any culpability if such representatives fully disclosed omissions and co-operated fully to correct the tax assessment. Analysis of a sample of cases where penalties were considered but not applied indicated that in 40 per cent negligence could not be attributed to representatives because they had relied on professional valuers or because of errors by banks or accountants. In September 2004, the Revenue secured its first prosecution for Inheritance Tax fraud, against a representative who had not declared assets he had transferred from the estate in the seven years before death.

2.16 Where penalties are applied the Revenue abates the maximum penalty available to take account of representatives' disclosure of errors and omissions, their co-operation and the gravity of the negligence. With Inheritance Tax, representatives may establish some details of the deceased's estate only after submitting a tax return, and the Revenue seeks to encourage representatives to disclose such changes. Its strategy is to give greater abatement of penalties where errors are voluntarily disclosed and the tax at stake is small. Representatives voluntarily disclosed revised figures in 62 of the 100 cases in 2003-04 where penalties were applied, and the Revenue abated the maximum penalty available on average by 95 per cent (ranging between 82 and 98 per cent) **(see Case Example 4).** However, the Revenue also significantly abated penalties in those cases where it had discovered the error – averaging 88 per cent, and ranging between 60 and 99 per cent – reflecting the co-operation of the representatives and the gravity of the negligence **(see Case Example 5)**.

Tackling artificial avoidance

2.17 There is an important distinction to be made between the way people legitimately organise their affairs to reduce their Inheritance Tax liability, described in Part 1, and artificial tax avoidance schemes. The tax-base for Inheritance Tax covers not only assets owned at death, but also assets recently given away and assets from which the estate derives some benefit. The question of whether such assets might thus be regarded as part of a person's estate lies at the centre of any consideration of the acceptability of avoidance schemes. **Figure 14** shows that the reported value of wealthier estates have proportionately more liquid assets, which increases the scope for tax avoidance, compared with lower value estates where residential property may be the main asset. Some schemes are complex and often marketed by professional tax advisers.

2.18 At the time they are marketed, avoidance schemes cannot be certain of working when a person eventually dies and Inheritance Tax becomes payable on their estate. Normal Revenue practice is not to set out guidance in advance about its attitude to specific avoidance schemes. Instead, it has monitored potentially abusive avoidance schemes used in tax returns presented after death and sometimes challenged particular schemes through litigation. Where further action is needed to close loopholes, Ministers have sought to change the tax legislation. One of the common features of abusive avoidance is a high degree of artificiality. For example, the Revenue is currently reviewing a capital redemption scheme which involves buying an asset which has a low value at death but a higher value later on. Where the Revenue is unable to counter an avoidance scheme under existing legislation, Ministers may decide that they need to change the law. **Figure 15** shows examples of some monitored schemes, and **Figure 16 overleaf** two examples – the *Ingram* and *Eversden* cases – of recent legal challenges. Both these cases were to tackle items declared as outright gifts but which might actually be 'gifts with reservation', where the owner of an asset removes it from his estate but continues to benefit from it while alive. Although many other countries have combined gift and death taxes, gifts with reservation remain a feature of avoidance schemes overseas (Appendix 3).

CASE EXAMPLE 4

Penalty abatement when error disclosed by the representative

The estate was settled in August 2003, with some £163,000 tax paid. In September the estate's solicitor informed the Revenue that an insurance policy of the deceased worth over £200,000 had subsequently come to light. The Revenue was not satisfied that the representative had taken all reasonable steps to identify assets at the time and imposed a penalty for negligence. The maximum penalty it could have imposed was the tax due of £85,000 plus £1,500, in addition to requiring payment of the tax due. This was abated on the grounds of voluntary disclosure (30 per cent), co-operation (40 per cent) and lack of gravity (27 per cent). The penalty imposed was therefore £2,556 – three per cent of the maximum available penalty.

CASE EXAMPLE 5

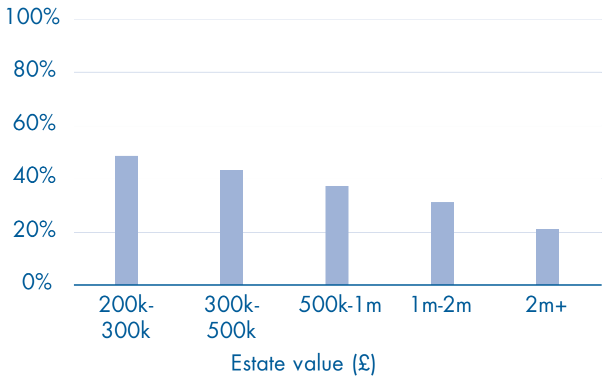
Penalty abatement when error discovered by the Revenue

After a husband died, the estate's solicitor submitted a return which valued a house at £290,000, based on an estate agents report prepared for the same solicitor when the wife had died six months before. At the time of the husband's death the house's value was assessed by the Valuation Office Agency at £460,000. Although the maximum penalty available was £69,500 (being the tax due on the £170,000 difference in value, plus £1,500), a penalty of £3,500 – five per cent – was applied. This reflected the solicitor's co-operation and the significance of the negligence, which took account of the solicitor's previously-stated intention to report the subsequent sale of the house (when the scale of any incorrect valuation would have become evident).

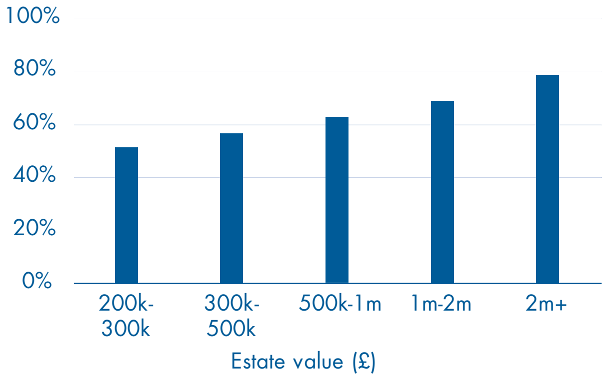
14 The relative distribution of asset mix, by size of estate, 2001-02

For estates around the tax threshold, residential property and other land and buildings accounts for nearly 50% of their value, while for estates of £2 million or more these account for less than half that proportion.

Residential property and other land and buildings



Other, more "liquid" assets (e.g. securities, cash etc)



Source: National Audit Office analysis of Inland Revenue data

NOTE: These figures are based on values of assets recorded in tax returns. Accordingly it may exclude the effect of some avoidance schemes which are designed to reduce the declarable value of estates.

15 Some of the Inheritance Tax avoidance schemes being monitored and challenged by the Revenue

Capital redemption schemes

An investment of a large sum in a capital redemption policy with a long term to run has a value early on which is much less than the eventual redemption sum, and indeed much less than the sum initially invested. The value of the investment, and the Inheritance Tax liability, will therefore be much reduced if the investor dies early in the term period.

Excluded property trusts

These schemes seek to use trusts to arrange for assets to be outside the scope of Inheritance Tax. The value of a person's 'interest in possession' in the benefits of non-discretionary trusts is liable for Inheritance Tax, but excluded property trusts seek to take advantage of the fact that trust assets sited outside the UK which are put into the trust by a person domiciled outside the UK are not subject to the Tax.

Gift and lease-back of property

These are artificial arrangements involving giving land or property away, leasing back the leasehold, and the recipient passing on the freehold to a third party. The second transaction might be claimed to be a transaction unconnected to the gift by the original donor, and thereby having an artificially depressed value for Inheritance Tax purposes because of the presence of the leasehold tenant.

'Gifts with reservation' to spouses

Although the Eversden ruling blocked some gift-with-reservation schemes in 2003 (see Figure 16), some estates are still attempting to use a series of trusts to disconnect an initial gift (covered by spouse relief) from a final transfer of the assets, which would be claimed to be not part of the original owner's estate despite them having enjoyed the use of the assets while alive.

Joint property schemes

These seek to optimise the spouse reliefs available to each spouse by one spouse leaving their part of a property to a discretionary trust of which the other is a beneficiary. When the surviving spouse dies, their estate might seek to claim that their benefit from the occupation of the part of the house owned by the trust was incidental to the benefit from living in that part owned by the spouse, and that the trust-owned part was therefore not part of their estate for Inheritance Tax purposes.

