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Taxes on Wealth Transfers

Taxation of wealth is a topic that excites strong passions. Some view it as the most direct means of effecting redistribution and key to achieving equality of opportunity. Others see it as the unjustified confiscation of private property by the state. Given these opposing viewpoints, it is not surprising that this is an area of taxation where international practice differs dramatically. Most OECD countries have taxes on income, spending, corporate profits, and so on, with recognizably similar goals. Practice with taxes on wealth varies widely. Some countries levy taxes directly upon wealth holdings, while others only tax transfers of wealth. There are some countries that do not tax wealth at all.

In this chapter, we focus specifically on the taxation of wealth transfers. Levying a tax on the stock of wealth is not appealing. To limit avoidance and distortions to the way that wealth is held, as well as for reasons of fairness, the base for such a tax would have to be as comprehensive a measure of wealth as possible. But many forms of wealth are difficult or impractical to value, from personal effects and durable goods to future pension rights—not to mention 'human capital'. These are very serious practical difficulties. And where attempts have been made to levy a tax on a measure of current wealth—in France, Greece, Norway, and Switzerland, for example—practical experience has not been encouraging.

There is also a persuasive economic argument against taxing the stock of wealth. A wealth tax in this form would tax not only inherited wealth but also wealth representing the individual's accumulated savings from taxed income. Taxing the stock of accumulated savings is closely related to taxing the returns to savings, and raises many of the same issues. We have already argued in favour of exempting a 'normal' return to savings but taxing 'excess' returns. A tax on the stock of accumulated savings does the opposite of this: it is equivalent to taxing the normal return to savings but exempting excess returns. To see this, suppose that I save £100 and the normal rate of return is 5%. A tax of 20% on the normal return is equivalent to a tax of 1% on the stock of wealth: both raise £1 from me (20% of £5 or 1% of £100) irrespective of the actual return I earn on my £100. It therefore discourages me from saving, but it taxes me no more if I manage to earn extremely high returns on my savings.[1] This seems exactly the wrong policy.

Wealth transfers are different. We explicitly excluded them from consideration when going through the theory and practice of the taxation of lifetime savings. Some of the arguments for and against their taxation are similar to those applying to taxes on lifetime savings, but some are quite different. An appropriate treatment of wealth transfers is an important complement to an appropriate tax treatment of lifetime savings.

Wealth transfers can come in the form of gifts between the living (*inter vivos* transfers) and bequests on death. Taxes on the latter are more common. There is an easily identified event where the vesting of ownership of the deceased's property in the hands of the heirs can be made conditional upon payment of the tax. In practice, taxing *inter vivos* transfers is difficult partly because it requires those concerned to report the taxable event. There are also many ways in which money can effectively be spent for the benefit of others without involving any direct transfer of money.

Views about the appropriateness of inheritance taxation remain sharply polarized. Those who are instinctively hostile to this form of taxation typically look at it from the perspective of the donor. They consider that individuals should have the right to leave their assets to whomever they choose without suffering a tax. If asset accumulation occurs from income that has already been subject to tax, inheritance taxation is seen to constitute 'double taxation'. Why should I be encouraged to spend my money before I die rather than providing for my children? Reflecting such views, estate taxes

[1] Except in so far as I will be taxed if I choose to save that money—adding to my stock of wealth, and the normal return thereon, to be taxed in the next period—rather than spending it. Note that this tax liability arises from more money being saved, not from excess returns being earned: no tax is levied on the excess returns if I spend them immediately.

in the US have brought forth the marvellous call to arms 'no taxation without respiration'.[2]

On the other hand, those who favour significant inheritance taxation often tend to look from the perspective of the recipient, arguing that it is anomalous to tax people on money they have earned while exempting from taxation money that comes to them through no effort of their own (except perhaps the effort expended in being kind to elderly loved ones). This is a very different perspective on social justice: one which tends to emphasize equality of opportunity. In addition, high levels of inheritance are frowned on as they can reduce effort among recipients—something which is often referred to as the *Carnegie effect* after the philanthropist Andrew Carnegie who observed that 'the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would'.

In this chapter, we lay out some of the economic principles behind the taxation of wealth transfers and clarify some of the issues around using taxation of wealth transfers to pursue equity objectives. We then consider some of the practical barriers to an effective system, before looking at some possible policy directions. But we start by providing a few statistics and some evidence of the potential importance of this subject.

15.1. THE DISTRIBUTION OF WEALTH

In the UK, the controversy over the legitimacy of wealth taxation has led to a somewhat half-hearted tax, with many loopholes and opportunities for avoidance through careful organization of affairs. This leads to charges of unfairness and makes a principled defence of the current inheritance tax difficult. But this is an issue of importance. Wealth is very unequally distributed in most countries, much more so than income. Figure 15.1 illustrates the extent of wealth inequality between households in the UK. The richest 10% of households own a staggering £4 million on average—more than ten times the average for all households—while the poorest 10% are net

[2] Steve Forbes, quoted in Gale and Slemrod (2001b).

debtors on average. The top 10% own almost five times as much wealth as the bottom half put together. Figure 15.1 also shows that wealth holdings are dominated by pensions and housing, which together account for more than three-quarters of households' wealth.

