NATIONAL AUDIT OFFICE

INLAND REVENUE

Inheritance Tax

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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.