Loan trust schemes

These involve putting assets into trusts which then sell them to the original donor (or their spouse) in return for an IOU. On death, the value of the benefit derived from using the assets while alive is claimed to be off-set by the IOU, reducing the net value of the estate liable to Inheritance Tax.

16 Court cases brought by the Revenue to tackle 'Gifts with reservation' avoidance

Some people have sought to avoid Inheritance Tax when they die by passing ownership of their assets (such as a house) to others while they are alive, but still enjoy the use of those assets – 'gifts with reservation'. Some types of such schemes have in recent years been blocked by subsequent legislation:

- The 1999 Finance Act blocked so-called *Ingram* cases, after the Inland Revenue was defeated in that particular case in the House of Lords. In that case, the deceased had divided the ownership of her home into a rent-free lease, which she kept, and a separate freehold which she gave away, and the Revenue had viewed the gift of the freehold as a gift with reservation, as the deceased had retained the right to live there without paying any rent.
- The 2003 Finance Act blocked similar *Eversden* schemes, named after another case that the Revenue lost in the courts. In that particular case, a wife first put her house into a short-lived interest in possession trust which gave her husband the benefit of living in the house. The gift was effectively to the husband, so attracted spouse relief. But soon after, that trust passed its asset to a discretionary trust with the husband and wife assigned as beneficiaries, and as a discretionary trust this was not liable to Inheritance Tax on the wife's death. The Revenue viewed the transfer to the second trust as a gift with reservation by the wife because she continued to live in the house, although the courts viewed it as a transaction between trusts and unconnected to the wife.

Source: National Audit Office

2.19 To tax those using 'gift with reservation' schemes which previous legislation and court precedents have not blocked, the 2004 Finance Act introduced an income tax charge on the notional benefit from assets still enjoyed by their previous owner. Someone affected by these new rules will be able to opt for exemption from the new tax charge by declaring that the assets should be included in their estate for Inheritance Tax purposes. The Act also introduced new disclosure rules requiring avoidance schemes to be notified to the Revenue. Initially, the requirement to disclose will not cover Inheritance Tax schemes, but the Government may change the regulations at a later date to extend them to cover these schemes.

The Tax Gap

2.20 With all taxes, a measure of the level of compliance is the size of the tax gap – the difference between the theoretical tax payable and the actual amount collected. Identifying the tax gap, and its component parts, provides a valuable means of targeting resources towards areas with the largest risk of loss, and developing strategies to help taxpayers comply. As described earlier, the Revenue is tackling specific areas of risk, but with no overall measure of the tax gap for Inheritance Tax it cannot demonstrate how well it is managing the risks of non-compliance.

2.21 In its latest Public Service Agreement, the Revenue has a target to reduce underpayment of direct tax and National Insurance Contributions due by at least £3 billion a year by 2007-08. This new target reflects work it has under way to improve its understanding of the tax gap for direct taxes, including Inheritance Tax. The Revenue intends to build on its own and Customs & Excise's experience. For example, Customs and Excise has made a top-down assessment of the tax gap for VAT, some 16 per cent, based on an overall theoretical tax liability derived from data on VAT-liable expenditures in different sectors of the economy, and bottom-up estimates of VAT losses arising from specific risks, such as from 'missing trader' fraud, the shadow economy and 'abusive avoidance'.[9] The Revenue itself has a 'random enquiry programme' to establish the extent of non-compliance on some other self-assessed taxes, where a random sample of tax returns are closely investigated for any shortfall in tax and the results extrapolated to give a global view of the level of under-declaration.

2.22 A top-down approach to identifying the tax gap for Inheritance Tax, such as that used for VAT, is inherently difficult, not least because of the range of reliefs and exemptions that might be claimed and the variety of ways in which estates can be structured to reduce their tax liability. In the United States, however, the Internal Revenue Service has estimated the tax gap for its similar Estate Tax. In its most recent analysis, for the 1992 tax year, it estimates this to be around $2.3 billion, comprising some $0.8 billion from the non-filing of returns and almost $1.6 billion – some 13 per cent – from under-reporting of estate values. To estimate the non-filing gap, the Internal Revenue Service used data from long-running surveys by the United States Department of Health and Human Services on the financial and health position of older Americans to model the likely number of people dying

9 *Audit of Assumptions for Budget 2004*, Session 2003-04, HC 434, paras 23-40.

each year and their wealth. The assessment of the under-reporting gap was derived from a detailed examination of around 4,500 tax returns that had been the subject of enquiry. The Internal Revenue Service extrapolated the results to produce a total figure after weighting them to reflect the different levels of compliance found in enquiry and non-enquiry cases.

2.23 In the UK there is less risk of a significant non-filing gap because the linkage with the probate system helps to ensure tax returns are submitted when the estate has an Inheritance Tax liability. This does not ensure tax returns are submitted, for example if probate is not needed for jointly-owned assets to continue to be used, but in many such cases probate is eventually needed when the remaining owner dies or the asset is sold, allowing the Revenue to call for a tax return **(Case Example 6)**. In the United States, probate is obtained before paying the Federal Estate Tax.

2.24 Nevertheless, there are aspects of the Internal Revenue Service approach that could be taken on board by the Inland Revenue in assessing the under-reporting gap. In the UK there is less external data on aggregate personal wealth – indeed the Office for National Statistics' data on wealth originates from Inheritance Tax data – and existing household surveys would have to be adjusted if they were to collect data that might help in assessing the gap.[10] There are also difficulties in making meaningful comparisons with other external data on aspects of wealth which might indicate possible under-reporting gaps for particular assets. For example, we compared Land Registry data on prices paid for houses with the average values declared on Inheritance Tax returns, as well as an insurance industry estimate of the insurable value of household goods against the value of goods included in tax returns. More work would be needed by the Revenue, however, if it were to be able to use such comparisons to assess any tax gap, because the value of residential property declared on returns only has to reflect the deceased's share in jointly-owned property and because 'insurance value' is not the same as the 'sale value' required for Inheritance Tax. The Revenue could however follow the practice of the Internal Revenue Service by using the results of its Inheritance Tax enquiry cases to estimate the under-reporting gap, which could also highlight the components within estates contributing most to that gap.

CASE EXAMPLE 6

The probate system reduces the potential tax gap from non-filing

A farm was jointly owned by two brothers and one of their daughters. When one brother died, his share passed to the others, with no probate needed to continue running the farm. When the other brother died he left his share of the farm to the daughter, and the residue of his estate to his son. Again, the business could continue without registration of a change of ownership of the farm, and it would not have been until the daughter died or wanted to sell the farm that probate would have been needed. However, in this case, the son questioned his inheritance and took out probate on the brothers' estates, which required the submission of Inheritance Tax returns for each of them.

10 There is an annual General Household Survey by the Office for National Statistics and a Family Resources Survey by the Department for Work and Pensions which provide some data on personal wealth, and there are other household surveys marketed by private polling organisations.

PART THREE
Improving the quality of service

3.1 In seeking to ensure that the correct amount of Inheritance Tax is paid, the Revenue aims to provide a good service and keep compliance costs to a minimum for representatives of estates – both professional representatives such as solicitors, accountants and banks, who submit around 70 per cent of returns to the Revenue; and personal representatives, often relatives of the deceased. This part examines three aspects of service:

- The ease with which representatives can meet their obligations.
- How promptly an estate's Inheritance Tax affairs are settled.
- The cost of meeting the Tax's requirements.

The ease with which Inheritance Tax requirements can be met

3.2 In recent years the Revenue has rationalised the main Inheritance Tax form and introduced a shorter version for representatives with no tax to pay because of the spouse or charity exemption. Other estates with no tax liability and below an 'exception' threshold needed only to submit a short form to the Probate Registries. Now, as described in paragraph 1.2, the changes to the excepted estate threshold introduced in the 2004 Finance Act mean that representatives of nearly all estates with no tax liability will only have to complete the short Inheritance Tax return, which they will submit to the Probate Registries. The Revenue expects that this will reduce the number of representatives who have to submit the main form – 67,500 in 2003-04 – by around 30,000.