Much of the difference in wealth between households is simply a result of their being at different stages of their life. In Chapter 13, we showed how people typically save during their working life and run down their assets in retirement. This would create the appearance of substantial cross-sectional inequality of wealth even if there were no inheritances and everyone followed the same earnings trajectory over their lives. Figure 15.2 shows that households do indeed reach their peak wealth in the run-up to retirement.[3] But it also shows substantial wealth inequality even within age groups: among households in the 55–64 age bracket, for example, a quarter have more than £800,000 of net assets while a quarter have less than £175,000.

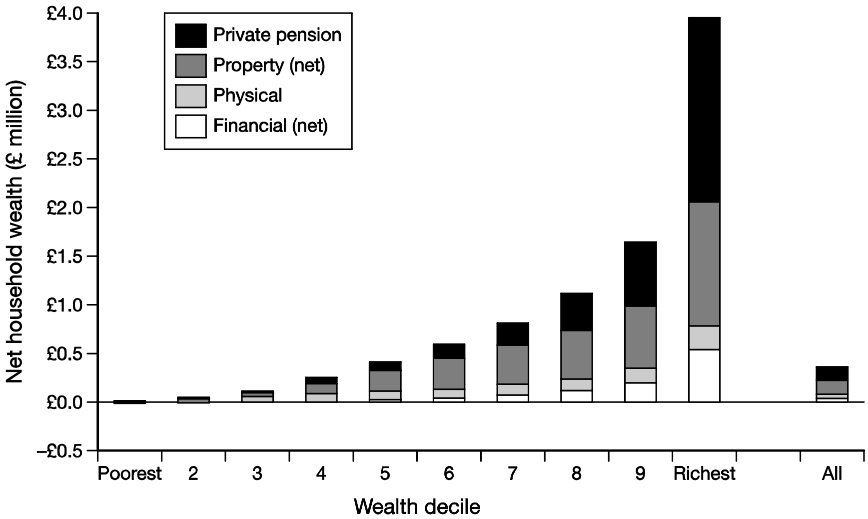

Figure 15.1. Distribution of net household wealth, 2006–08

Note: Excludes state pension rights.

Source: Office for National Statistics (2009), using data from the Wealth and Assets Survey 2006–08.

[3] Although these patterns may also reflect differences between cohorts in the amounts earned or inherited at a given age. Separating these out would require tracking the wealth of the same people over the course of their life cycle.

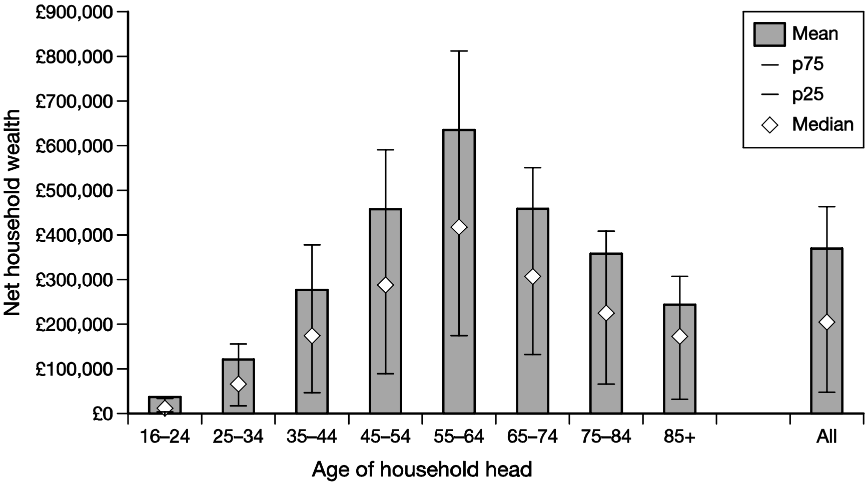

Figure 15.2. Distribution of net household wealth by age, 2006–08

Note: Includes private pension wealth but excludes state pension rights.

Source: Office for National Statistics (2009), using data from the Wealth and Assets Survey 2006–08.

The concentration of wealth has increased in recent years, following a longer period of gradual equalization.[4]

Receipts of gifts and inheritances are also, like wealth itself, unequally distributed. Those with more wealth to begin with are also those who are more likely to inherit. For example, the wealthiest fifth of people in their 50s consider themselves more than four times as likely to receive an inheritance of £100,000 or more than do the least wealthy fifth.[5] And it is clear that the existence of wealth transfer taxes has the potential to affect both how much wealth is built up and the form it takes, so that the level and structure of the tax do matter.

15.2. ECONOMIC PRINCIPLES AND OBJECTIVES

Of course, the fact that wealth is unequally distributed is not in itself enough to tell us how, or indeed whether, wealth transfers should be taxed. Taxing

[4] Atkinson and Piketty, 2007a.

