James Forrester October 29th, 2024

Inheritance tax needs reform both for fairness and efficiency

*Chancellor Rachel Reeves is expected to announce inheritance tax reforms in the October Budget as a way of raising funds and closing the fiscal "black hole". **James Forrester** argues that inheritance tax is ripe for reform given that the many tax reliefs mean that only a fraction of estates that qualify for inheritance tax end up paying the current tax rate of 40 per cent, with some paying as little as 4 per cent.*

In the run-up the Budget on October 30, there has been widespread speculation about which taxes might rise amid a £22 billion "blackhole" in the public finances. Among the taxes reportedly being considered by Chancellor Rachel Reeves is Inheritance Tax, with media reports suggesting that the Treasury is analysing reforms that could raise additional revenue from the levy. In a new report, we consider a range of reforms that could raise revenue for the Exchequer by limiting the tax reliefs that currently disproportionately benefit the largest estates, while increasing the tax-free Nil-Rate Band for the majority of estates.

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Inheritance Tax applies at a flat rate of 40 per cent on all estates worth over a tax-free Nil-Rate Band of £325,000. This 40 per cent rate has extremely high salience with the public and may be one of the reasons that the tax is regularly cited as the UK's most unpopular. And yet, most estates do not pay Inheritance Tax at all – only around 4 per cent of all deaths result in an Inheritance Tax bill, according to the most recent data published by HMRC. Even among estates that are large enough to pay the tax, hardly any pay close to 40 per cent.

The effect of tax reliefs on the rate of inheritance tax

The explanation lies in the proliferation of allowances, exemptions and reliefs that mean that the headline 40 per cent tax rate is not a good guide to the *effective* tax rates that estates actually pay. For example, the spouse exemption provides for the complete exemption from Inheritance Tax of assets transferred to a spouse or civil partner, so that the first death within a married couple often means no tax is due at all. The Transferrable Nil Rate Band allows for the transfer of the £325,000 tax-free Nil-Rate Band between spouses, and the Residence Nil-Rate Band, introduced in 2017, exempts the first £175,000 of residential property passed to a direct descendant. This allowance is also transferrable between spouses, meaning that many couples can pass on £1 million to their descendants free of Inheritance Tax.

However, as well as lowering the effective tax rates paid across the board, the proliferation of reliefs also means that many higher value estates pay lower tax rates than lower value estates. Our new findings show that estates worth more than £30 million (which have not been separated out in previous analyses such as the Office for Tax Simplification and HMRC) pay a lower Inheritance Tax rate on average than estates worth between £1 million and £1.5 million.

This inequity contributes to the perception that Inheritance Tax is borne most heavily by the "modestly wealthy", rather than by the very well-off. However, it is important to note that on average, the highest rates are paid by estates valued at between £2m and £7m, which still places them within the top 0.5 per cent of the wealthiest estates. Nevertheless, it is indeed the case that these estates do (on average) pay higher effective tax rates than estates worth more than £7m, the top 0.05 per cent.

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less than 9 per cent, and one in six pay less than 4 per cent.

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Why same wealth doesn’t mean same inheritance tax

However, the previous focus on *average* rates masks a huge variation in the effective tax rates paid by estates with the same amount of wealth. Even excluding estates eligible for the spouse exemption, a quarter of estates worth more than £10 million pay more than 37 per cent in Inheritance Tax, but another quarter pay less than 9 per cent, and one in six pay less than 4 per cent.

Business Relief and Agricultural Relief are important drivers of these huge differences in the effective tax rates paid by estates with the same amount of wealth. Business Relief provides up to 100 per cent relief on business assets and certain types of shares, while Agricultural Relief provides up to 100 per cent relief on the value of farmland and farm buildings. This implies that what matters for how much Inheritance Tax an estate pays is not just how much wealth the estate has in total, but which types of asset are held.

The stated aim of these reliefs is to ensure businesses do not have to be sold or broken up following the death of the owner, or to prevent the breakup of the farm, but the force of these policy justifications depends on the size of the business or farm (affecting its access to credit) and whether the deceased was an active or passive owner (in the case of farms, a working farmer or an agricultural landlord).

The benefits of these reliefs are also concentrated among a small number of large estates. Between 2018 and 2020, an average of £2.2 billion per year was provided in Business Relief to around 3,400 estates per year, with the vast majority of this relief (£1.9 billion annually, 83 per cent) provided to fewer than 800 estates per year that each claimed more than £500,000. At the same time, around 1,300 estates per year benefited from almost £900 million in Agricultural Relief on UK farmland. 64 per cent of estates claiming this relief claimed less than £500,000, but 83 per cent of the value of the relief went to those claiming more than this amount.

The UK’s current Inheritance Tax system also incorporates many smaller reliefs, each of which individually costs relatively little, but where the benefits are highly concentrated. For example, “heritage assets” are conditionally exempt from Inheritance Tax where the assets are deemed to be of “national, scientific, historic or artistic, scenic, architectural interest”. 96 per cent of this relief (around £300 million) was claimed by just 44 estates between 2018 and 2020. These estates benefited from an average of £7 million in relief on an average estate size of almost £20 million. We argue that there is a case for reviewing the effectiveness of this relief against its current objectives and considering whether alternative approaches might offer better value for money.

Together, these reforms could raise up to £500 million, whilst lowering effective tax rates (on average) for estates worth less than £2 million.

Reforming tax reliefs for efficiency and fairness

Our new report considers a range of reforms to limit the reliefs that currently benefit the largest estates by capping Business and Agricultural Relief at a combined total of £500,000 per estate and capping the spouse exemption at £10 million per estate, levels that would leave the vast majority of estates unaffected. At the same time, we propose raising the tax-free Nil-Rate Band from £325,000 to £500,000 for the majority of estates. Together, these reforms could raise up to £500 million, whilst lowering effective tax rates (on average) for estates worth less than £2 million. The reform would also make the Inheritance Tax system fairer by reducing the variation in rates paid between estates of the same value.

Around the world, countries adopt a variety of different models for taxing inheritances and lifetime transfers. The UK should look at these international examples and develop options for wholesale reform of Inheritance Tax. However, in the meantime, and even without major structural redesign, there are many options open to the government to improve the fairness and efficiency of the existing tax by reforming key reliefs and exemptions.

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About the author

James Forrester

James Forrester is a Research Assistant at the International Inequalities Institute at LSE, working with Dr Arun Advani and Dr Andy Summers. He is also a Research Economist at the Centre for Analysis of Taxation (CenTax), a new research centre co-hosted by LSE and University of Warwick.

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