3.3 The Revenue, consulting professional representatives, has also regularly reviewed its forms to make them more user-friendly. However, it has not had any input on form design from personal representatives. Recent feedback to the Revenue indicated that 48 per cent of personal representatives found the main form easy to follow and 36 per cent found the accompanying guidance notes easy to understand. We commissioned Jonquil Lowe[11] to assess the usability of Inheritance Tax forms for personal representatives, against a checklist developed by the National Audit Office for evaluating government forms.[12] She also reviewed in its draft state a re-designed short form, introduced for the new excepted estates procedures. The checklist envisages that a score of around 70 or more indicates a 'difficult form'. Her review found that while the main taxpaying form is difficult to complete without professional assistance, scoring higher than 70, this partly reflected the complexities of the tax system itself and the Revenue had generally made its forms more user-friendly. The shorter form filled in by the majority of estates is more straightforward to complete and scored substantially better than the 70 benchmark. Nevertheless, further improvements are possible, particularly on the main return. The results are summarised in **Figure 17 overleaf**.

11 Freelance financial researcher and author of the *Which? Guide to Giving and Inheriting*.
12 *Difficult Forms, How government agencies interact with citizens,* report by the Comptroller and Auditor General, HC 1145, Session 2002-03.

17 The usability of Inheritance Tax forms

The form and its score	Description	Areas of strength	Areas for improvement
'IHT200' main form **Score - 82** This indicates the form is difficult to use, and would be daunting to the non-professional approaching the tax for the first time. This in part reflects the complexity of the tax itself.	A core form and a modular structure of relevant insert-forms, along the lines of the Income Tax self-assessment form, which is filled in by all taxpaying and non-excepted estates.	■ Insert forms mean taxpayer only fills in relevant sections.	■ Reduce use of complex language and jargon ■ Re-order to make form more relevant to users ■ Use colour, sectional reminders and diagrams to aid navigation through guidance notes ■ Give more prominence to helpline number and return addresses
'IHT205' short form **Score - 35** This indicates that the form is relatively simple and most non-professionals should be able to complete the form without assistance.	Short form for personal representatives dealing with 'excepted estates', filled in by all excepted estates where representative is not a solicitor.	■ Use of clear language ■ Logical sequencing of the form ■ Concise and well-laid out guidance ■ Good signposting to the helpline number	■ More consistent labelling of part-questions ■ Better spacing between some questions
Re-designed 'IHT205' short form, in draft form. **Score - 49** This indicates that the form is relatively simple and most non-professionals should be able to complete the form without assistance. The added complexity compared to the current IHT205 is partly because of the need to cater for a wider range of users, covering both lower and higher (though non-taxpaying) estates. A re-evaluation of the form in its final draft stages scored it at 38. The improved score reflects work done by the Revenue in taking on board our suggestions for improvement.	Revised short form to cover new processes, introduced in the 2004 Finance Act, filled in by all estates below the tax threshold, or above the threshold but covered by spouse or charity exemptions.	■ Excellent signposting to the helpline number ■ Simpler for those who would previously have had to fill in the IHT200 main form.	■ Reduce ambiguous language ■ Make sequencing of questions more logical for the user ■ Make use of numbering systems more consistent

Source: J Lowe: *Usability of inheritance tax forms to the non-professional*, a report commissioned by the National Audit Office, March 2004

3.4 Assistance with completing the forms, and any other Inheritance Tax issues, is available to representatives in several ways:

- **Guidance notes** that accompany returns are comprehensive, and each aspect of an estate has a separate booklet so representatives need only read guidance relevant to their circumstances. The Revenue's role is not to advise people on how to arrange their financial affairs, so its guidance notes clarify only how these should be reported in Inheritance Tax returns. For valuing homes, the Revenue suggests that representatives might refer to prices in local estate agents or the property pages of local newspapers, but many commission professional property valuations to pre-empt enquiries. There are several websites that could be used to give a representative more confidence in their valuations, such as the Land Registry's on-line database of recent house sales by postcode area. If 'Islamic mortgages' **(Figure 18)** become more prevalent in future, guidance on valuing the houses involved might also be helpful, to supplement the Revenue's current approach of giving detailed guidance individually on the few cases that have so far arisen.

18 The valuation of properties using 'Islamic mortgages'

Sharia prohibition on the payment of interest, which affects the funding arrangements for buying a home, might affect the way some estates are valued for Inheritance Tax purposes. In recent years a number of so-called 'Islamic mortgages' have been developed which involve the lender buying a house and the occupant repaying to the lender over several years a sum which exceeds the original cost of the house. Only at the end of the repayment period is the ownership of the house fully transferred from the lender. The 2003 Finance Act stopped these mortgages incurring Stamp Duty liabilities twice, at the beginning and end of the mortgage, and it is estimated that Islamic mortgage advances might reach £4.5 billion by 2006.[13] Because for the duration of the mortgage the lender owns a share of the house, with the occupier making 'rental' payments, it may not be clear to potential representatives how the benefit from the house is to be valued on Inheritance Tax returns (rented accommodation is not included), and whether for example its valuation should relate to the current value of the property or the value of accumulated rental payments.

- **A joint probate/Inheritance Tax telephone helpline,** staffed by the Revenue, provides guidance and help on probate and Inheritance Tax issues. Feedback to the Revenue from professional representatives indicates that the helpline, which has received some 200,000 calls in its first year, is a much appreciated service.
- **The Revenue website.** It is not easy to navigate around the Inheritance Tax section. For example, not all the Inheritance Tax forms are in one place and some can only be found after persistent use of the Search facility.
- **Websites managed by other government departments.** The Court Service's website does not clearly display information on Inheritance Tax, provide links to Inheritance Tax forms, nor prominently display the helpline number or links to the Revenue's website where further information is available. The Court Service plans to launch a dedicated probate website in 2005, to provide easier access to Probate Service information and forms. Similarly, information on Inheritance Tax on the Government-wide website www.direct.gov.uk, was hard to find, until recently being located in the 'over-50s' section. The site does clearly display the number for the telephone helpline and offers links to the Revenue website for further detail. However, important information such as the Inheritance Tax threshold was out of date, with 2003-04 figures displayed four months after they had changed and there were no direct links to Inheritance Tax forms. The site was recently updated and details on Inheritance Tax are now also available in the 'basic tax' section.

3.5 One way of potentially simplifying the process is to introduce a facility for representatives to submit Inheritance Tax returns electronically. This might be easier for those who only have to fill in the short form, where copies of any Will or valuation reports would not be needed. The Revenue is in the early stages of designing such a service, and has not yet quantified the costs and benefits of doing so. In considering electronic returns the Revenue needs to weigh up the advantages for different types of representatives and their likely take-up rates, to tailor any prospective service to meet their needs.

3.6 Once any tax assessment is agreed with the Revenue, representatives need to pay any tax due before probate can be granted and assets in the estate distributed. Because of this, representatives have often needed to arrange a loan to pay the tax, with interest on the loan having to be reimbursed from the estate after probate. There are, however, several means of alleviating this cost:

- From April 2003 banks and building societies have allowed representatives to pay Inheritance Tax from certain accounts previously held by the deceased, before gaining probate. Already around one third of taxpaying estates have made some use of this, and some professional representatives would like a similar scheme for quoted shares to be introduced.
- Any National Savings or British Government Stock in the estate can be used to pay the tax due.
- Tax on land and property and some business assets can be paid in ten annual instalments. Although the Revenue does not routinely check whether such assets are disposed of with tax still outstanding, the potential loss of revenue from non-compliance is low. In a recent review the Revenue found that in 90 per cent of instalment cases the tax outstanding had been fully paid within three years of instalments commencing, and for any cases where instalments might continue inappropriately the potential loss to the Revenue is mitigated by the 4 per cent interest subsumed in the continuing instalment payments.

13 *Islamic Mortgages*, Datamonitor, November 2002.

The speed of service

3.7 As Inheritance Tax has to be paid before an estate's assets can be distributed, and interest on any tax due is payable from six months after the death, the speed with which cases are settled is an important aspect of the Revenue's service. In 1999 the Committee of Public Accounts noted that nearly 2,000 cases were then over three years old, including over 200 which were ten years old, and looked to the Revenue to settle cases more quickly. Since 1999 the Revenue has reduced these backlogs, to 882 cases over three years old and 83 over ten years old, as of June 2004. Over that interval, the speed of processing cases has also increased, from 82 per cent within 15 months to 90 per cent within 12 months, and in 2003-04 the Revenue met all but one of its targets for dealing with Inheritance Tax cases.