[5] Banks, Karlsen, and Oldfield, 2003, figure 3.11. See also Rowlingson and Mackay (2005).

wealth transfers is fraught with practical difficulties. As UK experience shows, it can lead to considerable resources being diverted to tax planning, distortions being created by different treatments of activities and assets, and ultimately failure to tax the target group effectively. We address some of these practical issues later in the chapter. But before we do so, it is important to give careful consideration to what we are trying to achieve. Without a coherent objective, the prospects for implementing a successful tax are slim.

We start by looking at how the effects of wealth transfer taxes, and the case for employing such taxes at all, depend in some measure on the motive for the transfer, and on how the government views donor and recipient and the relationship between them. We then look at the objectives for wealth transfer taxes.

Four different motives have been identified and each has a different consequence for what we might think is the appropriate tax treatment.[6]

Some bequests are accidental or unintended. Some people die before they have consumed their accumulated stock of wealth, perhaps because they saved for contingencies that did not occur or because they were constrained in annuitizing their wealth. There clearly are uncertainties around timing of death, and there does seem to be at least some unintended bequeathing of assets in this sense.

At the other extreme, wealth transfers may be calculated and strategic in nature. That is, they may be made as a reward for services provided during life. They are 'strategic' in the sense that I might hold out the prospect of a bequest in order to encourage a relative to behave in a particular way.

Some gifts and bequests are made for more noble reasons, of course. The donor might be motivated by pure altruism—that is, the donor directly values the welfare of the recipient. If I am purely altruistic, I may value the happiness of my heirs in just the same way as I value my own future happiness. I could be said to be considering my heirs as extensions of myself. So households become 'dynasties' that behave (in terms of decisions made) like a single individual with a very long life. In this case, there is a close relationship between wealth transfers and life-cycle savings. Each dynasty can be thought of as acting like a single individual, with inheritances playing

[6] Following Cremer and Pestieau (2006).

the same role as savings for the standard household: I transfer money to my heirs much like saving transfers money to my future self.

Pure altruism is subtly different from our fourth motive, that of 'joy of giving': I get pleasure from giving, but my satisfaction is not determined by the recipient's enjoyment of the transfer—rather, I might get a 'warm glow' from a sense of acting virtuously, or perhaps I care paternalistically about the recipient's financial security (rather than about how much *they* value the money).

Unfortunately, available empirical evidence does not give terribly clear guidance as to which motive is most important,[7] and it seems likely that all are relevant to some degree. We care about our children and our children's children, but we don't tend to see our descendants as simply continuations of ourselves. Some bequests will be unintended and some will have a strategic element, but it is hard to observe whose and how much.

Given that not all bequests are accidental, there undoubtedly will be an extent to which taxes on inherited wealth do affect saving and consumption decisions, and thereby create distortions in the same way that taxing the return to savings can create costly distortions. The idea that inheritance tax involves 'double taxation' of assets that have already been bought out of taxed income, and thereby reduces incentives to work and save, certainly seems to be behind some of the public unpopularity of inheritance taxes, according to work done with focus groups.[8] Of course, there is also an income effect on the recipients of transfers, who have an unambiguously reduced incentive to save and work. If you expect to receive a large inheritance, why save yourself?

In practice, there is limited empirical evidence on the effects of this. Some studies from the US suggest some small negative effects of estate taxes on the wealth accumulation of potential donors and some negative effects of anticipated receipt of inheritances by potential recipients.[9] One study suggested that receipt of an inheritance of $350,000 might reduce labour force participation rates by 12% and reduce the probability that both

[7] The literature surveyed in Gale and Slemrod (2001b) and Kopczuk (2010) neither confirms nor refutes any of the motives.

[8] Lewis and White, 2006; Prabhakar, 2008.

[9] Weil, 1994; Kopczuk and Slemrod, 2001.

members of a couple work by 14%.[10] By extension, taxes that reduce receipts should increase work incentives.

The motive for transferring wealth makes a big difference in analysing how wealth transfers should be taxed—but the implications of different motives for policy are not always clear-cut, and in some cases depend on how we frame the government's objectives.

Since purely accidental bequests are, by definition, not made by choice, taxing them would not change donors' behaviour. There would be no economic efficiency cost in taxing such unintended transfers, so that a tax rate of 100% could, in principle, be levied without distorting choice. Obviously, this could not apply to *inter vivos* transfers—this is the only motive that would directly justify taxing bequests on death differently from *inter vivos* gifts.

In the case of strategic bequests, one can draw an analogy between the bequest and a market transaction—a sale of services from one person to another—and argue that such transfers (the income from the sale) should be taxed. Indeed, one could argue that, in principle, VAT should be payable on the transfer.

Transfers motivated by altruism or by 'joy of giving' are the most difficult to analyse.[11] Theoretical policy prescriptions turn out to depend critically on the precise nature of the donor's motivations. For example, if I get a warm glow from giving, is my pleasure determined by the (before-tax) amount given or the (after-tax) amount received? The recipient's feelings also matter: do they care about the lost consumption that the donor suffered in order to transfer the wealth—or indeed the pleasure the donor may have got from doing so? And exactly how should the motivations of donor and recipient (and perhaps others) figure in governments' decision-making?