3.8 This improvement in the speed of case processing is also reflected in other parts of the Revenue that deal with Inheritance Tax cases, in particular in the Valuation Office Agency and Shares Valuation section. Unless no tax is due, all estates that include land or buildings and are near or above the tax threshold are referred to the Valuation Office Agency. In the Revenue's last survey of professional representatives in 2002, only 45 per cent were satisfied with the speed of the Agency's response. However, the Agency has improved its performance in recent years, despite a 40 per cent increase in its Inheritance Tax workload over that period. Around half of the 27,300 cases referred to the Agency in 2003-04 required only an initial appraisal, which were done promptly – 54 per cent are completed within ten days and 98 per cent within thirty. Cases take longer if a fuller enquiry is needed, with 19 per cent of these dealt with within twenty working days, and nine per cent taking more than six months. The Revenue expects further improvement from a pilot project started in April 2004 which co-located eight Agency staff with the Capital Taxes department. This team aims to improve risk assessments, so that processing times for lower-risk cases might be reduced by up to ten days. The Revenue will evaluate the pilot in December 2004 with a view to extending its coverage.

3.9 Referrals to the Shares Valuation section also contribute to the time some cases can take. In 1999 the Committee of Public Accounts recommended that the Revenue should speed up its shares valuation work to reduce the overall time taken to settle Inheritance Tax cases. The average time taken to process all types of shares valuation work, of which Inheritance Tax cases make up a fifth, has halved to five months. However, its improvement in dealing with Inheritance Tax cases has been less marked. Ninety per cent of Inheritance Tax referrals were settled within 12 months in 2003-04, compared with 88 per cent in 1998-99. As a result of more discriminating risk assessment within the Shares Valuation section, it has undertaken fewer detailed enquiries on Inheritance Tax cases – 1,600 in 2003-04 compared with 3,500 in 1999-00. Those enquiries that are undertaken are therefore likely to be more complex cases, so the proportion settled in 12 months has fallen from 77 per cent in 2000-01 to 72 per cent in 2003-04.

The costs of complying with Inheritance Tax

3.10 The cost and burden of complying with Inheritance Tax mainly falls on an estate's representative, and will depend on the complexity of the estate and whether or not a professional is used. The Revenue estimates that in 70 per cent of cases professionals, who charge fees, are used. Academic research has categorised the other costs of tax compliance for individuals into the cost of acquiring knowledge, the time taken completing returns, incidental expenses and the psychological burden – particularly important for Inheritance Tax where a personal representative might be a bereaved relative of the deceased.[14]

14 See for example Sandford C: *The rise and rise of tax compliance costs*, p. 1 in *Tax compliance Costs Measurement and Policy*, (1995) ed. Sandford C.

3.11 The Revenue has little information about the costs of compliance for Inheritance Tax. These are not straightforward to measure because of the difficulties in separating the inescapable costs from voluntary costs of implementing tax-saving measures, or separating costs incurred for Inheritance Tax purposes from those incurred in obtaining probate. A Law Society survey assessed the value of all probate, wills and trust work undertaken by solicitors in 2002 at some £750 million, a figure that subsumes Inheritance Tax costs.[15] To this could be added the fees charged by accountants and other advisors involved in similar work. The additional work involved on Inheritance Tax arises largely from completing tax returns, identifying lifetime gifts and valuing some assets, although assets sometimes need to be valued anyway to divide estates between beneficiaries. The Institute of Legacy Management estimates that the cost of using solicitors to deal with a deceased's estate should not typically be more than around 2 to 3.5 per cent of the estate's value (between £5,000 and £9,000 for an estate at the tax threshold) although for complex estates the figure might be higher.[16]

Monitoring the quality of service

3.12 The Revenue monitors quality of service in a number ways, most importantly through biennial surveys of personal and professional representatives, and performance indicators. These surveys were last carried out in 2001 and 2002, for its personal and professional representatives respectively, with around 95 per cent of representatives satisfied or very satisfied with the Revenue's overall performance. However, because the surveys received low response rates, with only 500 responses out of 7,000 professionals surveyed, and the questions were generalised, the Revenue is planning to introduce a new rolling telephone survey by the end of 2004. This should give it prompter feedback and allow it to target specific problem areas more quickly.

3.13 The Revenue also has a number of performance indicators to assess the speed and accuracy of its Inheritance Tax work. It has indicators for dealing with postal and telephone queries, and speed of settling Inheritance Tax cases. In assessing its speed of processing, however, the Revenue does not differentiate between estates of different sizes or the extent of checks and enquiries undertaken, limiting its ability to identify where quality of service could be improved. While the link between Inheritance Tax and the administration of an estate will prompt many to use professional assistance, monitoring long-term trends in the proportion of representatives who submit returns without professional help, currently about 30 per cent, might give a broad indicator of where improvements would make it easier for representatives, desirable particularly for smaller taxpaying estates which might not be expected to need professional management.

15 Law Society survey of fee income 2002.

16 The Institute of Legacy Management estimate that around 14 per cent of Wills include a charitable bequest. The figures used here are taken from estates where one or more charities receive a share of the residue of an estate, which the Institute estimate accounts for 45 per cent of estates where a charity benefits.

PART FOUR

The Heritage Exemption





4.1 This Part follows up previous recommendations by the Committee of Public Accounts on the Inheritance Tax exemption for heritage assets.

4.2 Assets of sufficient heritage importance may be exempted from the Tax, on condition that undertakings are kept to conserve the assets and to provide reasonable public access. If such undertakings are breached, or the asset is sold, tax becomes payable. Between 1984 and 1998 around £760 million of tax was deferred, at an average of £54 million a year. Since 1998, £114 million more tax has been deferred at an average of £19 million a year. The Revenue attributes this decrease to a tightening of eligibility and access criteria introduced in the 1998 Finance Act, discussed below. There are currently 332 exemptions for land and buildings in force, one more than in 1998, and 91,000 exempt chattels compared to 86,000 in 1998.

4.3 The Revenue assesses claims for conditional exemption, negotiates public access and other undertakings with owners, monitors compliance and publicises the assets involved on its website. In doing so, it obtains assistance from heritage agencies such as the Countryside Agency, English Heritage and Historic Scotland for land and buildings, and from the Museums Libraries and Archives Council (funded by the Department for Culture Media and Sport) for chattels.

Public Access

4.4 Exemption agreements for 90 per cent of the 332 exempt land and buildings allow a degree of open access. In its 1999 report the Committee of Public Accounts noted a difficulty in viewing some chattels where access was available by appointment only, and recommended that the interests of the public be considered as well as those of owners in negotiating reasonable public access agreements.

4.5 Under the 1998 Finance Act, new exemptions for land, buildings or chattels are normally accepted only if some degree of open public access is provided, and chattels must meet a stricter heritage standard. Previously, chattels only needed to be of a standard that would merit display in a museum, but the Act now requires that they be of 'pre-eminent' heritage importance.[17] With these changes the number of new approvals for chattel exemptions has fallen in every year except 2003-04 **(Figure 19 overleaf)** but the overall number of chattels on public display has so far changed little, and the number with by-appointment-only access has increased **(Figure 20 overleaf)**. This is because while fewer items have been exempted in their own right, others which would not be regarded as pre-eminent have been given an exemption as 'historically associated chattels' – items which may not be of sufficient quality to merit exemption individually but which have a long and close association with a heritage building. The standard for this did not change under the 1998 Act. Under the new rules, chattels cannot receive exemption where access is only

17 The Museums Libraries and Archives Council advises on whether chattels are of pre-eminent heritage importance. Chattels may be evaluated in their own right, or as part of a collection. The criteria, only one of which needs to be satisfied, are:
- Does the object have an especially close association with UK history and national life?
- Is the object of especial artistic or art-historical interest?
- Is the object of especial importance for the study of some particular form of art, learning or history?
- Does the object have an especially close association with a particular historic setting?

19 Heritage exemptions approved between 1998-99 and 2003-04

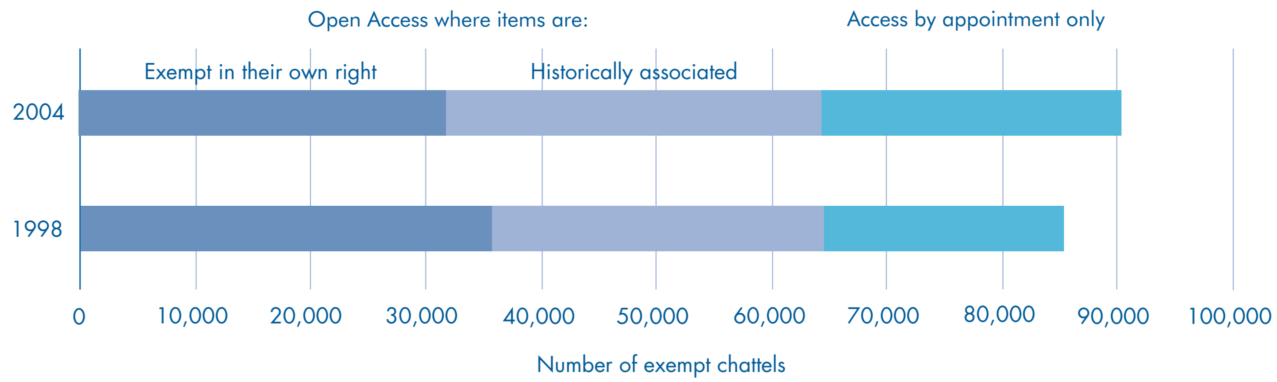
Year	Land & Buildings, and historically associated object, exemption cases approved	Chattels exemption cases approved	Total exemption cases approved
1998-99	10	72	82
1999-00	5	39	44
2000-01	2	20	22
2001-02	5	18	23
2002-03	6	14	20
2003-04	2	17	19

Source: Inland Revenue

NOTE: Although owners applying for a conditional exemption are required to submit a valuation, the Revenue does not necessarily discuss or agree it because if the claim is accepted the relief and value are equal, and if the asset later leaves the scheme the tax liability would be calculated according to the asset's value at that later date.

20 Exempt chattels, by right of access arrangement, in 1998 and 2004

The number of exempt chattels on public display is similar to that in 1998, but following the change in the heritage standard in the 1998 Finance Act some items which would have been exempted in their own right are now exempt because of their association with heritage properties. The number of chattels with by-appointment-only access has increased, despite the provisions of the Act, because of exemptions given to cases in the pipeline before the change in the legislation.



Source: Inland Revenue

available by-appointment. The increase in by-appointment-only chattels since 1998 relates to the subsequent agreement of exemption applications submitted before the change in the law in 1998, and their total number is now falling.

4.6 The 1998 Act also allowed the Revenue to propose open access requirements for existing appointment-only cases, where 'just and reasonable in all the circumstances'. Open access would not be reasonable in many existing cases, for example where owners have only a few items of limited interest. The Revenue has therefore not sought to alter all agreements. Of the 1,000 owners of the 26,000 by-appointment chattels, it has identified 44 who between them have 14,000 items, and is seeking to vary their agreements first. So far it has agreed new terms with 16 owners, enhancing access to nearly 1,900 chattels. The extent of 'open access' required is not quantified in the legislation. After consulting owners' representative groups, the Revenue has sought in new cases to secure at least 30 days open access a year. In practice, particularly where existing arrangements are being varied, some agreements are for less, depending on the circumstances of each case. There has been resistance from some owners to changing access and publicity arrangements already agreed in return for the exemption, arrangements which they expected to continue until they disposed of the items or until their death. In two such cases owners rejected the changes proposed by the Revenue and their cases were referred to the Special Commissioners. The Commissioners' decision, published in November 2004, confirmed that the Revenue could review existing undertakings and propose variations, but did not uphold the specific variations proposed in these particular cases. The decision will help the Revenue to determine the extent to which other agreements entered into before the 1998 legislation can be changed. In the longer term, existing wholly by-appointment cases will be eliminated – if not by renegotiation then by applying the new criteria and more open access requirements when the current owners die.

4.7 These developments might be expected to increase the number of visitors to heritage assets. However, the criteria used for granting exemptions are couched in terms of heritage importance, not their likely appeal to visitors if made more accessible. The legislation does not allow the Revenue to assess value for money in deciding whether to grant exemptions, and the Revenue is not responsible for attracting visitors. The number of visitors to exempt buildings, monitored by the Revenue, has remained steady at around four million a year since 1999 and is largely accounted for by a small number of large historic houses. In our earlier report, we found that only one in seven owners of by-appointment chattels had had a visitor in the last year. This reflected not just the difficulty in obtaining a visit appointment but also the sometimes limited interest in some heritage items. Reviewing numbers of visitors to those exempt chattels for which it has already renegotiated greater access could help inform the Revenue's strategy for any further negotiations with other owners.

Monitoring compliance

4.8 The Revenue checks periodically that exemption conditions are still being met; that the required level of public access is still available; assets are still in a good condition; and that they have not been sold. The Revenue has different procedures for different types of assets:

Land and buildings and historically associated objects:

- Short annual questionnaires sent by the Revenue to all owners; and
- Periodic site visits by heritage agency experts to all sites, on a five-yearly cycle.

Chattels:

- A detailed five-yearly written questionnaire sent by the Revenue to all owners; and
- Inspection visits by fine arts students on a random basis to 60 owners a year, approximately 6 per cent of owners.

18 www.inlandrevenue.gov.uk/heritage.

4.9 In 1999 the Committee of Public Accounts noted slippages in the five-yearly compliance visits of exempt land and buildings. Between 1995 and 1997, only two-thirds of the 130 planned inspections had been carried out, and the Committee recommended that the Revenue work closely with the heritage agencies to ensure that compliance checks were carried out as planned. Since then, the Revenue and the agencies have worked more closely in progressing inspections and the Revenue now ensures that it receives all monitoring reports from the agencies. During 2003-04, agencies had undertaken 76 of the 80 planned visits for the year, with four visits carried forward to the next year. Of the 348 annual questionnaires sent out in 2003-04, 85 per cent were returned within four months, with 17 still outstanding. As regards monitoring of chattels, 61 visits were carried out in 2003-04 and nine owners were advised to improve the standard of their access arrangements; and of 40 five-yearly questionnaires issued in 2003-04, two remain outstanding and are being pursued.

Publicity for Tax-exempted heritage assets

4.10 At the time of the Committee of Public Accounts' 1999 report, the Revenue was putting greater emphasis on using its website to publicise exempt heritage chattels, including its register of chattels accessible only by appointment. The Committee expected the Revenue to continue to seek opportunities to publicise these assets. Since 1999 the website register[18] has been extended to cover chattels with open access, and now includes 80,000 chattels, with work underway to include the last 10,000 items (which are in historic houses open to the public). The 1998 Finance Act also enabled the Revenue to publicise access arrangements for conditionally exempt land and buildings on its website. The properties of all but three owners are now on the register, and those three are under negotiation.

4.11 As the register has been extended, the Revenue has also improved its accuracy in response to the Committee's recommendations. In 1999 some descriptions of chattels were too vague or brief to be useful. The Revenue now uses the Museums Libraries and Archives Council to check information provided in the register for newly exempted cases; and entries for existing items are checked as part of the monitoring procedures. Use of the website register has grown significantly with 468,000 hits in 2002-03, compared with 30,000 in 1998-99. The Revenue has also made the website more useful by arranging links with the English Heritage and National Trust websites, including links for some specific chattels and properties.

APPENDIX 1

Study methodology

Semi-structured interviews and fieldwork visits

1 We interviewed staff in Inland Revenue departments with responsibility for Inheritance Tax, including: the Capital Taxes department; the Valuation Office Agency; the Shares Valuation section; Analysis and Research; the Centre for non-Residents; the Special Compliance Office; Complex Personal Returns; and the Solicitor's Office.

2 We also interviewed staff from other government departments and agencies, including: the Department for Constitutional Affairs (in connection with the Probate Service); the Department of Culture, Media and Sport and Museums Libraries and Archives Council (heritage reliefs); the Department of Trade and Industry (business reliefs); and the Department for the Environment, Food and Rural Affairs (agricultural reliefs).

3 We also consulted the Commission for Racial Equality, SHAP, the Muslim Council of Britain, Mr Ahmad Thomson (writer on Islamic financial matters) and Stonewall to get different perspectives on Inheritance Tax concerns.

Case examples

4 We reviewed a sample of 12 Inheritance Tax case-files to gain an understanding of the complexities involved in cases and illustrate the range of circumstances faced by taxpayers and the Inland Revenue; and 20 case-files where penalties had been applied or considered.