If donor and recipient behave as continuations of the same individual and transfers to the next generation are made much like saving for one's own future, we might apply the conclusions that we drew on savings taxation: that the normal return to capital should not be taxed; taxes should arise

[10] Holtz-Eakin, Joulfaian, and Rosen, 1993.

[11] For extensive discussion—and often heated debate—of the relationship between individuals' motivations, government objectives, and theoretically optimal policy, see e.g. Hammond (1988), Kaplow (1995 and 1998), Cremer and Pestieau (2006), Farhi and Werning (2010), and Boadway, Chamberlain, and Emmerson (2010).

either when labour income and excess returns are earned or when consumption occurs.[12] If there is an expenditure tax, then my children or later generations will pay tax on what they inherit when they come to spend it.[13] But there is no role for taxing transfers: consumption by different people (just like consumption at different times or consumption of different goods) should not be taxed differently.[14] However, this policy implication is not inevitable: even if donor and recipient behave as if they are continuations of the same individual, it is not clear that policymakers must think of them, or treat them, that way. As we shall see, governments might have other reasons for treating transfers to the next generation differently from savings.

While exploring the implications of different bequest motives is interesting and throws light on the issues involved in deciding upon the appropriate taxation of gifts and bequests, it is clear that on its own it does not take us very far in forming a practical policy recommendation. In our view, such considerations are certainly not enough to rule out taxing transfers. But with this conceptual background in place, we believe more progress can be made by looking at what the government's objectives for wealth transfer taxation might be.

The ethical case for taxation of inherited wealth is important. It was put thus by John Stuart Mill:

> I see nothing objectionable in fixing a limit to what anyone may acquire by mere favour of others, without any exercise of his faculties, and in requiring that if he desires any further accession of fortune, he shall work for it.[15]

The Meade Committee took a very similar view:

> Inherited wealth is widely considered—and we share the view—to be a proper subject for heavier taxation on grounds both of fairness and of economic incentives. The citizen who by his own effort and enterprise has built up a fortune is considered to deserve better tax treatment than the citizen who, merely as a result of the fortune

[12] This result is demonstrated in Cremer and Pestieau (2006) and Farhi and Werning (2010). The latter paper also demonstrates how it is sensitive to the definition of social welfare.

[13] Hashimzade and Myles (2007) have shown that an expenditure tax achieves more redistribution than an income tax precisely because it ultimately taxes initial wealth holdings (or 'old capital') when they are spent.

[14] This argument would, of course, still be subject to the same caveats as those about taxation of different goods (see Chapter 6) or at different times (see Chapter 13), e.g. if consumption by some people was more complementary to labour supply than consumption by others.

[15] Quoted in Reeves (2007, 210).

of birth, owns an equal property; and to tax the former more lightly than the latter will put a smaller obstacle in the way of effort and enterprise.[16]

Many people see pursuing equality of opportunity as an important goal for policy. Inequality in inheritance runs directly counter to that agenda. Whilst inequality resulting from differential ability and effort may be acceptable, inequality resulting from differences in opportunity may be less so. This provides a powerful argument for taxing transfers of wealth between generations, to reduce the advantage that some people get from being born into a well-off family. The fact that the ownership of inherited wealth is extremely concentrated may also add a further attraction to this argument for a wealth transfer tax. Further, there may be concerns about the access to power and status that access to wealth brings. (These concerns, of course, are not limited to inherited wealth.)

If it is equality of opportunity in this sense which matters, then three considerations for the design of a tax system follow. First, from the point of view of equity, it is the amount of money received by an individual which matters, rather than the amount given by the donor. It makes sense to think of the tax base as receipts by beneficiaries rather than gifts and bequests from donors. We should not tax a bequest of £1 million that is divided equally among ten recipients at a higher rate than a bequest of £100,000 given to one recipient. In each case, the impact on the recipient is the same—they receive £100,000. And if the argument for a wealth transfer tax is one of equality of opportunity, then it is the increased wealth of the recipient which should be the base for the tax. Second, again because it seems to make sense to look at this from the perspective of the recipient, one would ideally want to consider the total amount received in inheritance from all sources. If I receive £1 million from each of five rich uncles, I should be treated no differently from my sister who receives a single sum of £5 million from one rich aunt. Third, it is possible that if equality of *opportunity* is our concern, then we might want to distinguish between inheritance received when young and that received when old or, to take this a step further, we might want to vary taxation according to the age gap between the donor and the recipient. There is a stronger case for taxing wealth passed down to the next generation than for taxing gifts to people of the same age—let alone contributions to the

[16] Meade, 1978, 318.

care of an elderly relative. And it is not obvious that we should want to tax transfers directly from grandparents to grandchildren less heavily than transfers that happen in two stages (from grandparents to parents, then from parents to children), as would be implied by a system that taxed each transfer of wealth separately.

But we also need to keep in clear view what is and is not possible to achieve through the taxation of gifts and bequests. There are many drivers of inequality of opportunity that are not to do with direct transfers of wealth. Time spent with children, housing and material goods, education expenditure (in particular, private education), and much else vary between families and have a material effect on children's life chances. We need to be clear whether, and why, inheritance or other transfers of wealth are different and should be subject to taxation. The answer may well be that, practically, this is all that can be taxed, in which case we have to recognize that one consequence of only taxing direct transfers is that decisions may be distorted towards, for example, greater investment in education or other less tangible or earlier transfers—it being particularly hard to imagine that gifts received during childhood could be taxed effectively.

Of course, there is a great deal of public expenditure on welfare benefits, social services, early education, and schooling, which in large part is driven by various equity concerns. One might want to view taxation of wealth transfers as a complement to these activities of the state. Together with state education and so on, taxation of wealth received provides those in the next generation with a measure of insurance against particularly fortunate or unfortunate circumstances of birth.

Our view is that there is a case for wealth transfer taxation as one part of an overall policy aimed at reducing inequalities of opportunity. We have also emphasized in this volume the importance of taking a life-cycle perspective on taxation. Whilst recognizing the limitations, the logic of this position drives us to suggest a tax based on the recipient rather than on the donor, and a tax based on total receipts over a lifetime. The question then arises as to the practicability of such an approach.

15.3. WEALTH TRANSFER TAXES IN THE UK

The main effort to tax wealth transfers in the UK is inheritance tax, which is, so far as we know, the only tax in the UK that around half the population seriously believes should be abolished altogether,[17] with most of the rest wanting significant cuts. Yet the political difficulty and controversy created by the tax are out of all proportion to its importance as a source of revenue. In the UK, even after a decade of rapid growth in housing wealth, inheritance tax was paid on only 3% of estates on death in 2009–10 and raised less than 0.5% of all tax revenue.[18] The position is similar in the US, where only about 2% of estates were subject to the federal estate duty in 2009.[19] Given this apparently limited scope and impact, the degree of political salience is at first sight surprising.

And it is not because the idea and practice of taxing transfers at death are new. In the UK, and internationally, this area of taxation has a longer history than many. Inheritance taxes were established in a number of European countries by the 17th century and probate duty was introduced in the UK in 1694, a century before newfangled ideas such as taxing income received much of a hearing. One attraction, which was true then and remains so today to some extent, is the practical legal necessity of transferring the deceased's property to his or her heirs. That provides an opportunity both to value the wealth of the deceased, and to collect the tax by ensuring that the inheritors can only claim title to the estate once the tax is paid.

The UK inheritance tax (IHT) is levied at a rate of 40% of assets in excess of a tax-free allowance of £325,000 in 2010–11. Assets bequeathed to spouses or civil partners are entirely exempt from tax[20] and, since October 2007, unused tax-free allowances have been transferable between spouses, so that married couples and civil partners can collectively bequeath double the

[17] Hedges and Bromley, 2001.

[18] Out of a total of 555,000 deaths (Office for National Statistics, *Monthly Digest of Statistics*, table 2.4, http://www.statistics.gov.uk/statbase/TSDSeries1.asp), some 15,000 estates were taxed (HMRC statistics, table 1.4, http://www.hmrc.gov.uk/stats/tax_receipts/table1-4.pdf). A further 4,000 lifetime transfers were taxed. Revenue figures from HM Treasury (2011, table C.3).

[19] Gale and Slemrod, 2001.

[20] The exemption is limited if the spouse or civil partner is not domiciled in the UK, reflecting the fact that foreign assets are outside the scope of the tax if owned by a non-domiciled person.

allowance (i.e. £650,000 in 2010–11) tax free even if the first to die leaves their entire estate to the surviving partner. Gifts made within seven years of death are also subject to some tax, charged at a rate that is lower the further from death the gift is made, but otherwise *inter vivos* gifts between individuals are not subject to tax.[21] The other main exemptions from tax relate to gifts to charity and bequests of businesses, unquoted shares, and agricultural property. These reliefs between them are estimated to have reduced IHT liabilities by £770 million in 2010–11—a substantial amount in the context of a tax raising just £2.7 billion in total.[22]

Table 15.1 gives an indication of how assets were distributed in 2007–08 (the latest year for which data are available). The table only covers estates notified for probate, thus excluding around half of estates either (broadly speaking) because they were worth less than £5,000 or because they were jointly owned and passed automatically to a surviving spouse or civil partner—in both cases meaning there would be no IHT liability. Even excluding these, the large majority of estates were small—below £200,000 in value—and therefore not within the IHT net. Owner-occupied housing made up a large part of total assets and especially for those estates with

Table 15.1. Composition of estates by size (estates passing on death in 2007–08)

Size of estate (£ million)	Number of estates	Residential buildings	Cash	Securities	Other[a]
Below 0.2	162,954	61%	32%	5%	2%
0.2–0.3	54,795	63%	26%	5%	6%
0.3–0.5	32,786	56%	25%	11%	8%
0.5–1.0	14,615	44%	23%	20%	13%
1.0–2.0	4,045	35%	17%	30%	19%
Above 2.0	1,443	25%	12%	35%	29%
All	270,639	52%	24%	14%	10%

[a] Including other buildings and land, and insurance policies.