Stakeholder consultation and Advisory Panel

5 We convened an advisory panel to provide advice and feedback to the study team at major stages of examination to discuss audit plans and emerging findings and conclusions. The panel consisted of:

Michael Coulshed
The Association of Corporate Trustees

Peter Cushing
Inland Revenue

Nigel Eastaway
Chartered Institute of Taxation

Teresa Fritz
The Consumers' Association

Colin Gibson
Inland Revenue

Diana Graves
The Law Society, Wills and Equity Committee

Colin Lawson
Bath University, Centre for Public Economics

Jonquil Lowe
Author of the *Which? Guide to Giving and Inheriting*

Katherine Neal
The Law Society, Probate Section

Geoffrey Shindler
Society for Trust and Estate Practitioners

Richard Williams
The Law Society, Capital Taxes sub-committee

International Comparisons

6 We commissioned the International Bureau of Fiscal Documentation to undertake an analysis of Estate and Inheritance tax systems in eight countries – The United States, Ireland, Germany, The Netherlands, Belgium, Sweden, Canada and Australia.

Review of Inheritance Tax forms and guidance

7 We commissioned Jonquil Lowe, freelance financial researcher and author of the *Which? Guide to Giving and Inheriting*, to review the usability of the main Inheritance Tax forms and guidance from the perspective of a personal representative without professional assistance. The forms were assessed against a checklist devised by the National Audit Office, (*Improving and Reviewing Government Forms: A Practical Guide*, December 2003) for government departments to review the usability of their forms.

Inheritance Tax chronology

8 We commissioned Nigel Eastaway of the Chartered Institute of Taxation to produce a chronology of the legislative changes in the Inheritance Tax regime from 1975 to the present day. With the assistance of the Library of the House of Commons, we reviewed Parliamentary debates to identify the rationale behind some of the changes in the structure of the tax and its exemptions and reliefs.

Statistical analysis

9 We examined Inheritance Tax statistical data compiled by the Revenue's Analysis & Research section, and with its help we:

- Researched areas of potential tax gap (for property valuations and household goods);
- Identified accounts for case study review;
- Examined trends and projections of future workloads; and
- Examined the statistical relationship between certain types of assets and the value of estates, to establish the scope for using the Revenue's statistical data to identify 'outlier' cases to guide risk assessments.

APPENDIX 2

Action taken in response to the Committee of Public Accounts recommendations

PAC conclusion/ recommendation	Progress	Our assessment
On the management of casework		
Too many cases are taking too long to resolve with 1,500 cases in action for three years or more and 200 of these in action for ten years or more, against around 20,000 taxpaying cases a year. The Revenue should speed up the valuation of shares to help reduce the overall time to settle inheritance tax cases.	The Revenue has reduced case backlogs, to 882 cases over three years old and 83 over ten, and settled new cases more quickly overall – it now deals with 30,000 taxpaying cases a year and settles 70 per cent within 6 months and 90 per cent within 12 months. The Shares Valuation section refined its risk assessment process and has taken up significantly fewer cases for detailed enquiry. It has focussed on higher risk cases, which are more complex and take longer. So while the proportion of Inheritance Tax share valuations completed in 12 months has increased from 88 to 90 per cent over the last 4 years, the proportion of detailed enquiry cases settled in 12 months has fallen from 77 to 72 per cent.	The number of long outstanding cases has been more than halved and the overall speed of case processing has improved. The speed of processing share valuation cases has also improved, though less markedly, as risk assessment processes have been refined. [Paragraphs 3.7-3.9]
We expect the Revenue to take a firmer line with representatives to obtain the information to progress cases using the opportunities provided by new powers in the 1999 Finance Bill.	The 1999 Finance Act gave the Revenue powers to issue directions for information from people liable to file Inheritance Tax returns without requiring Special Commissioners' consent. The Revenue has publicised its approach to using directions and professional representatives have indicated their perception of a tougher attitude by the Revenue. Between 1999 and 2004 the Revenue issued 67 directions to representatives, and considers that the threat of issuing directions has been a useful tool in progressing un-cooperative cases, contributing to the reduction in outstanding cases noted above.	The Revenue has issued few directions, but the threatened use of directions has helped to progress cases where representatives have been un-cooperative. [Paragraphs 2.11 and 2.13]
On the identification of Inheritance Tax liabilities		
We are concerned about the cost-effectiveness of checking as many as 5,000 'excepted estates' [those which do not require a tax return to be submitted] each year. The Revenue should refine its sample further, as necessary, to reflect the assessed risk.	The compliance sample of excepted estates was reduced to around 3,000 in 2002-03, and skewed towards higher value estates. Changes in procedures introduced in the 2004 Finance Act will reduce the number of estates which have to submit a full tax return to the Revenue. This is intended to help reduce the compliance burden for both representatives and the Revenue. Undervalued estates near the tax threshold would produce tax losses if undetected, and so the Revenue is planning to undertake sample checks of such cases. It also has new penalty powers to deter non-compliance.	The sample check has been refined reflecting the risks involved. Procedural changes introduced with the 2004 Finance Act will increase the number of excepted estates, and the Revenue intends to take a similar approach to checking these cases as it applied previously to excepted cases. [Paragraphs 1.2 and 2.8]

PAC conclusion/ recommendation	Progress	Our assessment
On the identification of inheritance tax liabilities (cont)		
Checks on lifetime gifts are far from watertight and there is a risk that many gifts go unreported. The Revenue has accepted the need for new initiatives to improve compliance in this area and will need to be able to demonstrate their effectiveness.	The 1999 Finance Act included a specific requirement to declare lifetime gifts made within seven years of death (which are added to an estate for Inheritance Tax purposes), and Revenue presentations to professional representatives have made them more aware of their obligations to declare lifetime gifts. The Revenue conducted an exercise to test compliance on lifetime gifts which identified additional tax revenue of £475,000 from 100 cases, 11 per cent of which were non-compliant. Guidance on risk indicators was refined and Revenue compliance work yielded £14 million on lifetime gifts in 2003-04.	The Revenue has implemented changes to improve compliance on lifetime gifts, including revised checks based on risk indicators and measurement of the additional tax yield identified. It has also emphasised with representatives the importance of compliance, and improved compliance enquiry guidance for its staff. [Paragraph 2.8]
On penalties for non-compliance		
In imposing penalties the Revenue applied mitigation factors which often reduce the maximum penalty by as much as 95 per cent. This risks sending out the wrong signals about the seriousness of non-compliance. We expect the Revenue to give active consideration to penalty action whenever material understatements of tax liabilities have arisen through negligence or fraud.	Penalties for fraud and negligence were increased with the 1999 Finance Act and new powers were introduced in the 2004 Finance Act. Since 1999 the number of penalties for negligence has broadly remained the same, at around 100 a year, and there has recently been a prosecution for fraud. This reflects the particular difficulty with Inheritance Tax in establishing culpability for errors and also, the Revenue considers, the success of the deterrent effect from the higher level of penalties available and the publicity it has given to its readiness to apply them. Where penalties are applied, they are abated by 93 per cent on average, reflecting representatives' co-operation. Greater abatement is given where representatives disclose errors (95 per cent on average) than when they are discovered by the Revenue (88 per cent on average).	The Revenue actively considers penalties for fraud or negligence and higher penalties are now available. While the number of penalties has remained the same, this could reflect an increased deterrent effect. Available penalties are significantly abated, including when the Revenue discovers negligence. [Paragraphs 2.11- 2.16]
On tax exemptions for heritage property		
We look to the Revenue, in conjunction with interested parties, to examine the scope for improving the quality of information in the register, to stimulate more visits. We also expect the Revenue to seek opportunities to publicise the conditional exemption scheme using the internet and other media.	Heritage agencies are being used to check the accuracy and validity of information held for newly exempt items, and details of existing items are checked as part of the compliance inspection programme. The Revenue has increased the publicity for tax-exempt heritage assets through a dedicated website which now receives nearly half a million hits a year, and provides links to the websites of heritage agencies. Around 80,000 of the 90,000 exempt chattels are now on the website.	The quality of information in the register of exempt heritage assets has improved by including more items and checking the accuracy of the information. While visitor numbers are not monitored, website links are better and cross-linked to those of the heritage agencies. [Paragraphs 4.10 - 4.11]