Note: This table includes information on estates notified for probate before 1 July 2010 of people who died in the year to 5 April 2008, before reductions for reliefs and exemptions.

Source: Authors' calculations based on HMRC statistics, table 12.4 (http://www.hmrc.gov.uk/stats/inheritance_tax/table12-4.pdf).

[21] There may be a lifetime tax charge at a lower 20% rate for a gift into a trust.

[22] http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.pdf; HM Treasury, 2011, table C.3.

between £200,000 and £500,000 in total assets, which are those estates close to or just over the tax threshold (£300,000 in 2007–08).

This concentration of wealth in housing among those with modest estates, alongside rapid house price increases, was largely responsible for the increase in the number of estates taxed on death from 18,000 to 34,000 (from 3% to 6% of estates) between 1998–99 and 2006–07.[23] It is also likely to be responsible for some of the apparent discontent over IHT. The biggest estates had the largest amounts in shares and other assets. In trying to understand both the impact and the perception of IHT, it is important to recognize that it is harder to organize one's affairs so as to avoid paying tax when the main asset one owns is the house in which one lives. The fall in the number of estates liable for inheritance tax after 2006–07, down to 15,000 in 2009–10, was caused primarily by the introduction of transferable allowances between spouses, along with a cooling of the housing market from its Autumn 2007 peak and above-inflation increases in the inheritance tax threshold.

The current UK system does not stack up terribly well against any reasonable set of principles for the design of a tax on inherited wealth. We have already suggested that the logic behind a system of wealth transfer taxation implies that tax should be levied on the recipient and should be levied irrespective of whether the transfer was made at or before death. Of course, inheritance tax is not designed to meet these criteria, but even on its own logic it is not well designed. It ought to be as comprehensive as possible, both as a matter of fairness and in order to minimize opportunities for (economically costly) tax planning and avoidance. And it should presumably be designed in a way that garners public acceptance. There are specific and important ways in which the current system fails to conform to these criteria.

The first is the existence of reliefs, in particular for agricultural land and unquoted business assets. The UK is unusual in offering unlimited 100% relief on business assets—this is not available in France, Germany, or the US. These reliefs create just the sort of non-neutrality the tax system ought to try to avoid, pushing up the price of agricultural land and of certain offerings on the AIM market, and providing a large incentive to keep businesses going

[23] HMRC statistics, table 1.4, http://www.hmrc.gov.uk/stats/tax_receipts/table1-4.pdf and Office for National Statistics, *Monthly Digest of Statistics*, table 2.4, http://www.statistics.gov.uk/statbase/TSDSeries1.asp.

and in the family even if there are good financial reasons for disposing of them sooner. This is damaging economically. At the very least, the rules should be significantly tightened up to limit reliefs to a certain level and to, for example, active farmers and genuine sole or majority owners of businesses. Even here, however, we see no real merit in granting special treatment to preserve the wealth of a particular occupational group.[24]

Second, the current IHT regime introduces another non-neutrality—and, arguably, horizontal inequity—into the tax system through its treatment of marriage (and civil partnership). If I am married and leave my estate to my spouse, no tax is payable, and indeed I bequeath to her my tax-free allowance. If I leave my estate to my unmarried partner, tax is payable. This is unquestionably the biggest tax advantage for marriage in the current tax system.

Third, the UK system has a significant threshold, but then imposes tax at 40% on all bequests above that tax-free allowance. This is a rate twice the current basic rate of income tax. There is merit in a system with a high allowance and then a substantial marginal rate, but it seems likely that an initial lower rate would command greater public acceptance.

There is also a practical issue around how to deal with *trusts*. A trust is a relationship created by the donor that requires a *trustee* to hold property for the benefit of others. While trusts are often set up for entirely different reasons, they can potentially be used to avoid the payment of inheritance tax since they confer the benefits of wealth without transferring the ownership—they frequently operate to separate the entitlement to the income that trust property generates from the entitlement to the trust property itself. It is then necessary to decide how each interest should be taxed. In addition, and more importantly, an individual's interest under the trust may be uncertain. It may depend upon the occurrence of some future contingency—such as whether the individual survives to a particular age. Or it may depend upon the exercise in favour of an individual of some discretion vested in the trustees or another person. Trusts can continue over many years, during which it may not be known who will ultimately benefit from the trust property, and possibly skipping a generation entirely. Hence, special measures are needed

[24] There may be a case, which we do not consider here, for special measures to enable tax to be paid over time, rather than immediately, when the gifted or inherited assets are to be retained by the recipient and are otherwise illiquid.

to ensure that any tax on the transfer of inherited wealth from one individual to another cannot be avoided altogether through judicious use of trusts.

Trusts may be established for entirely legitimate personal or family reasons—for example, to provide for a disabled individual, to prevent family assets falling into spendthrift hands, or simply to ensure that an individual is only given the freedom to deal with assets as their own once they reach whatever age the donor regards as suitable. While the way in which particular trusts are taxed necessarily affects these personal and family decisions, we see no reason to devise a taxation regime that sets out to discourage the use of trusts or to express some moral view on the legitimacy or otherwise of particular trust objectives. Ideally, the regime for taxing transfers into and out of trusts and of property while it is held in trust should be compatible with whatever regime applies to the straightforward transfer of inherited wealth between individuals.

Unfortunately, this is extremely difficult to achieve. Experience clearly illustrates the obvious point that if certain trust arrangements are taxed more favourably than straightforward transfers of assets between individuals, the system will provide a significant incentive to adopt trust arrangements rather than making more straightforward choices. That is why the government now imposes a 20% tax on lifetime transfers of wealth into most kinds of trust.

All this aside, the fundamental practical issue raised by the current inheritance tax is that it is easily avoided by those—generally the very wealthy—who are able to transfer significant proportions of their wealth during their lifetime. The principal targets of the tax are frequently able to plan their affairs to minimize the impact of the tax before the occasion of its charge, provided they do not suffer the misfortune of an untimely and unexpected death. This planning is not open to the vast majority of us whose wealth is mainly tied up in the house in which we live, our pension, and modest assets over which it is important for us to retain control, especially as life expectancy and care costs increase. Maintaining an inheritance tax while not taxing lifetime gifts makes any justification of the tax much harder. It creates horizontal inequity according to when transfers are made. It results in vertical inequity because the wealthy are most likely to be able to exploit the differences. It encourages transfers to occur at a time dictated by the tax system.

So the biggest barrier to the effective operation of inheritance tax is the failure to tax *inter vivos* transfers. If one were to move to a tax on gifts and bequests received, the case for treating all receipts the same would be strong. There is no particular reason for distinguishing between wealth received from a living donor and that received from a dead one. Receipts can, in principle, be accounted for on a lifetime basis, with the tax being levied progressively. Moreover, the recipient would be taxed on all kinds of wealth they receive and not just bequests. Taxing the recipient accords well with the intuition that we discussed in the last section that the beneficiary of the inherited wealth should pay. So the same-sized stock of wealth should be taxed less when it is distributed more widely.

The downside, and it is a serious one, is that it is difficult to monitor the process of wealth acquisition. For a tax on receipts to work, it would be necessary for individuals to inform the tax authorities of all receipts over some minimum. Policing such a system would be hard—though some countries, such as Ireland, have some experience of such a system.[25] We would also have to accept some horizontal inequity and distortions around whatever boundary is chosen between taxable transfers of wealth and the kind of parental provision for children that could not possibly be taxed.

There are also significant practical difficulties in moving away from a tax that can be withheld from estates at the time of death. For a brief period, from 1975 until 1986, the UK had a gifts and bequests tax known as capital transfer tax, which sought to charge both lifetime gifts and bequests on a cumulative lifetime basis. It remained, however, a donor-based tax—the tax was charged by reference to the cumulative amount of the donor's gifts and bequests rather than by reference to the cumulative receipts of the beneficiary. The short life of the capital transfer tax illustrates one of its difficulties: namely, that with no political consensus on how to tax gifts and bequests, individuals may decide to await the next change of government in anticipation of a more favourable regime.

Logic dictates that if we are to have a tax on wealth transfers, it is best levied on the recipient. Ideally, such a tax would be levied on lifetime receipts, or at least receipts over a significant period, so as to minimize

[25] The capital acquisitions tax is currently charged at 25% to the extent that the aggregate of gifts or inheritances exceeds the relevant threshold, which depends upon the relationship between the donor and the recipient.

opportunities to avoid the tax by transferring assets over time. How difficult this may be to achieve remains unclear. It is a very long time since a thorough review of the system of wealth transfer taxation was carried out, and we are certainly not aware of any studies that have looked seriously at how, and whether, a change from taxing the donor to taxing the recipient could be made. It is surely time to devote some serious resources to determining the feasibility of such a move.

Finally, we should note that while the current inheritance tax represents a flawed attempt to tax wealth transfers on death, the UK simultaneously maintains an equally flawed subsidy to certain wealth transfers on death: 'forgiveness' of capital gains tax (CGT). The deceased's estate is not liable for CGT on any increase in the value of assets prior to death, and those inheriting the assets are deemed to acquire them at their market value at the date of death, so any rise in value that occurs before death escapes tax completely. This cost the Exchequer £690 million in 2010–11[26]—equivalent to a quarter of the total yield from IHT.

Forgiveness of CGT at death reflects the presence of IHT: politicians understandably baulk at the idea of imposing (say) 28% CGT on top of 40% IHT. But that is a weak argument. CGT exemption does not, and should not, offset the impact of IHT.

In purely practical terms, the current system does not eliminate double taxation or zero taxation. Assets transferred in the seven years before death can still attract both IHT and CGT. Conversely, CGT is forgiven even when estates are below the IHT threshold and so no IHT would be paid anyway. And the two taxes exempt different asset classes: people's main homes are exempt from CGT, while agricultural property and unquoted businesses are not (though entrepreneur's relief does provide a reduced rate for owner-managed businesses).