PAC conclusion/ recommendation	Progress	Our assessment
On tax exemptions for heritage property (cont)		
In view of the substantial tax reliefs which have been provided, we expect the Revenue to recognise the interests of the public, as well as those of the owners, when negotiating reasonable open public access to newly-exempt chattels.	As a result of the 1998 Finance Act, new exemptions are only given for items meeting a stricter quality standard – of pre-eminent heritage importance – and all new chattel exemptions must have some degree of open public access. The Act also allowed the Revenue to propose open-access requirements for existing appointment-only cases. For collections that were previously by-appointment-only, the Revenue has been able to agree terms with sixteen of the owners, and some degree of public access is now provided for nearly 1,900 chattels. Two other owners rejected the changes proposed, and their cases were referred to the Special Commissioners. The Commissioners have confirmed that the Revenue can review and propose changes to existing agreements, though did not uphold the specific variations proposed in these particular cases. The decision will help the Revenue to detemine the extent to which other agreements entered into before the 1998 legislation can be changed.	Open public access is now required for all new exemptions. This has been extended to some of the more significant previously existing exemption cases. [Paragraphs 4.4 - 4.7]
We are disturbed at slippages in the Department's compliance programme and its failure to carry out even basic checks, such as on publicity in tourist guides. We urge the Revenue to work closely with the heritage agencies to ensure that effective compliance checks are duly carried out in accordance with agreed plans and targets.	The Revenue has strengthened its compliance checks, and checks on publicity in tourist guides are now included in the annual monitoring programme for exempt land and buildings. Most inspections and questionnaire checks are completed as planned, or completed within the following year.	The compliance checks on heritage assets are now more robust, and most are completed as planned. [Paragraphs 4.8 - 4.9]
We are concerned that there do not appear to be arrangements for monitoring and reviewing on a regular basis the value achieved from the substantial sums of tax foregone. We look to the Revenue and Treasury to clarify where responsibility should lie for monitoring the overall value achieved by the heritage exemption scheme and its success in meeting its stated objectives.	Ministers keep tax policy, including policy on Inheritance Tax, under review, with advice from Revenue and Treasury officials. Decisions on whether the heritage exemption, or the other Inheritance Tax reliefs, are justified and continue to meet their objectives lie with Ministers.	New heritage exemptions are now confined to items of a pre-eminent standard and where open public access is provided. New exemptions average £19 million a year, whereas before the 1998 legislation they were running at more than twice that level. [Paragraphs 4.2 and 4.5 - 4.7]


QBDX 361973
CERTIFIED COPY
OF AN ENTRY
DEATH
Last Will
and
Inheritance Tax
Date of Grant

APPENDIX 3

International Comparisons

We commissioned the International Bureau of Fiscal Documentation to report on the inheritance/gift taxes of eight countries, to show the different approaches that can be taken in implementing this kind of tax – United States, Ireland, Germany, Netherlands, Belgium, Sweden, Canada and Australia. The essential features of their systems are summarised in the Table below and analysis overleaf.

Country	Tax receipts (2001)	Basis for tax:			
		Tax on Gifts?	Tax on Death?	Tax on Estate?	Tax on Recipients?
UK	£2,390m	At death – gifts within 7 yrs of death	Yes	Yes	No
US	£17,310m	Yes	Yes	Yes	No
Ireland	£100m	Yes	Yes	No	Yes
Germany	£1,830m	Yes	Yes	No	Yes
Netherlands	£770m	At death – gifts within 180 days of death	Yes	No	Yes
Belgium	£730m	At death – gifts within 3 yrs of death	Yes	No	Yes
Sweden	£190m	Yes	Yes	No	Yes
Canada	–	No	No	No	No
Australia	–	No	No	No	No

Family reliefs?	Business/Agricultural reliefs?	Rates of tax
Spouse exemption	Yes	Single 40% rate, on estates exceeding £263,000
Spouse exemption	Yes, depending on continued use after death	Rates of 18% - 48% on estates/gifts exceeding £840,000
Spouse exemption, and different reliefs for various relatives	Yes, depending on continued use after death	Single 20% rate, on estates/gifts exceeding recipient-based allowances
Different reliefs for spouse (plus relief for a shared home) and other relatives	Yes, depending on continued use after death	Rates of 7% - 50% on estates/gifts exceeding recipient-based allowances
Different reliefs for cohabiting 'partners' and relatives	Yes, depending on continued use after death	Rates of 5% - 65% on estates exceeding recipient-based allowances
Different reliefs for cohabiting 'partners' and relatives	Yes, in one Region depending on continued use after death	Rates of 3% - 90% on estates exceeding recipient-based allowances
Different reliefs for cohabiting 'partners' and relatives	Yes, depending on continued use after death	Rates of 10% - 30% on estates/gifts exceeding recipient-based allowances
N/A	N/A	N/A
N/A	N/A	N/A

Types of system

The European countries that we examined tailor tax rates, allowances and reliefs to the status of the recipient of the inheritance, rather than according to the value of the deceased's estate. The *Netherlands*, a typical example, has three basic tax classes of recipient, so that for example the deceased's child receiving £30,000 would pay tax at a marginal rate of 12 per cent and a sibling 35 per cent.

When Capital Transfer Tax (Inheritance Tax's predecessor) was introduced in 1975, the then Chancellor of the Exchequer considered changing the UK system to a tax on inheritance received, but did not do so because:

- the likely direct effect on redistribution of wealth under a recipient-based system would be mainly realised within families rather than across wider society;
- it might have reduced the tax yield, if bequests were spread thinly to minimise the tax liability;
- it would have cost more to administer, as the number of taxpayers would have been greater;
- it would have created more record keeping if the tax were still to be paid by the deceased's estate; and
- the process of fundamentally changing the system would have brought a hiatus in revenue collection.[19]

Of the countries surveyed, the *United States*[20] has a similar system to that of the United Kingdom, with a tax on the estate rather than recipients. However, it has two additional taxes to complement its Estate Tax, with all three having the same rates and reliefs. It has a Generation-Skipping Transfer Tax, which was introduced to counter tax avoidance using trusts. In the UK the tax treatment of interest-in-possession trusts reduces the rationale for an equivalent tax. Like most European systems examined, it also has a tax on lifetime gifts.

Australia abolished its Inheritance Tax in 1984, while *Canada* operates a form of Capital Gains Tax which assumes a disposal of assets at fair market value when someone dies.

Interaction of taxes on lifetime gifts and inheritances

In the UK, gifts are deemed to make up part of a deceased person's estate if they are made in the seven years before death – their value is added to that of the donor's estate when inheritance tax is calculated. Gifts are therefore 'potentially exempt transfers' – they are exempt if the donor lives for seven more years. The current system has evolved since the introduction of Capital Transfer Tax in 1975, when the tax was applied to both lifetime gifts and estates on death. Tax on lifetime gifts was assessed annually, based on their cumulative total. From 1981, only gifts made in the last ten years were aggregated for calculating the gift tax element, and in 1986 this was replaced by the potentially exempt transfers system.

All countries surveyed who operate an inheritance tax also had gift taxes, although in the *Netherlands, Belgium* and the UK this only applies to gifts made within a certain period of the donor's death. The *United States* Gift Tax is similar to the UK system of 1975, with a tax on the aggregation of lifetime gifts. *Germany* aggregates gifts over a ten year period, as the UK system did in 1981, although in their case it is a beneficiary's receipt that is aggregated. In *Sweden* gift tax is charged on the total transfers in each year, and there is only a retrospective cumulation of gifts for the years immediately before death. Over time this cumulation period in *Sweden* has been extended from two years to ten.

19 House of Commons debates, 21 January 1975, c1356-58.
20 The United States system of Estate Tax and the Generation Skipping Transfer Tax is due to be phased out after 2009. The Gift Tax will remain in operation.

Gifts with reservation

In the UK some people have sought to avoid Inheritance Tax by passing ownership of their assets (such as a house) to others, while still enjoying the use of those assets up to their death - 'gifts with reservation'. In other countries, gift taxes might mitigate the significance of avoidance through making gifts with reservation, but this is still an area of potential avoidance. In *Germany*, for example, donors have sought to take advantage of separate tax allowances for gifts and inheritances, by the donor giving part of an asset away while alive and then the remainder on his death. When the asset involved is the family home, donors have used the value of their continuing benefit (being able to remain in the house) to reduce the value of the gift, and the tax authorities have introduced provisions to tackle this avoidance. In *Sweden*, on the other hand, gifts with reservation are not considered gifts until the donor's benefit comes to an end (with his death, for example), when the full value of the asset would be subject to tax. In *Ireland* the valuation of gifts with reservation reflects not just the donor's continuing use of it but also the period over which the recipient owns the encumbered asset.