More fundamentally, the two taxes serve different purposes. CGT is a tax on returns to savings, not on wealth transfers. As Boadway, Chamberlain, and Emmerson (2010, 801) put it,

> the aim of capital gains tax is to ensure that capital gains are treated on a par with other forms of income such as dividends and interest which will already have been taxed as they accrue (and are also then subject to a wealth transfer tax). Wealth transfer taxation has different ends.

[26] HMRC statistics, table 1.5, http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.pdf.

'Double taxation' of wealth that was already taxed as income (or will be taxed as expenditure) is inherent to wealth transfer taxation. The principles discussed in the previous section essentially concerned whether there is a case for such double taxation. Coexistence of CGT with wealth transfer taxation would merely make this double taxation more explicit.[27] If policymakers do not accept the argument for taxing transfers, then they should not tax them: simply abolish inheritance tax. But if there is an argument for taxing transfers, that must be on top of the regime for taxing returns to capital.

The regime for taxing returns to savings should be designed appropriately on its own merits, while wealth transfer taxation should tax the value of wealth transferred; it should not depend on the historical returns earned on those particular assets. Forgiveness of CGT at death looks like another half-hearted reluctance to adopt a principled position. But it is highly distortionary. It encourages people to hold on to assets that have risen in value, even if it would be more profitable to sell them and use the proceeds in some other way before death (at which point other assets, including the proceeds from selling the original assets, could be passed on instead) and even if it would be preferable to pass on the assets (or the proceeds from selling them) immediately. If people expect to be able to bequeath assets on death, it also encourages them to buy assets that yield returns in the form of capital gains and to convert income into capital gains where possible.

Wealth transfer taxation may affect how much people save, but it should not unnecessarily distort asset allocations in this way. Whatever kind of wealth transfer tax one does (or does not) want, there is no case for forgiveness of CGT on death.

[27] Note also that ending forgiveness of CGT at death need not necessarily mean that CGT would be payable at the same time as IHT. If an asset were retained by the recipient, the system could be designed so that CGT liability was triggered only on sale of the asset, with the base price deemed to be the original purchase price rather than the market value when the asset changed hands. That is how *inter vivos* transfers between spouses and civil partners are already treated for CGT purposes.

15.4. CONCLUSIONS

The arguments against taxing the normal return to life-cycle savings do not apply with equal force to the taxation of bequests and other transfers of wealth. There may be a particular case for taxing inherited wealth on equity grounds. Yet the current system of inheritance taxation in the UK is something of a mess. Its notable failings are largely to do with the fact that it is half-hearted and hence fails to tax the wealthiest.

By taxing transfers only on or near death, it allows the richest to organize their affairs to avoid taxation. Only those with very large amounts of wealth can afford to give most of it away several years before they die. And by exempting business assets and agricultural land, IHT creates distortions that have no economic justification and promote avoidance among those who can engage in tax planning. As Kay and King noted in 1990, inheritance tax favours 'the healthy, wealthy and well advised',[28] and nothing much has changed in the 20 years since then to affect that judgement. Few can aspire to be rich enough to avoid inheritance taxation, but many aspire to wealth levels at which they would end up paying it. As currently structured, it therefore resembles a tax on aspiration.

It is not so surprising, therefore, that IHT is unpopular. Some countries have responded to similar concerns by abolishing their inheritance and transfer taxes altogether. Such responses inevitably make the retention of such taxes in other countries more problematic (in particular in the form adopted by the UK), given the increasing mobility of those who might otherwise find themselves subject to such taxes.

We do not believe the UK should move towards abolition. It is not required by the dictates of efficiency; nor is it justified in the face of great, and growing, inequality in wealth. But while there is a case to maintain some form of tax on inherited wealth, the argument for leaving things as they are is weak.

Whatever else is done, forgiveness of capital gains tax at death should be ended. As a way to offset the impact of inheritance tax, it is poorly targeted. But, in any case, no choice of a tax regime for wealth transfers justifies

[28] Kay and King, 1990, 107.

creating the bizarre distortions to asset allocation decisions that this policy does.

A minimal reform to inheritance tax itself would be to maintain it in more or less its current form but to widen its base to include business assets and agricultural property. There may in addition be a case for levying it at a lower rate than 40%, at least on an initial tranche of assets.

But the biggest barrier to the effective working of inheritance tax as it currently stands is that it is levied only at or close to death, allowing the wealthy to avoid it altogether by the simple expedient of passing on wealth well before they die. Put this fact together with the logic of such a tax, which suggests that a tax on the recipient makes more sense than a tax on the donor, and the case for a tax on lifetime receipts looks strong. That case does need to be balanced against the practical difficulties of implementation. Such a tax would have to depend on self-assessment. There may be particular issues arising from international mobility. But a movement towards a tax on lifetime receipts would be more defensible than the current system, both on grounds of fairness and on grounds of economic efficiency. The present halfway house simply provides ammunition to the abolitionists.