Inheritance Tax reliefs

In the UK spouse relief is only available to married couples. The recently passed Civil Partnership Act establishes a new legal relationship for same-sex couples, and the spouse exemption or other Inheritance Tax implications for such couples will be dealt with in a future Finance Bill. Some countries surveyed had different approaches. *Germany, United States* and *Ireland* gave preferential tax treatment only to married couples. In *Sweden*, cohabitants have the same status as spouses for its inheritance tax, and in *Belgium* all partners – a spouse, unmarried partner, same-sex partner or relative of the deceased – have the same status provided they have lived with the deceased for at least a year before death. In the *Netherlands*, a tax free allowance for partners varies with the number of years that they had lived with the deceased, and according to whether they had had children.

Rates of relief for business and agricultural assets vary, from the UK's full relief for unquoted shares and agricultural assets, to *Ireland* where agricultural properties are taxed on only 10 per cent of their market value and *Sweden* where businesses assets have a taxable value of 30 per cent of their market value. In some countries a business must be retained for five or ten years after inheriting it for the tax concession to be retained – in *Netherlands*, for example, relief on 30 per cent of the value of the farm or business is conditional on its continuation for five years, with tax on the remaining 70 per cent deferred for 10 years.

APPENDIX 4

Chronology of Inheritance Tax reliefs and exemptions

Inheritance Tax was introduced in 1986, replacing a similar Capital Transfer Tax which was introduced in 1975, and before that Estate Duty introduced in 1896. In recent decades, most Finance Acts have implemented changes to some aspects of the tax. Below are some of the more significant changes to aspects of the tax regime, highlighting where Parliamentary debates have addressed the objectives or rationale for the changes made.

Business Reliefs

Finance Acts	Main changes in reliefs	Rationale, where set out by Ministers in Parliamentary debates
1975	■ For assets in businesses of up to £250,000, payment of Inheritance Tax possible in instalments.	To prevent the break-up of small businesses which because of their small size would be difficult to sell or float to release funds to pay the tax otherwise due.[21]
1976, 1977	■ A controlling shareholding – 50% relief from tax. ■ A controlling interest, other than in shares – 30% relief. ■ A non-controlling interest, and held in unquoted shares – 20% relief.	To continue to ensure the viability of businesses, while maintaining a balance of treatment between those with business assets and those with other assets which do not attract relief.[22]
1987, 1988	■ Relief for a non-controlling shareholding interest (but with 25% voting interest) increased to 50%.	Reliefs raised for non-controlling (minority) shareholdings because such assets might not be sufficiently liquid to meet a tax liability. But a differential in rates of relief between controlling and minority holdings is necessary because a minority holding is similar to an ordinary portfolio investment.[23]
1992	■ Relief for a controlling shareholding, held as unquoted shares, increased to 100%. ■ Other controlling interests, increased to 50%. ■ Non-controlling interests held in unquoted shares increased to 50%.	*No substantive debate in Finance Bill*
1996	■ Non-controlling interests held in unquoted shares increased to 100%.	*No substantive debate in Finance Bill*

21 House of Commons debates, Standing Committee A, Session 1974-75, 18 February 1975, Col 2154.
22 House of Commons debates, Standing Committee E, Session 1975-76, 24 June 1976, Cols 1232, 1242, 1244-6, 1261.
23 House of Commons debates, Standing Committee A, Session 1988-89, 30 June 1988, Col 829.

Agricultural Reliefs

Finance Acts	Main changes in reliefs	Rationale, where set out by Ministers in Parliamentary debates
1975	■ 50% relief for 'small, full-time working farmers'; for 20 times annual rental value for up to 1,000 acres, within a cap of £250,000.	To prevent the break-up of small farms. Fragmentation of farms greater than 1,000 acres would not reduce farms below an efficient level.[24] No relief for agricultural landlords, to maintain equity with owners of other types of assets which do not attract relief.[25]
1981	■ 20% relief introduced for landlords of tenanted farms.	To encourage landlords to make more tenancies available.[26]
1992	■ After some reliefs for landlords with tenanted farms were increased in 1983 and 1984, these were consolidated and raised to 50%. ■ Working farmer's relief, introduced in 1975, raised to 100%.	100% relief for working farmers to help prevent break-up of farms. A similar rate of relief for landlords is not appropriate because that would disadvantage other types of landlord (i.e. outside agriculture), and if agricultural landlords had to sell their properties to meet a tax liability their tenants' rights of possession would not be affected.[27]
1996	■ Landlord's tenanted farms relief raised in most cases to 100%, so that nearly all agricultural reliefs now at 100%.	*No substantive debate in Finance Bill*

Heritage Conditional Exemption

Finance Acts	Main changes in reliefs	Rationale, where set out by Ministers in Parliamentary debates
1975	■ Continuing the provisions of Estate Duty, conditional exemption from tax for chattels (of a quality that merits display in a museum) and for heritage land and buildings.	To ensure that the "national heritage is preserved as far as possible," and that there is no threat to historic houses "in the event of a sudden and untimely death."[28]
1998	Amendments to rules for qualifying heritage assets: ■ Heritage assets have to meet the higher quality requirement of being of pre-eminent national scientific, historic or artistic interest. Museum standard chattels cannot be exempted unless closely associated with a building of outstanding historical or architectural interest. ■ The option of heritage assets being available for public inspection only by prior appointment is removed, unless the preservation of item requires access to be restricted. ■ Disclosure requirements (for instance listing on the Revenue's register) introduced. ■ Existing conditional exemption agreements may be amended by the Revenue, where 'reasonable in all the circumstances'.	Overall objective to ensure "that the public get proper access to the heritage assets that they as taxpayers help to preserve."[29] Provision for access only by prior appointment abolished, because it was "open to abuse and has been much criticised."[30]

24 House of Commons debates, Standing Committee A, Session 1974-75, 11 February 1975, Col 1302.
25 House of Commons debates, Standing Committee A, Session 1974-75, 11 February 1975, Col 1251.
26 House of Commons debates, Standing Committee E, Session 1980-81, 18 June 1981, Cols 778, 781.
27 House of Commons debates, Session 1991-92, 30 June 1992, Cols 422.
28 House of Commons debates, Session 1974-75, 5 March 1975, Col 1557.
29 Finance (no.2) Bill, House of Commons Standing Committee E (pt 5).
30 Finance (no.2) Bill, House of Commons Standing Committee E (pt 5).

Spouse relief

Finance Acts	Main changes in reliefs	Rationale, where set out by Ministers in Parliamentary debates
1975	■ Relief for first spouse (rather than surviving spouse as under Estate Duty).	To reduce burden on surviving spouse, who would be otherwise faced with having to raise the tax after the breadwinner had died, and might otherwise have had to sell the home to raise the tax payment.[31]

Trusts

Finance Acts	Main changes in reliefs	Rationale, where set out by Ministers in Parliamentary debates
1975	■ Tax levied on settlements in trusts.	'Broad principle … that charge to tax should be neither greater nor smaller than the charge on property held absolutely'.[32] To close previous avoidance under Estate Duty, which by-passed this general principle.[33]
	■ 10 year periodic charge introduced for discretionary trusts.	"…designed to produce broadly the same result as the charge on property owned by individuals, where it can be expected that the whole property will on average be subjected to a tax charge once a generation."[34]

Rates and bands

Finance Acts	Main changes in reliefs	Rationale, where set out by Ministers in Parliamentary debates
1988	■ Introduced a single tax rate of 40% for all transfers over the tax free allowance in place of 16 bands each with progressive marginal rates of tax.	*No substantive debate in Finance Bill*

31 House of Commons debates, 6 March 1975 col 1796; 21 January 1975 cols 1370-1.
32 White Paper (Cmnd 5705, Aug 1974), para 17; and see also House of Commons debates, 17 December 1974 col 1378.
33 House of Commons debates, 17 December 1974, col 1373.
34 House of Commons debates, 17 December 1974, col 1379.